The Impact of Tax Reform on Securitization and Other Financing Transactions—What You Need to Know

1. Introduction

On December 22, 2017, the bill known as the "Tax Cuts and Jobs Act" (the "Tax Act") became law.[1] This Legal Update focuses on the provisions of the Tax Act that may apply to securitization and other financing transactions and analyzes its likely impact on a number of different business lines. We have assumed that readers have a general understanding of the operative provisions in the Tax Act. For an overview of the Tax Act's main provisions, please see "The Good, the Bad and the Ugly—Fundamental Tax Reform Is Enacted Into Law."

Some press coverage suggests that, as a result of the Tax Act, traditional borrowers may look to capitalize their businesses with non-debt structures. Although it is too early to determine the overall effect of the Tax Act on the securitization and finance markets, various factors suggest that a precipitous decline in borrowings is unlikely. These factors include the favorable withholding treatment available for non-US investors with respect to debt, the general preference for creditors' rights that accompany debt, and the potentially higher cost (including with respect to dilution) of a preferred or common stock issuance.

2. Choice of Entity Considerations

Currently, the majority of onshore securitizations and structured finance transactions are undertaken through pass-through (non-corporate) structures. The Tax Act reduced the federal corporate income tax rate to 21%, leading taxpayers to reevaluate "choice of entity" decisions. In our view, for a number of reasons, the lowered corporate income tax rate is unlikely to materially alter sponsors' traditional use of pass-through (non-corporate) issuers in onshore securitization and structured finance transactions.

First, with respect to "rated" transactions, rating agencies typically require the elimination of entity-level tax risk to the issuer. In this regard, the use of a corporate securitization issuer could be problematic even if such issuer is a member of a consolidated tax group.[2]

Second, where the equity residual of a pass-through issuer is owned solely by one or more corporations, the new 21% corporate tax rate will be enjoyed at the equity holder level even if the issuer is structured as a pass-through entity, rendering unnecessary a shift to a corporate issuer.

Third, in cases where securitization equity is not owned by a corporation (e.g., where a fund that includes US individuals as investors owns all or a portion of the Issuer's equity), the aforementioned 21% corporate income tax rate imposed at a corporate issuer level does not directly address or account for the "second layer" of tax imposed on individuals residing at the investor level with respect to profits distributed from the securitized assets.[3] It is not uncommon in many structured finance transactions, particularly those involving a static asset pool, that any cash remaining at the end of a relevant period is distributed on the equity residual after applicable debt service requirements are satisfied. In this setting, under the Tax Act, the effective federal income tax rate imposed on investors with respect to such profits distributed as dividends by a corporate securitization issuer could be as high as 36.8% (not including the 3.8% Medicare tax that may apply).

By comparison, the effective federal income tax rate imposed on business income derived by investor individuals on an equity investment in a pass-through issuer structure could be nearly the same, at 37% (not including the 3.8% Medicare tax that may apply). This 37% tax rate for individuals may be able to be reduced in the case of transactions that involve certain pass-through issuers that have employees (i.e., W-2 earners) or tangible personal property, as discussed more fully below in a later section of this Legal Update. However, a typical non-leasing securitization or structured finance transaction is unlikely to feature much in the way of either of these employee or tangible property qualities. As a result, the magnitude of tax rate difference between a corporate and non-corporate issuer likely should not be significant for transactions that include individuals as investors in the equity residual. On the other hand, it is worth noting that, depending on the circumstances, a possible benefit of using a corporate issuer in a transaction that includes individuals investing in the equity residual could be that the Tax Act does not limit the deduction claimed by a corporation for state and local income and property taxes, if any, although this uncapped deduction should also be available to the extent allocable to a corporate investor that owns securitization equity in a pass-through issuer subject to such taxes.

In sum, while a facts and circumstances analysis must be employed in each case, in the absence of implementing regulations that dramatically alter the application of the new tax legislation, one or more of the above considerations may deter sponsors (and investors) from altering their traditional choice of entity decision that onshore securitization and other US domestic structured finance issuers be established as pass-through vehicles for federal tax purposes.

3. Industry-Specific Considerations.

The remainder of this Legal Update provides observations on how the Tax Act may impact typical transactions taken in various industries. For your convenience, please click on the following links to jump directly to our analysis of your respective industry of interest: (a) Securitization of Interest-Bearing Assets, (b) Securitization of Non-Interest-Bearing Assets, (c) CLOs, (d) Real Estate Businesses/REITs, (e) Trade Finance/Factoring, (f) Leveraged Finance/Repo Financings/Structured Financings and (g) Insurance-Linked Securities.

A. SECURITIZATIONS OF INTEREST-BEARING ASSETS

In this section, we use the following simple hypothetical transaction as a basis for part of the discussion: (i) a US sponsor forms a new US domestic special purpose vehicle ("SPV") to act as issuer in a securitization of a static pool of consumer loans, (ii) the SPV issues $80 million of notes at par, which bear interest currently at a blended 5% average interest rate, (iii) the SPV uses the $80 million proceeds from the issuance of its notes, along with a $20 million capital contribution from the sponsor, to acquire a $100 million principal balance of loans at par that pay and accrue interest currently at a consistent 8% blended average interest rate and (iv) servicing and other third party provider fees of the issuer equal 2% of the unpaid principal balance of the collateral pool.[4]

With the above in mind, in the first full taxable year of the transaction, the issuer recognizes, for federal income tax purposes, $8 million of interest income, $4 million of deductible interest expense and $2 million of deductible fee expense. Accordingly, the issuer earns $2 million of net income ($8m interest income – $4m interest expense – $2m servicing expense = $2m).

Choice of Entity. As to choice of entity in this example, if the SPV issuer is established as a US domestic "C" corporation, its $2 million of net taxable income in the first year would be subject to $420,000 of federal income tax ($2m x 21% corporate income tax rate = $420k). The issuer's distribution to its shareholders of the remaining $1.58 million of net earnings would generally be eligible for the qualified dividend rate, which is 20% for individual shareholders (not including the 3.8% Medicare tax that may apply). Thus, if the sponsor was a fund that featured US individual investors, the tax imposed on the $1.58 million dividend distribution (i.e., the "second layer" of taxation) would be $316,000 ($1.58 m x 20%), leaving a net after-tax total of $1.264 million. The two layers of federal income tax imposed on the issuer's earnings (first, on the issuer and then on the investor) would be subject to total US federal income taxes for the year of $736,000, translating to a 36.8% effective tax rate.

Alternatively, if the SPV was established as a pass-through entity, the $2 million of net income would generally not be subject to federal entity level tax, but individual direct or indirect holders of equity in the issuer would generally be subject to a 37% tax on the $2 million of income, whether or not distributed. If the beneficial owners of the pass-through were individuals, the resulting tax would be $740,000 ($2m x 37%), leaving a net after-tax total of $1.26 million. While this is theoretically somewhat of a less favorable result to the parties, the Tax Act does contains a provision that, in certain cases, could reduce such additional tax under a pass-through structure, as discussed below.

The Tax Act provides a new deduction on non-corporate taxpayers equal to 20% of their "qualified business income" (the "199A Deduction"). [5] To the extent available, the 199A Deduction could reduce the 37% top marginal ordinary income tax rate described in the hypothetical above. A taxpayer's qualified business income includes the taxpayer's net amount of qualified items of income, gain, deduction and loss earned with respect to any qualified trade or business of the taxpayer. Items of income, gain, deduction and loss generally are "qualified" if they are effectively connected with any type of US trade or business except certain excluded types of "service" trades or businesses.

The 199A Deduction is limited to the taxpayer's taxable income reduced by net capital gain. The deduction with respect to each qualified trade or business is also capped at the greater of (i) 50% of the taxpayer's allocable share of W-2 wages with respect to the qualified business or (ii) the sum of 25% of the taxpayer's allocable share of W-2 wages with respect to the qualified business and 2.5% of the unadjusted basis, immediately after acquisition (i.e., without regard to any depreciation), of all "qualified property."[6] Qualified property is defined as depreciable tangible property that (i) has been owned by the taxpayer not more than the greater of ten years and the applicable recovery period[7] and (ii) is held for use in the qualified trade or business at the close of the applicable taxable year and actually used at any point during such taxable year in the production of qualified business income. This limitation is intended to limit the 199A Deduction to income from those qualified trade or businesses with employees or that involve substantial capital investment.

Notably, in a typical securitization of debt instruments, the assets held by the SPV would be limited to the underlying loans (and other rights incidental thereto). Such assets generally would not constitute tangible personal property. Further, in order to minimize the risk of competing creditors, the SPV would not typically have any employees. As such, the 199A Deduction for qualified business income is unlikely to apply with respect to income allocated to individual equity owners of a securitization SPV that holds interest-bearing assets. While the potential availability of the 199A Deduction for noncorporate beneficial owners of a securitization SPV could provide an incentive for such SPVs to be structured with employees rather than contractors for servicing or other purposes, we generally expect that issuer-level overhead and limitation of liability concerns will predominate over the desire to implement any such structures.

Net Business Interest Expense. For tax years beginning after December 31, 2017, a new limit on deductions for net "business interest" expense is applicable ("163(j)") to taxpayers such as partnerships and corporations (but not REMICs[8]), excluding taxpayers with gross receipts less than an applicable threshold (e.g., $25 million) or operating in certain industries and floor plan financing interest.[9] Business interest expense is interest paid or accrued on indebtedness properly allocable to a trade or business. Under the Tax Act, a business is generally subject to a disallowance of the deduction for net interest expense in excess of 30% of the business's adjusted taxable income ("ATI"). For purposes of this limitation, ATI is determined in a manner similar to EBITDA[10] for taxable years 2018 through 2021.[11] The amount of interest expense that is disallowed will be carried forward indefinitely and treated as interest expense in succeeding taxable years. In a typical securitization of loans, due to excess spread and overcollateralization, the amount of interest income will (most likely) always exceed the amount of interest expense; in such a case, there would be no net business interest expense and the interest deduction limitation imposed by 163(j) would not be implicated. However, it is possible that, in the later years of certain securitizations, the amortization of the SPV's senior bonds, coupled with the higher interest rate typically applicable to the remaining junior bonds, could result in later years having more interest expense than interest income. Thus, there potentially could be net business interest expense subject to the 30% limitation under 163(j). Sponsors and investors should model the expected performance of future transactions to get a sense of the likelihood of application of 163(j) to their particular circumstances.[12]

A sponsor may seek to reduce its overall interest expense to avoid running afoul of 163(j) by eliminating a junior class of notes (which typically has a higher relative interest rate) and issuing trust certificates (equity interests) instead. The effect of this change is that the return to that investor is in the form of distributions on the residual instead of interest payments. In certain circumstances, this modification may mean the sponsor is using a securitization vehicle that is classified as a partnership for US federal income tax purposes instead of what otherwise would have been a disregarded entity. As detailed below in 3.b., 163(j) applies at the partnership level with special rules, so a sponsor must evaluate the expected interest expense limitation consequences of using such a partnership SPV issuer.

The BEAT. In another interest limitation rule, where an SPV pays interest to parties holding debt securities that are "related"[13] to a large corporate equity investor, the Base Erosion Anti-Abuse Tax (the "BEAT") can also apply to eliminate the interest deduction in respect thereof. Although a description of the specific mechanics of the BEAT is beyond the scope of this Legal Update, suffice it to say that the BEAT can be triggered where the debt securities of a pass-through (or corporate) SPV are acquired by a non-US party that is an affiliate of the equity holder (or corporate SPV). It is not yet clear whether the BEAT will impact structured finance transactions.

New Partnership Withholding (Code §1446(f)). An additional consideration for securitizations is the Tax Act's new withholding rule on transfers of certain partnership interests. The Tax Act enacted a new law which treats the portion of gain (or loss) from the sale or exchange of an interest in a partnership that is engaged in a US trade or business as "effectively connected income" to the extent the gain (or loss) from the sale or exchange of the partnership's assets would be so treated. As a corollary to this new law, the Tax Act now requires the purchaser of a partnership interest to withhold 10% of the sales price on the sale or exchange of the partnership interest unless the transferor certifies that the transferor is not a non-US person. In the event a purchaser fails to withhold, the partnership must withhold on distributions to the transferor (the new partner) in an amount equal to the underwithholding (plus interest). The practical implications of these rules on securitization vehicles that are partnerships are not yet clear. The withholding requirement only applies to the extent any portion of gain on a partnership interest transfer is "effectively connected income," and many partnerships in securitizations are structured to not be engaged in a US trade or business; however, we do not yet have guidance as to whether any certifications or deliveries can provide a purchaser comfort that there is no withholding obligation on that basis. In addition, if a partnership in a securitization is operating under the assumption that there is risk that it may have "effectively connected income," it may be challenging to create procedures for transfers to include the delivery of the US person certification, in particular where the residual interests are held through the Depository Trust Company.

Financial Accounting Conformity. Finally, generally effective beginning in 2018 (but delayed until 2019 for debt instruments with original issue discount), most accrual-method taxpayers must take items of income into account for federal income tax purposes no later than the time such items of income are included on certain audited financial statements or annual reports (with certain exceptions) prepared by taxpayer (such rules, "451(b)").[14] Under these new provisions, an accrual-method US holder of a note in a typical securitization transaction who prepares an "applicable financial statement" as defined in Code §451 generally would be required to include certain items of income such as original issue discount no later than the time such amounts are reflected on such a financial statement.[15] This could result in an acceleration of income recognition for income (but not loss or deduction) items. The statutory provision leaves various unanswered question that will likely require regulatory guidance, including whether the rule applies to *de minimis* OID and market discount. In addition, this rule equally applies to the equity investor side of a securitization to the extent such owner includes those receivables in its applicable financial statement. The acceleration of income for the equity investor could potentially cause recognition of phantom income to such taxpayers as a result of a mismatch of income and expense (especially considering the fact that, under the Tax Act, net operating losses arising after December 31, 2017, may not be carried back). 451(b) could apply to various of the business lines described herein.

B. SECURITIZATIONS OF NON-INTEREST-BEARING ASSETS

There are four primary provisions of the Tax Act that impact a typical securitization of non-interest-bearing assets (such as a securitization of operating leases): (i) 163(j), (ii) the repeal of nonrecognition for like kind exchanges of non-real property (subject to a transition rule for property relinquished prior to 2018), (iii) the ability to immediately expense 100% of certain new and used property through 2022, and (iv) the limitation with respect to the use of net operating loss ("NOL") carryforwards in any given year (applicable to NOLs arising as of January 1, 2018, for calendar year taxpayers). For purposes of evaluating the impact of the Tax Act on a securitization of non-interest-bearing assets, it must be noted that a leasing business has distinguishing features from those described in the above discussion regarding securitization of interest-bearing assets.

163(j). The analysis must begin with 163(j) considerations. As explained above, 163(j) effectively caps the deduction for net interest expense in a given year to 30% of an amount calculated in a manner similar but not identical to EBITDA for five years and thereafter at 30% of "tax" EBIT. However, as mentioned above, the limitation does not apply to interest on "floor plan financing indebtedness." There are also exceptions for certain types of businesses, such as electing real estate businesses.

Applying 163(j) to a simplified hypothetical example, consider the following: a corporation has as its sole business a 100% equity ownership interest in a single securitization transaction that holds the right to rental income receipts.[16] If the pool generates $100 of rental income and the issuer incurs $100 of interest expense, there would be net interest expense of $100 (because the $100 received is rental income, not interest income). Therefore, 163(j) would apply to limit the interest deduction to $30. As a result, the corporate owner would be subject to tax on $70 of income. This $70 of net income is "phantom income" because the corporation pays interest expense with cash flows from the portfolio without a corresponding deduction in the current year. The remaining $70 of interest (i.e., the amount not allowed as a current deduction) is treated as an interest expense carryforward and subject to the 163(j) limitation that can be used to offset income in future years. In contrast, if the collateral pool featured interest-producing assets, there would have been no net interest expense, 163(j) would provide no limitation, and the corporate taxpayer would not have taxable income.

In a real-world situation, our hypothetical corporation is likely to have other assets and liabilities in addition to the securitization transaction, and the overall effect of 163(j) would need to be assessed based on the corporation's particular circumstances. As noted above, the new depreciation/expensing and net operating loss rules may impact that analysis. However, even where a corporation would otherwise have other taxable income outside of the securitization transaction that would mitigate the problem raised in the first example, the phantom income could nevertheless persist if the securitization vehicle is treated as a partnership for US federal income tax purposes.[17]

Where the securitization vehicle is a partnership for US federal income tax purposes, the 163(j) analysis applies at the partnership level and then, under a fairly complicated set of rules, further applies 163(j) to each partner's allocable share of partnership income and carryover interest expense based on the partnership level 163(j) limitation.

More specifically, each partner's share of the partnership's taxable income or loss is determined based on the partnership's taxable income or loss being calculated in a manner that takes into account the net interest expense limitation equal to 30% of the partnership's ATI (i.e., the EBITDA or EBIT-similar calculation of income). To prevent double-counting, the partner's distributive share of partnership taxable income is not included in the calculation of ATI at the partner level, subject to an exception for "excess income." Partnership "excess income" is essentially the portion of the 30% limitation at the partnership level (i.e., 30% x ATI) that exceeded the amount of interest expense of the partnership, which under a complicated set of rules gets allocated to the partners. A partner's share of the partnership's excess income is included in the calculation of the partner's ATI and therefore is generally available to reduce the impact of the 163(j) limitation on the partner's interest expense from other businesses for that year.[18] However, if the excess income is not utilized at either the partnership or partner level then it is no longer available for subsequent years.

There is also no excess interest expense carryforward at the partnership level, but the rules provide mechanics that permit the carryover to be used at the partner level in the succeeding year to the extent there is excess partnership income allocated to the partners. To the extent there is not excess partnership income, the interest expense carries forward indefinitely until there is. To illustrate, consider the hypothetical above, except that the securitization entity is a partnership for US federal income tax purposes. In this case, the partnership would have $70 of taxable income, which it would allocate to the partners in accordance with their sharing ratios.

Because the partnership had $70 of excess net interest expense (i.e., interest expense that was not deductible because of 163(j)), the $70 of interest expense is treated as carryforward interest expense that gets allocated to the partners in the next succeeding year when there is excess partnership income. Thus, the carryover interest expense at the partner level is not deductible against the partner's income from its other businesses. However, the partner can recover a benefit from unused interest expense carryforwards upon sale. A partner reduces its tax basis in the partnership interest by allocations of excess interest expense carryforward (whether or not used), and to the extent of any unused excess interest expenses at the time of a sale of the partnership interest, the partner's tax basis in the partnership interest is increased by that amount immediately prior to the sale.[19]

As alluded to above, where a sponsor's leased assets are owned by an entity treated as a disregarded entity for tax and financed with debt from a securitization transaction or otherwise, the sponsor must manage its depreciation elections (e.g., expensing) with respect to the assets and the associated NOLs that could arise and also consider how the interest expense might impact the potential application of the 163(j) limitation to its overall interest expense. The planning evaluation should also take into account the timing of the flip to an EBIT-based calculation of income for purposes of applying the 30% limitation. A sponsor may have some ability to manage income timing (and thereby manage the 163(j) implications) by virtue of the flexibility given to taxpayers in making depreciation elections. Sponsors should exercise caution in this regard because such elections can produce NOLs that might not otherwise have arisen. The Tax Act includes an 80% limitation on the use of NOLs each year. This can make deferred depreciation (rather than 100% expensing) a better option to shield income in a subsequent year because NOLs can no longer be applied as a complete shield against taxable income in a particular year.

Sale-Leasebacks. That being said, one planning opportunity that arises for companies that originate leases and seek to reduce their overall interest expense is that, rather than issuing debt, the company may prefer to enter into a sale-leaseback or a leveraged lease with securitization debt.

In a sale-leaseback, the company finances its portfolio by selling it to a lessor and leasing it back under a head lease (with the company subleasing the assets to its customers). The company may hold the asset portfolio in an SPV treated as a disregarded entity for purposes of these transactions. Assuming the leases at the head lease and sublease levels are true leases for income tax purposes, the issuer is paying rent (as opposed to interest) to the head lessor, which means that the 30% interest expense limit of 163(j) would not apply to the company's financing source. Presumably, some of the economic benefit realized by the lessor (as a result of depreciating the purchased equipment) would be shared with the lessee in the form of lower rental payments under the head lease.

The sale-leaseback structure can be further adapted to include leverage, and securitization technology can be utilized to provide the leverage. For the leverage component, the head lessor could be a trust that issues trust certificates in a securitization. The head lessor would use the proceeds of the certificate offering, along with equity from its parent, to acquire the assets from the leasing company. As in the simple sale-leaseback, the company would be leasing the assets from the head lessor and subleasing the assets to its customers. The cash received by the company from its customer's subleases would be used to pay rent due to the head lessor. The head lessor, in turn, would use the rent received from the company to service the trust certificates, and the excess cash would be distributed to the head lessor's parent. The likely candidate to be the head lessor's parent would be a bank, given that a bank can utilize depreciation (such as immediate expensing if available in respect of the assets) and likely generates sufficient interest income such that its interest expense on its customer deposits (i.e., its normal source of funding), plus the interest expense for the trust certificates, would not be more in any year than its interest income from its lending operations.

A more detailed description of the implications of the Tax Act on leasing businesses, including related planning opportunities, will be made available by Mayer Brown in the near future.

C. CLOs

Choice of Entity. Unlike most other securitization vehicles, CLOs have historically been structured as [non-]US corporations formed in low tax jurisdictions. Utilizing carefully crafted investment guidelines, these entities avoid US federal income taxation by limiting their activities to investment and other activities that qualify for the "securities trading safe harbor."[20] As a result, these entities are not engaged in the conduct of a "trade or business within the United States" or "ETB," the prerequisite for subjecting a non-US corporation to net basis US federal income tax. In addition, these CLOs typically limit their investments to loans the interest on which qualifies for the "portfolio interest exemption," thereby avoiding the 30% withholding tax on US source fixed and determinable, annual and periodic income.

Non-US investors in both the debt and the stock of the CLO (the latter of which typically takes the form of "subordinated notes" or "sub notes") escape both net basis US federal income tax and 30% US withholding tax because the interest and dividends are foreign source. US investors in CLO debt generally include income pursuant to their method of accounting or on a constant yield basis in respect of original issue discount. US investors in sub notes, however, are generally subject to income on a pass-through basis under either (i) the "passive foreign investment company" (or "PFIC") rules[21] or (ii) the "controlled foreign corporation" (or "CFC") rules. Prior to the enactment of the Tax Act, few CLOs qualified as CFCs, resulting in most US investors investing in sub notes including income under the PFIC rules.

More recently, some CLOs have been structured as partnerships for US federal income tax purposes. This allows US equity investors to include income under the generally more favorable partnership tax rules rather than the PFIC or CFC rules. The status of such CLOs as not ETB is still relevant for non-US equity investors, who usually invest through a non-US feeder corporation. Thus, while the form of the entity differs, the activities (including the investment guidelines) remain the same.

There appears to be little impetus to revise these structures in light of the Tax Act. The reduction in the corporate tax rate mitigates the tax impact of a corporation CLO being treated as ETB but provides no further benefit to an entity that is not subject to US income tax. At first glance, US equity investors in partnership CLOs may appear to benefit from the 199A Deduction (described above in "Securitizations of Interest-Bearing Assets"). However, the 199A Deduction is limited to income that is effectively connected with a US trade or business—anathema to non-US equity investors. As a result, CLO investors, US and non-US alike, are left with largely the same choice-of-entity considerations.[22]

Other Issues. The Tax Act does impact CLOs in several other important ways. Changes to the CFC rules potentially expand the class of US investors in CLOs subject to pass-through taxation and the entities treated as CFCs. In addition, 451(b) (discussed above in 3.a.) may require accelerated income inclusions for certain US investors.

Under prior law, US investors treated as owning 10% of more of the total combined voting power of all classes of stock of a CFC ("10% US Shareholders") were subject to pass-through taxation in respect of certain income of the CFC (which generally includes the typical income of a CLO). Restricting the test to voting power created opportunities to avoid CFC pass-through taxation by limiting the voting power but not the value of certain classes of stock. While it is not believed that this was a widespread practice in the CLO area, some holders of sub notes in corporate CLOs may have taken the position that the creditor rights afforded them did not rise to the level of voting power for this purpose. In addition, holders of "should" level CLO notes[23] could comfort themselves with the notion that their notes did not convey the requisite voting power to require CFC inclusions if such notes were recharacterized as stock of the CLO. The Tax Act eliminates these positions by revising the test to include 10% or more of voting power or *value*.

This change, along with a change in the stock attribution rules, also potentially increases the number of corporate CLOs (and certain CLO blocker subsidiaries) that may be treated as CFCs rather than PFICs. A non-US corporation is treated as a CFC if 10% US Shareholders own, in the aggregate, more than 50% of the vote or value of the stock of the corporation. For this purpose, ownership of stock is attributed based on certain relationships, including from a corporation to a shareholder owning 10% or more of the value of its stock and to a corporation from a shareholder owning 50% or more of the value of the corporation's stock. Under prior law, the attribution of stock from a shareholder to a corporation (i.e., "downward attribution") did not apply if the shareholder was a non-US person and the corporation was a US person. The Tax Act removed this limitation, allowing downward attribution from a 50% non-US shareholder to a US corporation.

With downward attribution, a corporate CLO may be treated as a CFC if a non-US corporation with a US subsidiary (regardless of the size of the US subsidiary) is treated as owning the requisite amount of stock of the CLO. When coupled with the expansion of the 10% US Shareholder test, a non-US investor with a US subsidiary that owns a substantial amount of "should" level notes could cause a corporate CLO to be treated as a CFC.

Moreover, a non-US blocker subsidiary of a corporate CLO may unexpectedly be treated as a CFC, even if the CLO itself is not a CFC. If the CLO establishes both a US blocker corporation and a non-US blocker corporation, downward attribution would cause the US blocker corporation to be treated as owning all of the stock of the non-US blocker corporation, resulting in CFC status for the latter. In many circumstances, a 10% US Shareholder of the CLO would be subject to pass-through taxation in respect of the non-US blocker corporation, even if the CLO itself were not a CFC.

A US investor's failure to treat a corporate CLO or its non-US blocker subsidiary as a CFC may seem to result in little effect. After all, the US investor would likely include the income of the CLO and its non-US blocker subsidiary on a pass-through basis pursuant to the PFIC rules. Appearances, as they say, can be deceptive. 10% US Shareholders of CFCs are required to file IRS Form 5471.[24] A failure to file this form prevents the running of the statute of limitations for any tax return to which the form relates, leaving the tax return open to assessment.[25] A reasonable cause exception limits the open items to those required to be furnished on IRS Form 5471, but it is unclear whether mistaking a CFC for a PFIC is a reasonable cause.[26]

The Tax Act also removed the requirement that a non-US corporation must qualify as a CFC for a period of 30 uninterrupted days during a taxable year before a 10% US Shareholder is required to include income of the CFC on a pass-through basis. After this change, any 10% US Shareholder that owns stock of a non-US corporation at any time that it qualifies as a CFC will be subject to pass-through inclusions, even if CFC status is transitory.[27]

As described above in 3.a., the Tax Act requires most accrual method taxpayers to include income for tax purposes no later than the time such items are included on the taxpayer's audited financial statements or annual reports. This is expected to have little impact on corporate CLOs themselves, but some US investors may be required to accelerate income in respect of CLO notes.

Original issue discount[28] and market discount appear particularly susceptible to acceleration. Additional tax disclosure in CLO offering documents will be necessary to inform US investors of this risk.

While partnership CLOs will avoid grappling with the CFC ramifications of the Tax Act, many of the issues described above in respect of securitizations of interest-bearing assets will be applicable. In addition, enhanced tax disclosure in respect of 451(b) will be required.

D. REAL ESTATE BUSINESSES/REITS

Real estate businesses can generally elect out of 163(j). However, a real estate business making this election must depreciate its real estate assets using the alternative depreciation system (ADS) which generally requires the use of longer depreciation periods (e.g., 30 years for residential rental property and 40 years for non-residential real property) than those permitted under the regular depreciation rules. A real estate business for this purpose is defined by reference to Code §469(c)(7)(C), which refers to any "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business." Further guidance is needed to determine the outer limits of this definition for purposes of 163(j). In particular, the Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at n. 697 indicates that such definition includes a REIT. However, the Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at n. 487 notes that a mortgage broker who is a broker of financial instruments is not in a real estate business for this purpose, which calls into question a pure mortgage REIT's eligibility for this election.

The Tax Act (as part of the 199A Deduction) provides that individuals may deduct 20% of their ordinary REIT dividends, which results in an effective federal tax rate of 29.6% on ordinary REIT dividends for an individual who is subject to tax at the 37% rate. This deduction applies to dividends paid by both equity REITs and mortgage REITs and, unlike the 20% deduction for qualified business income earned through a pass-through entity, is not limited to certain types of businesses and does not require the payment of W-2 wages or the ownership of depreciable tangible property. A REIT's capital gain dividends and qualified dividends are not eligible for the 20% deduction, but continue to be taxed at a maximum rate of 20% for individuals. This reduction in the effective tax rate on ordinary REIT dividends may cause REITs to be used more frequently for investing in real estate and mortgage debt, subject to the various limitations that apply to the ownership, assets and income of REITs.

E. TRADE FINANCE/FACTORING

Many "trade receivables"[29] sale transactions in the structured finance space are structured as non-recourse transactions with the owner of the receivable selling it to an unrelated third party. As a result, the buyer of the trade receivable takes the risk of non-payment from the account debtor. Such fact (among others) would generally suggest that the transaction should not be viewed as constituting leverage incurred by the seller of the trade receivables. Nevertheless, the transaction can generally be viewed from a capital perspective as providing financing to the seller. One benefit of such a structure after the Tax Act would be that the financing can be provided in a manner that doesn't generate interest expense for purposes of 163(j). For example, the sale of a $100 receivable to a bank for $95 could produce a "loss" rather than interest expense.

Notwithstanding the above-described benefit, the seller of the trade receivables would still need to consider the effects of such a sale transaction, because the discount applied to the purchase price would likely constitute a loss or a reduction in the amount realized on the sale of the related inventory (i.e., the sale of a widget with a cost of goods of $70 in exchange for a promise to pay $100 would likely produce $25 of net adjusted taxable income, rather than $30).[30] This diminution reflecting the sale price to the bank would reduce the seller's income for purposes of calculating "adjusted taxable income" under 163(j), which could cause a limitation to apply to the seller's otherwise unrelated interest expense.

On the other hand, a trade receivables transaction that constitutes a secured financing will have the "seller's" interest component of the transaction subject to 163(j) like other debt structures.

As described above, the disparate treatment between a sale of trade receivables and a financing secured by such trade receivables highlights (another) important reason to utilize a structure and documentation that evidence the intent of the parties in as clear a manner as possible.

F. LEVERAGED FINANCE/REPO FINANCINGS/STRUCTURED FINANCINGS

163(j). As discussed above, the Tax Act amended 163(j) to limit the deductibility of certain business interest. This limitation could affect leveraged finance, repo and structured finance transactions with the same general considerations described above.

In a typical repo transaction, the repo seller will sell an asset (or a pool of assets) to a buyer at a discount to fair market value, subject to the seller's obligation to repurchase those assets for a price that includes a "price differential," which is a surrogate for interest. For US federal tax purposes, the transaction is likely treated as a secured loan rather than as a distinct sale and repurchase, with the repo seller being treated as the borrower and the repo buyer being treated as the lender (and the amount of interest paid by borrower to lender determined based on income on the assets and payments of price differential between the seller and buyer).

The impact of 163(j) on such transactions depends on the nature of the underlying assets. If the assets held by the borrower/issuer (or in the case of a repo transaction, the assets subject to the repurchase obligation) are debt instruments that generate interest income, that income would generally be "business interest income" and would generally be expected to exceed business interest expense, so that corresponding business interest expense would be fully deductible. But if those assets were not debt instruments – e.g., if they were leases and leased property – then the 30% cap could limit the current deductibility of interest expense, resulting in the recognition of phantom income.

The same 163(j) considerations apply in a non-limited recourse financing, such as a typical full recourse credit facility.

Related Party Hybrid Transactions. Further, the Tax Act contains rules precluding interest deductions in respect of payments made (or accrued) to related parties in hybrid transactions. Although the specifics of these rules are beyond the scope of this Legal Update, for this purpose, a "hybrid transaction" generally includes transactions in which the amounts paid are not included in the income of such related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or where such related party is allowed a deduction with respect to such amount under the tax law of such country. The disallowance rules also apply to related party payments made by or to a hybrid entity. For this purpose, a "hybrid entity" includes any entity which is either (a) treated as fiscally transparent for purposes of the US tax law but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax or (b) treated as fiscally transparent for purposes of such tax law but not so treated for purposes of US tax law.

Collateral Package Issues and Code §956. Critical to any borrowing transaction is the collateral and credit enhancement that supports repayment of the debt. Credit agreements currently used by borrowing groups generally have standard provisions intended to prevent US members of the group from having a taxable "deemed-dividend" inclusion under Code §956. In relevant part, Code §956 was enacted to prevent US corporations from currently obtaining the economic benefit of the previously untaxed earnings of a "controlled foreign corporation," as defined in Code §957 of the Code (a "CFC") through various means, including the pledging of the CFC stock and guarantees provided by the CFC to enhance the collateral package for a borrowing by the US corporation. Under Code §956, an "investment in US property" by a CFC subjects a 10% US Shareholder, defined under prior law as a US person who owns 10% or more of the total voting power of that foreign corporation, to tax if such investment was made with earnings that have not been previously taxed in the United States. The tax triggered by Code §956 is intended to tax the US shareholders of the CFC as if the CFC had actually distributed a dividend to the US shareholders (which would be subject to current taxation), and then the US shareholders made such investment in US property (i.e., a "deemed-dividend").

The Tax Act adds a 100% dividends received deduction (the "participation exemption") for the foreign-source portion of dividends received from a "specified 10% owned foreign corporation," meaning a foreign corporation (other than a passive foreign investment company that is not also a controlled foreign corporation) with a domestic corporation as a US shareholder. This generally means that 10% domestic corporate shareholders can receive distributions of accumulated and current earnings and profits from their non-US subsidiaries without being subject to federal income tax. It was thus widely expected that the Tax Act would repeal Code §956 with respect to domestic corporations because this deemed dividend construct would be rendered largely irrelevant by the fact that an actual repatriation could be achieved tax-free. However, despite this new tax-free repatriation regime, Code §956 has been retained, so borrowing groups will need to remain vigilant with respect to the Code §956 deemed-dividend issue.

The Tax Act includes numerous provisions that change the calculus in evaluating the Code §956 deemed-dividend issue. For example, not only was Code §956 unexpectedly retained, but the Tax Act changes two relevant rules, making the application of Code §956 to borrowing arrangements more complicated than under prior law, which could render the standard Code §956 provisions in credit agreements no longer adequate to protect the borrowing group from a deemed-dividend.

The two rules are described above in 3.c. (CLOs). As noted there, the Tax Act expands the definition of a "United States shareholder" to not only include a US person owning (applying certain attribution rules) 10% or more of the combined voting power of all classes of voting stock of a CFC but also include a US person who owns 10% or more of the total *value* of shares of all classes of stock of a CFC. The Tax Act also adds downward attribution rules that allow stock owned by a foreign person to be attributed to a US person. This downward attribution rule is effective for the last taxable year of a foreign corporation beginning *before* January 1, 2018 (so generally the 2017 taxable year).

As a result of these new rules, a US subsidiary of a foreign parent is attributed its foreign parent's ownership of a foreign subsidiary. In many cases, this could result in the classification of the foreign subsidiary as a CFC. If that CFC were to guarantee debt of the sister US subsidiary, this guarantee could constitute an "investment in US property" that could trigger a deemed-dividend. The inclusion of an amount equal to the lesser of the guaranteed amount and the CFC's earnings and profits in taxable income is only relevant to a 10% US Shareholder that owns that CFC directly or indirectly. Therefore, if no US person (including a US partnership) owns 10% or more of the vote or value of foreign parent (or other entity in a chain above foreign parent), the CFC's investment in US property would not trigger a deemed-dividend that is included in a taxpayer's income. Alternatively, if there is such a 10% US

Shareholder of the foreign parent or another entity further up the ownership chain, a deemed-dividend could be triggered to that 10% US Shareholder. While the legislative history to the downward attribution rule states that attribution is not intended to result in CFCs that will cause inclusions to an unrelated 10% US Shareholder, the amended statute does not provide for this exception.[31] It is thus important to note in this context that the US Tax Court released a decision this month, *SIH Partners LLLP v. Commissioner*, 150 T.C. No. 3, T.C., No. 3427-15 (January 18, 2018), which highlights that the Tax Court is not sympathetic to unexpected adverse Code §956 deemed-dividend inclusions. Therefore, parties are well advised to tread carefully with respect to collateral packages that involve US and non-US affiliates.

It should also be noted that there is no "grandfather" provision in these statutes, so that a transaction with facts similar to those described above that would not have triggered a deemed-dividend under prior law can now be subject to such adverse consequences unless the collateral package is modified to take into account the revisions contained in the Tax Act. Notwithstanding such point, the magnitude of such adverse consequences may be more limited than under prior law, as described in the next succeeding paragraph.[32]

Potential Mitigation of Code §956 Issues. Other provisions of the Tax Act could soften the perceived negative consequences of Code §956. That is, Code §956 results in a deemed-dividend only to the extent that the relevant CFC has untaxed earnings and profits. However, the Tax Act includes a special one-time Code §965 deemed repatriation to United States shareholders of deferred earnings and profits of all CFCs (for which United States shareholders are subject to special tax rates). In addition, as noted above in 3.c. (CLOs), the Tax Act adds a new type of subpart F tax called "GILTI", which, very generally, requires a United States shareholder of a CFC to include in income, as a deemed dividend, the excess of the United States shareholder's net CFC "tested income" over a net "deemed tangible income return." Therefore, between Code §965 and GILTI (and the unchanged subpart F income rules), many CFCs may have plenty of previously taxed earnings and profits, which, when included pursuant to Code §956 as a deemed-dividend would not be subject to tax a second time.[33] Finally, as noted above, there is now the ability to repatriate earnings without US federal taxation to domestic corporate shareholders.

Ultimately, these considerations may encourage (a) the development of different borrower requirements in credit agreements, including mandatory cash repatriation of free cashflow back to the US, (b) different modeling of collateral and value in setting up credit agreements and (c) modifications to "standard" collateral packages for facilities that include US and non-US companies (whether domestic parented or foreign parented). For example, there may be an uptick in US/non-US co-borrower structures, which could be desirable as compared to a foreign borrowing followed by a debt push down to the US affiliate, due to the aforementioned 163(j) limitations and BEAT imposed by the Tax Act.

Tax Distributions. Credit agreements also have fairly standard provisions for pass-through borrowers relating to tax distributions. The tax distributions are intended to allow the owners of the borrowers to access the amount necessary for them to pay the taxes associated with the borrowers' businesses. The allowance of these distributions are generally viewed as being comparable with the allowance for a corporate borrower to pay its own income tax (or contribute to a parent corporation's tax). As discussed above, the Tax Act makes various changes that impact a taxpayer's effective tax rates, such as a 21% corporate rate, a noncorporate taxpayer's 199A Deduction and the ability to deduct state and local income taxes. These considerations may lead to new approaches to the tax distribution provisions.

G. INSURANCE-LINKED SECURITIES

Insurance "sidecars" and "cat bonds" are two types of transfer of insurance risk accomplished in well-established forms of transactions in a special corner of the securitization market. The change in the definition of "United States shareholder" for CFC purposes and the revision of the insurance exception for PFIC purposes will have an impact on these two markets.

Both "sidecars" and cat bond issuers are likely to be classified as "insurance companies" for tax purposes and therefore the entities must be treated as corporations rather than as pass-through entities under the regulations under Code §7701. An insurance "sidecar" is usually structured as a segregated cell of a Bermuda or Cayman segregated cell company ("SCC"). The general account, or "core," of the SCC is typically owned by an insurance company which cedes risks it has incurred to a cell of the SCC in a reinsurance transaction. Investors purchase non-voting preferred stock of the cell for an amount equal to the aggregate amount of the reinsurance transaction. The cell then uses the proceeds of the offering to collateralize its reinsurance obligation. The "core" exercises control over the cell, but it has an economic interest in the cell. The offering documents generally state that there is some uncertainty whether the segregated cell is treated as a separate entity from the core, and consequently it is unclear whether the stock purchased by the investor is stock of the core or stock of the cell, and then describe the tax consequences for both alternatives. But the change in definition of "United States shareholder" to be a 10% vote or *value* test will be relevant to either view of the issuer. If a US person acquires enough stock in the offering to equal or exceed 10% of the value of the issuer, that investor will be a 10% US Shareholder of the issuer for purpose of the CFC rules.

The income earned by the "sidecar" entity would have qualified for an exception to passive income treatment under the PFIC rules if the "sidecar" insurance company derived that income through the "active conduct" of an insurance business. The recent tax legislation added a further requirement to this exception. Under the new rules, the issuer must not only satisfy the actual conduct of an insurance business test but also must be a "qualifying insurance corporation." A "qualifying insurance corporation" is a foreign corporation that would qualify for taxation as an insurance company if it were a domestic corporation and its applicable insurance liabilities constitute more than 25% (or 10% in certain cases to be provided in Treasury regulations) of the corporation's total assets.

"Cat bonds" are nominally debt securities of a special purpose insurance company. "Cat bond" entities are typically not segregated cell companies. Because the special purpose reinsurer that is the issuer of a "cat bond" typically has *de minimis* equity, the "cat bonds" are treated as equity for tax purposes. The tax disclosure typically advises that the "cat bonds" could be treated as voting stock for CFC purposes. The change in the definition of "United States shareholder" to adopt a 10% of vote *or* value test makes clear that a US investor who owns 10% of an issuer's "cat bond" will be treated as a 10% US Shareholder for CFC purposes.

Although "cat bond" disclosures generally expressed skepticism that the "cat bond" income would qualify as income from the "active conduct" of an insurance business for the prior-law PFIC exception, the addition of the "qualifying insurance corporation" 25% test made it even less likely that a "cat bond" special purposes reinsurer would qualify for the PFIC exception.

It remains to be seen how the structure and mechanics of sidecars and cat bonds may be altered in light of these Tax Act implications. For example, sidecar deals tend to have a one-year duration, and investors tend to roll over their investment into the subsequent year's deal (assuming no triggering event occurs under the respective reinsurance contracts). As a result of the Tax Act, to the extent that a sidecar transaction is treated as a PFIC or a CFC, US investors in sidecars may have a need for current cash distributions of available funds to cure phantom income liquidity issues.

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Endnotes

[1] Pub. L. 115-97, 131 Stat. 2054 (2017).

[2] *See* Treasury Regulation §1.1502-6.

[3] Although a 100% dividends received deduction ("DRD") is generally available to a corporation that wholly owns a corporate issuer paying the dividend, the Tax Act reduces the DRD for dividends received by a corporate investor from 20%-owned corporations from 80% (as was the case under prior law) to 65% and from 70% to 50% in the case of dividends received by a corporation from less than 20%-owned corporations.

[4] Typically, securitizations of interest-bearing assets are structured with at least two forms of credit enhancement. First, there is usually a spread between the average interest rate received by the securitization vehicle on the underlying assets over the cost of capital reflected in the rate or rates payable on the debt securities issued by the vehicle (i.e., "excess spread"). Second, the amount financed by the securitization vehicle is usually less than the total principal balance of assets held by the vehicle (i.e., "overcollateralization"). For ease of illustration in this Legal Update, we do not take into account potential state and local taxes.

[5] If an issuer-partnership is treated as engaged in a trade or business (within the meaning of Code §162), then the deduction is available. Alternatively, if such partnership is treated as undertaking investing activity and not a trade or business, individual partners would be precluded from claiming miscellaneous itemized deductions (through 2025), which would typically prevent a deduction of the servicing fees.

[6] Code § 199A(b)(2).

[7] E.g., the "recovery period" for automobiles is five years; thus, automobiles would provide the "qualified property" benefit for ten years, so long as the taxpayer continued to own the automobile for the 10-year period. Recovery periods can generally be found in Rev. Proc. 87-56, 1987-2 C.B. 674.

[8] 163(j) only applies to interest expense and interest income allocable to a trade or business, and does not impact investment interest within the meaning of Code §163(d). Pursuant to 1.860C-2(b)(4), a REMIC is not treated as carrying on a trade or business for purposes of Code §162, and ordinary operating expenses are deductible under Code §212.

[9] Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness, in turn, means indebtedness (i) used to finance the acquisition of motor vehicles held for sale or lease and (ii) secured by the inventory so acquired.

[10] There are certain differences between how EBITDA is determined for Generally Accepted Accounting Purposes ("GAAP") and ATI. For instance, the equivalent of "earnings" for ATI purposes is taxable income (with certain adjustments, for instance without regard to interest income), rather than GAAP earnings. *See* Code §163(j)(8).

[11] Starting in 2022, ATI is determined in a manner similar to EBIT.

[12] The Tax Act includes another new rule with respect to certain trade or business deductions. Noncorporate taxpayers may not deduct "excess business losses," which are generally the taxable

year's trade or business expenses that exceed the taxpayer's gross income or gain attributable to trade or business for that taxable year plus $500,000 for married taxpayers filing a joint return (and $250,000 for other individuals). The excess business losses become net operating losses in the next taxable year.

[13] Pursuant to Code §59A(g), the term "related party" for this purpose means, with respect to any applicable taxpayer: (A) any 25-percent owner of the taxpayer, (B) any person who is related (within the meaning of Code §§267(b) or 707(b)(1)) to the taxpayer or any 25% owner of the taxpayer, and (C) any other person who is related (within the meaning of Code §482) to the taxpayer. The term "25% owner" means, with respect to any corporation, any person who owns at least 25% of A) the total voting power of all classes of stock of a corporation entitled to vote or (B) the total value of all classes of stock of such corporation. In addition, Code §318 shall apply for purposes of the foregoing definition of "related party," except that (A) "10%" shall be substituted for "50%" in Code §318(a)(2)(C), and (B) subparagraphs (A), (B) and (C) of Code §318(a)(3) shall not be applied so as to consider a United States person as owning stock that is owned by a person who is not a United States person.

[14] Note that the timing of the recognition of "rental" income is excluded from this rule. *See* Code §451(b)(2). Further, the differences in income profile resulting from how a lease transaction is construed for financial statement and federal income tax purposes is excluded from this rule. Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at n. 872.

[15] An "applicable financial statement" means:

(A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission; (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, (III) partners, or other proprietors, or to (IV) beneficiaries, or (V) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i); or (iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer de scribed in clause (i) or (ii);

(B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the United States Securities and Exchange Commission and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A); or

(C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B).

[16] Note that 163(j) only applies to interest expense allocable to a trade or business (presumably as described in Code §162); however, the Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at n. 688 implies that all interest expense of a corporation is allocable to a trade or business for this purpose.

[17] This may place additional pressure on transactions in which notes are issued that do not receive unqualified "will" level debt for tax opinions.

[18] This is subject to special rules that operate to ensure that any "excess income" is first used to offset "excess interest" expense from the partnership. In addition, there are certain basis adjustment rules to a partner's partnership interest.

[19] These rules will undoubtedly require further guidance and certain initial questions are apparent. For instance, the partnership rules do not explicitly provide for an allocation of net interest income at the partnership level for use at the partner level in determining a partner's 163(j) limitation. In other words, assume the partnership has more interest income than interest expense. The partnership will calculate its taxable income without any 163(j) limitation because there is no net interest expense. However, while 163(j) allocates "excess income" to the partner for potential use against partner level interest expense, the "excess income" is solely based on the ATI calculation at the partnership level, and that ATI calculation would not include net interest income of the partnership. Thus, it is possible to read 163(j) as providing that partnership interest income is taken into account solely for purposes of determining the partnership's ability to deduct interest expense for purposes of the partnership level taxable income or loss, but any (excess) interest income is not otherwise allocable to the partner and is not available to impact partner level 163(j) determinations. Under an alternative interpretation of 163(j), it might be possible to argue that net business interest income at the partnership should flow through under general partnership principles and therefore factor into the 163(j) limitation at the partner level. However, absent further guidance, it is difficult to rely on this alternative interpretation, as 163(j) does not explicitly support it. Another potential issue arises because, as noted above, 163(j) only applies to interest allocable to a trade or business. Interest allocable to investment property is instead subject to Code §163(d). However, all interest income and expense of a corporation is trade or business interest (i.e., interest income allocable to investment property owned by a corporation is considered trade or business interest). Therefore, if a corporation is a partner in a securitization partnership that does not have a trade or business, 163(j) presumably still applies to the corporation in respect of its investment in the partnership. In that case, it is unclear whether 163(j) applies solely to the corporation's allocable share of the partnership's income (i.e.,

entirely at the partner level) or if the 163(j) limitation applies at the partnership level for purposes of determining the corporation's allocable share of the partnership's income, which would raise a myriad of additional questions given that the 163(j) limitation would not apply for purposes of determining any other partner's income if that partner were an individual. It seems that 163(j) should not apply at the partnership level under those circumstances, because the partnership itself does not have interest income or expense allocable to a trade or business. However, the statute is not clear on this point.

[20] *See* Code §864(b)(2).

[21] Although the PFIC rules do not force inclusion on a pass-through basis, U.S. investors in sub notes are usually advised to make a "qualified electing fund" (or "QEF" election) to avoid additions to tax. U.S. investors making a QEF election include the earnings and profits of the CLO on a pass-through basis.

[22] The new 163(j) net business interest expense limitation (discussed in detail above in "Securitizations of Interest Bearing Assets") could theoretically affect the choice between corporate CLOs and partnership CLOs. If the interest expense of the CLO were to exceed the interest income in a taxable period, 163(j) might limit the interest deduction of U.S. equity investors in partnership CLOs. U.S. equity investors in corporate CLOs, however, may receive the benefit of such interest expense through a reduction in the earnings and profits of the CLO. Any potential benefit would likely be a margin factor in choice-of-entity considerations, because the situations in which a CLO would experience net interest expense appear extremely limited.

[23] In connection with the issuance of notes by a CLO, tax counsel typically opines regarding the level of comfort that each class of notes is properly characterized as debt for U.S. federal income tax purposes. A "should" level of comfort generally indicates a substantial risk that the class of notes could be characterized as other than debt. Some classes of notes receive no opinion, which usually indicates a great risk of recharacterization.

[24] *See* Code §6038(a)(4).

[25] *See* Code §6501(c)(8)(A).

[26] *See* Code §6501(c)(8)(B).

[27] New Code §951A requires 10% U.S. Shareholders to include the "global intangible low-taxed income" or "GILTI" in respect of CFCs. The GILTI of any CFC does not include income of the CFC that is included by a 10% U.S. Shareholder on a pass-through basis. All of the income of a typical corporate CLO that is a CFC would be includible on a pass-through basis by a 10% U.S. Shareholder. As a result, the GILTI provisions should not impact corporate CLOs.

[28] Application to OID is delayed until 2019.

[29] For this purpose, we mean receivables in respect of which the goods have been delivered or the services have been performed, as applicable, and that do not bear stated interest.

[30] *See* also Code §§483 or 1274. These rules generally consist of trade receivables issued for the sale of property (not the performance of services) and for which payments are due more than 183 days from the issuance date.

[31] Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at 507.

[32] In addition, subject to any applicable limitations, corporate United States shareholder may take into account available foreign tax credits associated with a deemed dividend under Code §956.

[33] *See* Code §959(c).

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