

## Onshore CLOs May Make Sense For Insurer Investors

By **Jason Schwartz, Gregg Jubin and Danielle Katz** (March 10, 2020, 4:49 PM EDT)

U.S. insurer investment in collateralized loan obligations, or CLOs, has increased steadily over the past several years and totaled approximately \$122 billion in book/adjusted carrying value as of the end of 2018.[1]

CLOs are an attractive investment for many U.S. insurers because they typically pay a higher return than more traditional similarly rated investments. Also, by issuing multiple classes of notes with different seniorities and payment characteristics, CLOs let U.S. insurers tailor their investments to their own risk profiles.

One downside for U.S. insurers considering a CLO investment is that U.S.-managed CLOs typically are organized in the Cayman Islands. U.S. insurers prefer to use their limited foreign-investment buckets to acquire even higher yielding assets.

Historically, Cayman-domiciled CLOs have organized U.S. subsidiaries to co-issue certain notes, and some U.S. insurers have treated these co-issued notes as U.S. obligations. However, because a co-issuer has no material assets or income, it is unclear whether co-issued notes would in fact be viewed as U.S. obligations.

So, why not organize more CLOs in the U.S.? CLOs that invest primarily in middle-market loans, or MML CLOs, often are organized in the U.S. However, the vast majority of CLOs, which invest in broadly syndicated commercial loans, or BSL CLOs, typically are organized in the Cayman Islands. Moving BSL CLOs onshore would prevent their securities from counting against U.S. insurers' foreign investment buckets while decisively eliminating the need for a co-issuer.

### What is a CLO?

CLOs are actively managed special purpose vehicles that issue securities mainly to institutional investors, invest the proceeds primarily in commercial loans and reinvest principal payments for a specified reinvestment period. Interest (and, after the reinvestment period, principal) received by CLOs on their assets is used to pay interest and principal on the rated securities that they issue.

For U.S. tax purposes, CLOs treat their senior securities as debt and their most junior class (which bears



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the first risk of any losses but also has the most significant potential upside) as equity.

### **Are There Downsides to U.S. Domiciliation?**

The sole nontax downside to organizing a BSL CLO in the U.S. is that foreigners will have to represent that they are qualified purchasers within the meaning of the Investment Company Act of 1940. The few potential tax downsides can easily be avoided.

#### ***Qualified Purchasers***

BSL CLOs historically have not required foreigners to represent that they are qualified purchasers. By contrast, foreigners investing in a U.S.-domiciled BSL CLO generally would need to represent that they are qualified purchasers. This will not be a novel concept for foreigners that already invest in MML CLOs, which, as mentioned above, frequently are U.S.-domiciled.

#### ***Potential Tax Downsides***

The U.S. imposes entity-level tax on U.S.-domiciled corporations, so U.S.-domiciled BSL CLOs generally will need to be treated as partnerships for U.S. tax purposes.

There are actually several potential tax benefits to organizing a CLO as a partnership.[2] Any potential downsides are limited to certain types of equity investors and can be easily resolved by introducing an income note issuer into the structure.

An income note issuer is a Cayman Islands feeder fund that is treated as a corporation for U.S. tax purposes, holds CLO equity, and issues income notes backed by the CLO equity. The income notes are treated as equity in the income note issuer for U.S. tax purposes.

#### ***Delivery of K-1s***

Domestic partnerships have to deliver a Schedule K-1 annually to each equity investor to report the investor's share of the partnership's tax items, even if the investor does not, itself, need to file a U.S. tax return.

Arrangers of U.S.-domiciled BSL CLOs should consider preparing explanatory materials for prospective foreign equity investors to assure them that the receipt of a Schedule K-1 will not, in and of itself, impose any U.S. tax filing obligations on them.

Alternatively, if foreigners remain reluctant to receive a Schedule K-1, then they can invest in the CLO equity through an income note issuer. The CLO will issue a Schedule K-1 to the income note issuer, but the income note issuer is not required to pass the Schedule K-1 on to foreigners.

#### ***Deduction Limitations***

Expenses of a BSL CLO that is treated as a partnership for U.S. tax purposes flow through to U.S. equity holders, but U.S. individuals are subject to limitations on their ability to deduct their share of management fees and interest expense paid by the CLO. By contrast, under the regimes applicable to U.S. equity holders of foreign corporate CLOs (such as most BSL CLOs to date), the CLO's expenses are deducted against its earnings each year, without limitation, in determining the amounts that the U.S.

holders are required to include in income on a flow-through basis. Accordingly, some U.S. individuals might prefer to invest in U.S.-domiciled BSL CLO equity through an income note issuer.

### *Unrelated Business Taxable Income*

Universities, foundations, pension funds and other tax-exempt organizations generally are not taxed on income earned from their tax-exempt activities, but are taxed at regular corporate rates on their unrelated business taxable income, which generally includes income or gain from debt-financed investments.

If a tax-exempt organization invests in the equity of a partnership that borrows money to make investments (such as a U.S.-domiciled BSL CLO that issues notes to finance its purchase of commercial loans), its allocable share of income or gain from the partnership's debt-financed investments generally will be unrelated business taxable income.

By contrast, investing in equity of a corporation does not give rise to unrelated business taxable income for a tax-exempt organization. Accordingly, tax-exempt organizations might prefer to invest in U.S.-domiciled BSL CLO equity through an income note issuer.

### *Theoretical Trade or Business Risk*

The IRS asserts that regularly lending money through a U.S. agent (such as a CLO's U.S. collateral manager) is a U.S. trade or business for U.S. tax purposes. Foreign equity investors in partnerships that are engaged in a U.S. trade or business are subject to U.S. income tax.

BSL CLOs acquire loans only on the secondary market, and receive tax opinions to the effect that they will not be engaged in a U.S. trade or business.

However, if prospective foreign equity investors still are nervous about any theoretical U.S. tax risk, they can invest in the CLO's equity through an income note issuer, which effectively blocks foreigners from directly incurring any U.S. tax liability if the IRS does successfully assert that the CLO is engaged in a U.S. trade or business. If the CLO is engaged in a U.S. trade or business, the income note issuer would, itself, bear any resulting tax liability.

### **Additional Reasons for U.S. Domiciliation**

There are two other reasons why U.S. domiciliation might make sense. First, it is less expensive to organize an entity in the U.S. than in the Cayman Islands (although, as noted above, some equity investors might still want to invest through a Cayman-domiciled income note issuer).

Second, Europe recently added the Cayman Islands to its blacklist of noncooperative tax jurisdictions. Although this development does not have any immediate impact for Cayman-domiciled CLOs, it might make prospective European Union investors more amenable to investing in U.S.-domiciled issuers.

### **Closing Thoughts**

Deviations from the status quo in capital markets transactions tend to cause hand-wringing. But in the case of BSL CLOs, the status quo of using Cayman-domiciled issuers could limit U.S. insurers' ability to invest. Why accept this limitation when an alternative structure is readily available?

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[1] National Association of Insurance Commissioners, U.S. Insurance Industry's Exposure to Collateralized Loan Obligations as of Year-End 2018 (July 2019), available at [https://www.naic.org/capital\\_markets\\_archive\\_index.htm](https://www.naic.org/capital_markets_archive_index.htm); see also Advisor Magazine, In Search of Yield, U.S. Insurers Boost Investments in CLOs (June 17, 2019) (quoting a Moody's vice president's statement that "U.S. life insurers added \$45 billion of gross CLO investments in 2018 and buying continues into 2019."), available at <https://www.lifehealth.com/search-yield-u-s-insurers-boost-investments-clos>.

[2] See Jason Schwartz & David S. Miller, 6585 T.M., Collateralized Loan Obligations, at I.B.