Making the Most of Distressed Collateralized Loan Obligations

by Jason Schwartz

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In this article, the author describes how an investor can make the most out of a collateralized loan obligation issuer that becomes distressed as a result of economic fallout stemming from the COVID-19 pandemic.

The COVID-19 pandemic has created significant headwinds for commercial loans.[1] An acceleration of borrower defaults on those loans increases the likelihood of a downward spiral for some issuers of collateralized loan obligations (CLOs), which are major investors in commercial loans. Defaults and ratings downgrades on the loans can cause a CLO to flunk the overcollateralization test that typically applies to its most senior class of rated notes, or to miss a scheduled interest payment on either of its two most senior classes. Those failures can trigger an event of default under the CLO's indenture, which can empower a majority or supermajority of the CLO's controlling class (typically, the most senior outstanding class) to direct an acceleration of the rated notes.

But crisis also brings opportunity. A CLO with built-in losses can be an attractive springboard for new investment, even if an event of default has occurred under the CLO's indenture. Not only might a talented collateral manager be able to build value in the CLO by working out the CLO's historic assets, but the CLO might be able to use losses on any sales of those historic assets to offset current taxable income.

This article describes one approach that Investor, a U.S. taxpayer, might use to get the most out of a distressed CLO. Very generally, under this strategy, Investor acquires the CLO's equity interests with the expectation of causing the CLO to work out its historic assets and acquire new income-producing assets, and times any sales of the CLO's historic assets so that losses recognized on the sales offset income on the new assets.

If the CLO were a domestic corporation or a partnership, section 382 or 743, respectively, would all but eliminate Investor's ability to use the CLO's built-in losses. As discussed in Section III.C, section 382 limits the amount of net operating losses and built-in losses a corporation can use after undergoing an ownership change. Section 743 requires a partnership to step down the basis of its assets to fair market value on a transfer of the partnership's equity interests if, immediately after the transfer, the transferee would be allocated a loss of more than $250,000 on a sale of the partnership's assets at FMV. But CLOs typically are organized as foreign corporations, and as long as Investor has a sufficient nontax business purpose for acquiring a foreign corporate CLO, no provision appears to limit Investor's ability to reduce its income inclusions under the passive foreign investment company and controlled foreign corporation rules when the CLO recognizes built-in losses.

[1] Paul J. Davies and Cezary Podkul, "Struggling Corporate Borrowers Raise Risks in Loans Funds," *The Wall Street Journal*, May 22, 2020; Podkul and Davies, "Financial Engineering Made Risky Loans Seem Safe. Now They Face a Huge Test," *The Wall Street Journal*, Mar. 20, 2020; and Matt Wirz and Nick Timiraos, "The Next Coronavirus Financial Crisis: Record Piles of Risky Corporate Debt," *The Wall Street Journal*, Mar. 19, 2020.

I. Step-by-Step Strategy

Investor's strategy entails the following steps:

- *Step 1: Due Diligence*. Investor determines the distressed CLO's value, taking into account its built-in losses.
- *Step 2: Acceleration and Asset Sale*. Investor acquires the controlling class of the distressed CLO's notes and causes the CLO's indenture trustee to declare an acceleration event if one has not already been declared. Investor then directs the trustee to auction off the CLO's assets and apply any proceeds to the repayment of any principal and interest owing on the CLO's rated notes. Investor successfully bids to acquire the CLO's assets, using for its bid a combination of cash and amounts owed to Investor on the CLO notes that it holds. The trustee applies the proceeds of the bid to pay down the CLO's notes sequentially. Any CLO notes that remain outstanding are canceled, and the indenture is discharged under its terms.
- *Step 3: Equity Acquisition*. Investor directs the CLO not to transfer its assets to Investor, but instead arranges for the CLO's ordinary shareholder (which, typically, is a Cayman Islands fiduciary institution) to transfer the CLO's ordinary shares to Investor.
- *Step 4: Subsidiary Formation*. Before the end of the year in which the CLO's notes are canceled, Investor (now the CLO's sole equity holder) causes the CLO to form a Cayman Islands subsidiary treated as a corporation for U.S. tax purposes and to contribute all the CLO's assets to the subsidiary. The CLO and subsidiary jointly elect for the subsidiary to take a carryover basis in the assets, and for the CLO's basis in the subsidiary's equity interests to be limited to the FMV of those assets.
- *Step 5: Workout and Sale of Loss Assets; Acquisition of Income-Producing Assets*. Investor contributes cash to the CLO, which in turn contributes the cash to the subsidiary. The subsidiary uses the cash to acquire income-producing assets. The subsidiary also tries to work out its historic assets. If the subsidiary sells any historic assets, it may arrange the sales so that any losses on the sales offset income on the income-producing assets. As a result, Investor's income inclusions from the CLO are minimized. By contrast, if Investor had acquired and held the income-producing assets directly, it would have been subject to tax on all the income, even if it had separately held the CLO's equity interests.

The roadmap, while superficially straightforward, is riddled with practical and legal complexities. Taxpayers considering the strategy should be prepared for extensive negotiations with the CLO's indenture trustee, ordinary shareholder, and possibly other parties, and should appreciate that aspects of the strategy may be subject to IRS challenge.

II. CLO Basics

A. Overview

CLOs are actively managed special purpose vehicles that issue notes 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 sequentially pay interest and principal on the notes they issue.[2]

Most CLOs (including those discussed in this article) are treated as foreign corporations for U.S. tax purposes and take measures to ensure that they are not treated as engaged in the conduct of a U.S. trade or business and therefore are not subject to U.S. net income tax.

CLOs treat their rated notes as debt and their most junior class of notes (or subordinated notes) as equity for U.S. tax purposes for as long as they are outstanding. The subordinated notes are unrated and represent the CLO's economic equity. They bear the first risk of economic loss on the CLO's assets, and their right to receive payments is junior to that of the rated notes. The subordinated notes also benefit from investment returns on the CLO's assets after the CLO pays all interest and principal on the rated notes. The

[2] For a comprehensive discussion of CLOs, see Jason Schwartz and David Miller, "Collateralized Loan Obligations," *Tax Management Portfolio* 6585 (2018).

subordinated notes do not entitle holders to vote for directors but, as a practical matter, the directors do not make any decisions that affect the economic affairs of the CLO. The subordinated noteholders can (by majority or supermajority) cause the CLO to redeem the rated notes in whole or in part by class, effect a refinancing or re-pricing, issue additional securities, declare a tax event, remove the collateral manager for cause, and appoint a new collateral manager.

CLOs also issue ordinary shares to a Cayman Islands fiduciary institution. While nominally the CLO's equity, the shares do not entitle the holder to receive any material distributions from the CLO for as long as the subordinated notes are outstanding. The holder may be entitled to elect the CLO's directors but, in practice, the directors usually are selected by a corporate services provider that provides administrative services to the CLO.

Accordingly, for as long as the subordinated notes remain outstanding, U.S. tax practitioners typically ignore the ordinary shares as a class of interests in the CLO. However, if all rated and subordinated notes are canceled or redeemed, then the ordinary shares, as the sole outstanding interests in the CLO, should be treated as the CLO's equity for U.S. tax purposes.

B. PFIC and CFC Regimes

Because substantially all their taxable income consists of interest collections on the loans they hold (and, during their reinvestment period, gain on loan sales), CLOs are treated as PFICs.[3]

The PFIC provisions were enacted in 1986 to prevent U.S. taxpayers from deferring tax recognition on stocks, securities, and other passive assets by holding those assets in a corporation organized in a tax haven. Under the PFIC provisions, if a U.S. taxpayer owns stock in a PFIC, any gain on the sale of the PFIC stock is subject to tax at ordinary income rates (instead of capital gains rates) and the U.S. taxpayer is subject to an interest charge on the gain and excess distributions, unless the U.S. taxpayer makes an election to treat the PFIC as a qualified electing fund.[4] If a U.S. taxpayer makes a QEF election, it is subject to U.S. income tax on its pro rata share of the PFIC's ordinary income and net capital gain (whether or not it actually receives distributions), up to the amount of the PFIC's earnings and profits (calculated using U.S. tax principles).[5] Subsequent distributions by the PFIC are treated first as previously taxed income and are not taxed to the extent of the taxpayer's previous QEF inclusions.[6]

CLOs are always PFICs, and virtually all U.S. equity holders in a CLO make QEF elections unless the CLO is a CFC and the holders are 10 percent U.S. shareholders of the CLO. The CFC rules supersede the PFIC rules when both apply.[7]

The tax consequences to a CLO's U.S. equity holders that are subject to the CFC rules are substantially similar to the tax consequences to a U.S. equity holder that has made a QEF election and is not subject to the CFC rules. The principal difference is that an individual U.S. equity holder that has made a QEF election and is not subject to the CFC rules receives long-term capital gain treatment on loans the CLO sells at a gain after holding them for more than one year, whereas an individual U.S. equity holder that is subject to the CFC rules does not.

The CFC rules were enacted in 1962 to prevent U.S. taxpayers from deferring their U.S. tax through controlled corporations that hold stocks, securities, and other passive assets. Very generally, the CFC rules require each U.S. person that directly or indirectly owns at least 10 percent of a foreign corporation's stock, by vote or value, at any time during the tax year to include its pro rata share of the CFC's subpart F income as ordinary income. Subsequent distributions by the CFC are treated first as previously taxed income and are not taxed to the extent of the taxpayer's previous subpart F inclusions.[8] The CFC rules also

[3] *See* section 1297(a); Notice 88-22, 1988-1 C.B. 489.

[4] Section 1291.

[5] Section 1293(a), (e).

[6] Section 1293(c).

[7] Section 1297(d).

[8] Section 959.

generally characterize gain recognized by any 10 percent U.S. shareholder on the disposition of CFC stock as ordinary income to the extent of the shareholder's share of the CFC's previously untaxed E&P.[9]

A 10 percent U.S. shareholder is a U.S. person that directly, indirectly, or constructively (applying attribution rules) owns at least 10 percent of the total combined voting power of all classes of a foreign corporation's voting stock or at least 10 percent of the total value of shares of all classes of the corporation's stock.[10] A foreign corporation is a CFC if in the aggregate, 10 percent U.S. shareholders directly, indirectly, or constructively own more than 50 percent of either the total combined voting power of all classes of the CFC's voting stock or the total value of the CFC's stock.[11]

Subpart F income includes foreign personal holding company income (FPHCI), which in turn includes interest, capital gains from the disposition of property that gives rise to interest, and similar passive income.[12] All of a CFC's income for a tax year is treated as subpart F income if the CFC's gross FPHCI exceeds 70 percent of its gross income for the tax year.[13] Because substantially all of a CLO's income consists of FPHCI, all of its income is subpart F income. However, a 10 percent U.S. shareholder's subpart F income inclusions are limited to the CFC's E&P.[14]

Under both the PFIC and CFC rules, losses do not flow through to U.S. taxpayers on a current basis and cannot be used by the CLO to offset income and gains from other years. Instead, any annual net losses recognized by the CLO generally are trapped in the CLO until a U.S. taxpayer disposes of its equity interests, at which point the taxpayer recognizes more capital loss (or less capital gain) than it otherwise would have.

[9] Section 1248.

[10] Section 951(b).

[11] Section 957(a).

[12] Section 952(a)(2); section 954(a)(1); section 954(c)(1).

[13] Section 954(b)(3)(B); reg. section 1.954-1(b)(1)(ii).

[14] Section 952(c)(1)(A); reg. section 1.952-2(c).

III. Applying the Investor's Strategy

A. Step 1: Due Diligence

1. Valuing the CLO

The value to Investor of acquiring a distressed CLO is contingent on the viability of turning around some of the CLO's assets and the value of the built-in losses inherent in the assets. The first factor falls outside the purview of tax law. The second factor depends on the CLO's basis in its assets and the assets' values when the CLO ultimately disposes of them.

To illustrate, assume the CLO originally issued \$10 of subordinated notes and \$90 of rated notes and used the proceeds to acquire a \$100 pool of loans. The pool is now worth \$12, so Investor should expect an outlay of approximately \$12 to acquire the CLO. If the CLO's basis in the pool of loans is still \$100 and the effective rate is 21 percent, the value of the CLO's built-in losses to Investor, before the CLO engages in any workout activities, is approximately \$18.48 (\$100 basis minus the pool's \$12 current value, multiplied by the 21 percent rate). Any subsequent workout activities that increase the value of the CLO's assets also reduce the CLO's built-in losses. Here, each \$1 of appreciation in the value of a loan would reduce the utility of the CLO's built-in losses by \$0.21 (\$1 * 0.21).

As loan defaults mount, a CLO might be required to write down some of the loans it holds. Any write-down could reduce income inclusions for the CLO's U.S. equity holders under the PFIC or CFC rules, but would make the CLO less valuable to Investor, because more write-downs during the CLO's lifetime result in fewer losses available to take later.

2. Loan Write-Downs

Sections 165(g) and 166 govern loan write-downs, and which section applies depends on the nature of the loan. Section 165(g) generally imposes a more stringent standard for loan write-downs than section 166, because it requires identifiable events to establish worthlessness.

Section 165(g) applies to worthless securities, and broadly defines securities to include any evidence of indebtedness that is issued by a corporation and is in registered form. Syndicated corporate loans of the type that CLOs acquire are always in registered form. Accordingly, section 165(g) should apply to loans held by a CLO that are issued by a corporation. If the loans instead are issued by an entity treated as a partnership for U.S. tax purposes, section 166 should apply.[15]

Under section 165(g), if a security held as a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from a sale or exchange on the last day of the tax year. Reg. section 1.165-1(b) provides that to be deductible under section 165, a loss must be evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the tax year. The deemed sale or exchange in section 165(g) appears to satisfy the requirement for a completed transaction. Identifiable events are events that limit or destroy the potential value of the securities,[16] such as a cessation of business operations when the debtor's insolvency renders current repayment impossible.[17] A mere decline in market value is not in and of itself an identifiable event.[18] Although some courts have found stock to be worthless despite the absence of a clearly identifiable event, in exceptional cases in which there is no reasonable hope and expectation of any future value recovery, proving complete worthlessness of debt should not be possible if the debtor continues to have any value or potential value.[19]

Like section 165(g), section 166(a)(1) provides a deduction for debt that becomes worthless during the tax year. However, unlike section 165(g), section 166 does not require an identifiable event to establish worthlessness. Instead, when applying section 166, courts generally have applied a facts and circumstances analysis to determine whether a taxpayer is justified in abandoning hope of recovery.[20] Relevant factors include the value of any collateral securing the debt and the financial condition of the debtor. Section 166 also allows a deduction for partial worthlessness if the taxpayer charges off the loan's uncollectible amount on its books and records and the IRS is satisfied that the debt is recoverable only in part.[21] In practice, CLOs usually do not take partial write-downs, probably because of the high burden of proving partial worthlessness.[22]

The deductions for wholly worthless debts under sections 165(g) and 166 are not elective — that is, a sale for $0 will not give rise to a deductible loss if the loan was required to have been fully written down under section 165(g) or 166 in an earlier year. Accordingly, before acquiring a distressed CLO, Investor should assess the viability of working out its assets. It should also try to ascertain whether the CLO has recognized losses under section 165(g) or 166, as well as the risk of the IRS successfully asserting that the CLO should have taken losses under one of those sections in earlier tax years. In practice, it might be difficult for Investor to obtain that information before it owns the CLO.

B. Step 2: Acceleration and Asset Sale

1. Event of Default

Typically, an event of default under the CLO's indenture occurs if either the aggregate principal amount of the CLO's assets, divided by the outstanding principal amount of the CLO's most senior class of rated notes, is less than 102.5 percent on any monthly measurement date, or the CLO fails to pay interest on either of its two most senior classes of rated notes on any quarterly payment date. For the first test, the principal amount of any defaulted loans and any loans over a specified percentage of the CLO's assets (typically 7.5 percent) that are rated CCC+/Caa1 or below is subject to a haircut, so that an increase in loan defaults or downgrades makes it harder to pass the test.

After an event of default, a majority or supermajority of the CLO's controlling class can direct the trustee to accelerate the maturity of all

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[15] *See* section 166(e); *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 189 (1934).

[16] *Morton v. Commissioner*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

[17] *Goldberg v. Commissioner*, T.C. Memo. 1970-27.

[18] Reg. section 1.165-5(f).

[19] *See, e.g.*, *Morton*, 38 B.T.A. 1270; *Steadman v. Commissioner*, 50 T.C. 369 (1968); *Richards v. Commissioner*, T.C. Memo. 1959-64; *Bilthouse v. United States*, 553 F.3d 513 (7th Cir. 2009). *See also Brown v. Commissioner*, T.C. Memo. 1988-174.

[20] *See, e.g.*, *Cole v. Commissioner*, 871 F.2d 64 (7th Cir. 1989).

[21] *See, e.g.*, *Findley v. Commissioner*, 25 T.C. 311, 318 (1955), *aff'd per curiam*, 236 F.2d 959 (1956).

[22] *See, e.g.*, *Record Wide Distributions Inc. v. Commissioner*, 682 F.2d 204, 207 (8th Cir. 1982); *Brimberry v. Commissioner*, 588 F.2d 975 (5th Cir. 1979).

the CLO's rated notes. Once all principal and interest on the rated notes is declared due and payable, a majority or supermajority of the CLO's controlling class can further direct the trustee to conduct a sale of the CLO's assets; apply the proceeds to paying the rated notes; and discharge the indenture, canceling any notes that are then still outstanding.

2. Canceling Rated Notes

The tax consequences to a CLO of canceling its rated notes for an amount less than their principal amount depends on whether the rated notes are treated as recourse or nonrecourse debt for U.S. tax purposes. CLO indentures describe the rated notes as nonrecourse obligations, but the code does not define recourse and nonrecourse.

For U.S. tax purposes, a recourse liability commonly is understood to impose personal liability on the obligor, whereas a nonrecourse liability provides creditors with recourse only to specified assets.[23] Under those definitions, a CLO's rated notes are recourse obligations because the noteholders have recourse to all of the CLO's assets on an event of default (because the CLO does not own any assets other than those specified in the CLO's indenture). However, the matter is not free from doubt.

If the rated notes are recourse debt, the CLO will recognize cancellation of debt (COD) income on canceling them.[24] Although COD income ordinarily would be taxed to the CLO's equity holders at ordinary income rates, section 108(b) provides that an insolvent taxpayer (such as the CLO) is not required to recognize COD income if the face amount of its outstanding debt exceeds the FMV of its assets immediately before cancellation. Instead, under section 108(b)(2)(E), the taxpayer is required to reduce its tax basis in its property by the amount of its COD income.[25]

By contrast, if the rated notes were nonrecourse debt obligations, the CLO would recognize gain in an amount equal to the difference between the face amount of the discharged notes and the amount paid to discharge the notes.[26] That gain would be taxed to the CLO's equity holders when recognized, and could not be excluded under section 108(b).

C. Step 3: Equity Acquisition

If the CLO transfers its assets to Investor under the asset sale conducted in step 2, Investor's basis in the assets would be stepped down to their FMV. To ensure the assets retain their high basis, Investor must acquire the CLO's equity interests instead of acquiring the assets. Because all of the CLO's notes (including the subordinated notes) are canceled when the CLO's indenture is discharged, the CLO's ordinary shares, as the only outstanding interests in the CLO, are the CLO's U.S. tax equity after the discharge.

Section 382 limits the amount of NOLs and built-in losses a corporation can use after an ownership change. An ownership change generally occurs if the amount of the corporation's stock owned by 5 percent shareholders increases by more than 50 percent over a rolling three-year period. The section 382 limitation generally is the value of the corporation's stock immediately before the ownership change multiplied by the highest long-term applicable federal rate in effect during the three-month period ending with the calendar month in which the ownership change occurs. The value of a foreign corporation that does not have any income effectively connected with a U.S. trade or business (such as a CLO) is deemed to be $0.

By limiting the amount of built-in losses and NOLs a corporation can use after an ownership change, section 382 largely eliminates solely tax-motivated acquisitions of domestic and foreign loss corporations that are engaged in a U.S. trade or business. However, section 382 appears not to limit a corporation's ability to reduce its E&P by recognized built-in losses, even after an ownership change.

Neither the code nor the regulations directly define E&P, but the term is understood to "approximate a corporation's power to make distributions which are more than just a return of

[23] *See Commissioner v. Tufts*, 461 U.S. 300, 302 (1983); reg. section 1.752-1(a)(2).

[24] *See* section 61(a)(11).

[25] *See infra* Section III.D.

[26] *Tufts*, 461 U.S. 300; section 7701(g); reg. section 1.1001-2.

investment."[27] Reg. section 1.312-6(a) provides that the amount of E&P depends on the method of accounting properly used in computing taxable income. It is unlikely that section 382 represents a method of accounting for this purpose because the regs refer only to the cash, accrual, and installment methods. When Congress has intended to preclude a loss from reducing E&P, it has done so expressly.[28] Any other losses generally reduce E&P, despite limitations on their tax deductibility.[29]

As discussed, U.S. equity holders of CLOs are subject to either the PFIC or CFC rules, and a U.S. taxpayer's income inclusions for a PFIC or CFC are limited to the entity's E&P. Because section 382 appears not to prevent a CLO from reducing its E&P after an ownership change, it also appears not to preclude the CLO from reducing its U.S. equity holders' QEF or subpart F inclusions by recognizing built-in losses, even if the built-in losses are attributable to periods before the ownership change.

D. Step 4: Subsidiary Formation

As noted, if a CLO's rated notes are treated as recourse obligations for U.S. tax purposes, then under section 108(b)(2)(E), the CLO is required to reduce its tax basis in its property (but not below zero) by the amount of COD income that its equity holders can exclude as a result of its insolvency. The basis reduction is effective at the beginning of the tax year following the tax year in which the discharge occurs.[30] A reduction of the CLO's basis in its loss-producing assets under section 108(b)(2)(E) would significantly reduce the CLO's built-in losses.

The CLO can avoid that by contributing the assets to a newly formed Cayman Islands subsidiary before the basis reduction becomes effective, as long as the contribution is respected as tax free under section 351. Section 362(e) generally steps down the tax basis of any built-in loss property contributed to a subsidiary in a contribution described in section 351. However, under section 362(e)(2)(C) and reg. section 1.362-4(d), the contributor and contributee can instead jointly elect for the contributor's basis in contributee stock it receives in the contribution to be limited to the FMV of the contributed assets. The CLO and its subsidiary would make that election, with the subsidiary taking a high carryover basis in the assets contributed to it.

The IRS consistently asserts that to be tax-free under section 351, a contribution must have a valid business purpose.[31] (It has not always been successful in that assertion.[32]) Arguably, the CLO's contribution of assets to a new subsidiary segregates them from the CLO's historic business, thereby reducing the risk that the CLO's historic creditors could assert a claim over the assets.[33]

E. Step 5: Loss and Income-Producing Assets

1. Loan Modifications

As noted, CLOs take measures to ensure that they are not treated as engaged in the conduct of a U.S. trade or business. Under section 864(b)(2)(A)(ii), a CLO that is not a dealer is not treated as engaged in a U.S. trade or business as a result of trading in stocks and securities for its own account, even if the trading is effected by a collateral manager with discretionary authority to act from within the United States on behalf of the CLO. However, that safe harbor apparently is unavailable to a foreign person (such as a CLO) that makes loans to the public.[34] Accordingly, to satisfy the safe harbor, CLOs are subject to various restrictions intended to ensure that any purchase of a loan by U.S. management personnel on a CLO's behalf is clearly a secondary market transaction instead of an origination.

Under reg. section 1.1001-3, a significant modification of a loan is treated as a retirement of

[27] *Henry C. Beck Co. v. Commissioner*, 52 T.C. 1, 6 (1969), *aff'd per curiam*, 433 F.2d 309 (5th Cir. 1970).

[28] *See, e.g.*, section 312(f); section 312(n)(1).

[29] *See, e.g.*, prop. reg. section 1.163(j)-4(c)(1); reg. section 1.312-7(b)(1); IRS Form 5452, "Worksheet for Figuring Current Year Earnings and Profits"; Rev. Rul. 75-515, 1975-2 C.B. 117; Rev. Rul. 63-63, 1963-1 C.B. 10.

[30] Section 1017(a); reg. section 1.1017-1(a).

[31] *See, e.g.*, Rev. Rul. 60-331, 1960-2 C.B. 189; FSA 200224011; FSA 200134002; FSA 200121013.

[32] *See generally* Howard Rothman et al., "Transfers to Controlled Corporations: Related Problems," *Tax Management Portfolio* 759, at IV.B (2014).

[33] *Cf.* LTR 200251016; LTR 200252096; and LTR 200315028 (respecting the use of a wholly owned foreign corporation by a tax-exempt organization to avoid unrelated business taxable income when the foreign corporation provided an added layer of limited liability).

[34] AM 2009-010.

the pre-modified loan in exchange for a newly issued loan. The new loan that is deemed to arise on a significant modification is potentially an origination that could jeopardize a CLO's ability to rely on section 864(b)(2)(A)(ii), especially if the CLO had acquired the loan expecting to work it out.[35]

Even so, most tax practitioners allow a CLO to participate in a loan workout if, at acquisition, the loan was performing and the CLO did not expect the loan to default, but the loan subsequently defaulted (or default became imminent) and the workout was necessary to protect the CLO's investment. Those types of workouts are typical byproducts of being an investor, and do not give rise to a customer relationship reflective of a U.S. trade or business.[36] Similarly, many tax practitioners are fine with a CLO advancing additional funds to a borrower in connection with a workout, as long as the advance also is made to protect the CLO's investment.

The same analysis arguably should apply to workouts effected by a subsidiary that acquires loans from the CLO in step 5, as long as the acquisition is treated as a tax-free contribution by the CLO to the subsidiary under section 351. Although the subsidiary acquires the loans from the CLO with the expectation of working them out, the CLO acquired the loans without that expectation. The subsidiary's acquisition is not pursuant to a taxable disposition, so the loans arguably retain their character as investments in the subsidiary's hands under section 864(b)(2)(A)(ii) (just as they retain their built-in investment gains or losses). However, that conclusion is not doubt-free.

Even if a CLO subsidiary satisfies section 864(b)(2)(A)(ii), it still will be treated as engaged in a U.S. trade or business if it invests in a partnership that itself is engaged in a U.S. trade or business, or if it disposes of a U.S. real property interest.[37] Accordingly, if a workout might require the subsidiary to take possession of those types of equity securities, the subsidiary may prefer to first contribute the loan to a blocker corporation, which would bear any consequent filing and payment obligations.

2. Acquisitions and Sales

The CLO subsidiary must continue to satisfy section 864(b)(2)(A)(ii) when acquiring new assets. For example, if the subsidiary acquires loans, it generally must ensure that those acquisitions are secondary market transactions instead of originations.

To enable the CLO subsidiary to acquire new assets, Investor likely would contribute cash to the CLO, which in turn would contribute the cash to the subsidiary. If Investor wishes to contribute assets other than cash, it should be mindful that it will be required to recognize any built-in gain in the contributed assets on the contribution.[38]

IV. Potential Application of Antiabuse Rules

A. Substance Over Form

The tax consequences of a transaction often are determined based on substance rather than legal form. On that basis, could the IRS successfully assert that the CLO transferred its assets to Investor in step 3 and Investor subsequently contributed the assets back to the CLO? If so, the assets would have a stepped-up basis after their deemed contribution back to the CLO.

Substance-over-form considerations permeate the case law on whether a transfer of ownership has occurred. In general, a sale of property occurs for U.S. tax purposes when the benefits and burdens of ownership are transferred from the

[35] *Cf. Whipple v. Commissioner*, 373 U.S. 193 (1963) (the development of corporations as doing businesses for sale to customers in the ordinary course could give rise to a U.S. trade or business because "there is compensation other than the normal investor's return, income received directly for his own services rather than indirectly through the corporate enterprise").

[36] *Cf.* Rev. Rul. 73-460, 1973-2 C.B. 424 (grantor trust did not impermissibly vary its investments by selling an obligation for which the issuer was in default or default in the reasonably foreseeable future was likely); *Kelly v. Patterson*, 331 F.2d 753, 755 (5th Cir. 1964) (multiple loans by shareholder to distressed corporation to protect shareholder's investment did not give rise to a trade or business and therefore could not be deducted as business bad debts under section 166).

[37] Sections 875, 897.

[38] *See* section 367(a)(1).

seller to the buyer.[39] Although that standard is amorphous, it appears to support a conclusion that Investor does not directly acquire the CLO's assets: Legal title to the assets never passes from the CLO to Investor; the parties treat the transaction as a sale of the CLO's equity interests; and the CLO continues at all times to be entitled to profits and losses of the assets.[40]

Moreover, when the IRS does successfully recast a transaction under substance-over-form principles, it generally does so by collapsing a multistep transaction into its simplest form.[41] Characterizing a transfer of CLO equity to Investor as instead an asset sale by the CLO to Investor, a sale of the CLO's equity interests to Investor, and Investor's contribution of the assets back to the CLO arguably would be incongruous with that approach.

B. Section 269

Under section 269, if the principal purpose of any person's acquisition of control over a corporation is the evasion or avoidance of U.S. tax by securing a deduction, credit, or other allowance that the person would not otherwise enjoy, the IRS may deny it. For section 269 purposes, acquiring control over a corporation includes forming a new corporation.

Section 269 applies only when tax evasion or avoidance exceeds in importance any other purpose. Accordingly, as an initial matter, section 269 should not apply to Investor's acquisition of a CLO if Investor would have acquired the CLO even in the absence of its built-in losses.

Assuming the IRS successfully asserts that the principal purpose of Investor's acquisition is tax evasion or avoidance, there is still an argument that section 269 should not apply to change the calculation of the CLO subsidiary's E&P, even though that calculation affects Investor's QEF or subpart F inclusions.[42] Stated differently, despite section 269's potentially broad reach, the CLO subsidiary's calculation of its own E&P might not be an allowance secured by Investor under section 269.[43] A contrary conclusion could require the subsidiary to keep multiple tax books — one in which its E&P are calculated in accordance with section 312, and another in which reductions to E&P are denied in calculating Investor's pro rata share of E&P under the PFIC or CFC rules.

Moreover, read literally, section 269 applies only if the diminution of tax liability depends on the taxpayer's acquisition of control over the corporation.[44] The ability of a CLO or its subsidiary to reduce its E&P with losses recognized on historic assets does not depend on its equity holders' acquisition of control over it.

On the other hand, regulations provide that the other allowances that the IRS can deny under section 269 include "anything in the internal revenue laws which has the effect of diminishing tax liability," and the Joint Committee on Taxation has indicated that Congress assumed that section 269 could affect a foreign corporation's calculation of its E&P.[45] Accordingly, there remains a risk that a court could apply section 269 to increase Investor's QEF or subpart F inclusions unless Investor can show that its principal purpose was not tax evasion or avoidance.

C. Economic Substance Doctrine

If the economic substance doctrine is relevant to a transaction, the IRS may disregard the transaction unless it meaningfully changes the

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[39] *Frank Lyon Co. v. United States*, 435 U.S. 561, 571 (1978). *See also Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221, 1237-1238 (factors in determining whether benefits and burdens are transferred include whether legal title passes, how the parties treat the transaction, whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments, and which party receives the profits from the operation and sale of the property).

[40] *See id.*

[41] *See Grodt & McKay*, 77 T.C. at 1237; *cf.* section 1091 (generally disallowing losses on sales of stock and securities if the taxpayer acquires substantially identical assets within 30 days).

[42] *See, e.g., Siegel v. Commissioner*, 45 T.C. 566 (1966) (acq.); *Nutt v. Commissioner*, 39 T.C. 231 (1962) (acq.); *Modern Home Fire & Casualty Insurance Co. v. Commissioner*, 54 T.C. 839 (1970) (acq.); Rev. Rul. 76-363, 1976-2 C.B. 90; Rev. Rul. 70-238, 1970-1 C.B. 61; *Supreme Investment Corp. v. United States*, 468 F.2d 370 (5th Cir. 1972); and Rev. Rul. 70-223, 1970-1 C.B. 79.

[43] *See, e.g., Siegel*, 45 T.C. at 578; *Nutt*, 39 T.C. at 250; and *Alprosa Watch Corp. v. Commissioner*, 11 T.C. 240 (1948). *But see Commissioner v. British Motor Car Distributors Ltd.*, 278 F.2d 392, 394 (9th Cir. 1960) ("We should be closing our eyes to the realities of the situation were we to refuse to recognize that the persons who have acquired the corporation did so to secure for *themselves* a very real tax benefit to be realized by them *through* the acquired corporation and which they could not otherwise have realized" (emphasis in original).)

[44] *See, e.g., Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411, 417 (1948).

[45] JCT, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 972 (May 4, 1987).

taxpayer's economic position without regard to U.S. tax effects (the objective test) and the taxpayer has a substantial nontax purpose for entering into the transaction (the subjective test).[46] If the IRS successfully applies the economic substance doctrine to disregard the CLO's contribution of its historic assets to a subsidiary, then the CLO's basis in those assets would be stepped down to FMV under section 108(b)(2)(E) on the first day of the tax year following the CLO's cancelation of its notes.

Whether the economic substance doctrine is relevant to a transaction is determined under common law as if section 7701(o) had not been enacted. Legislative history provides that the doctrine is not intended to apply to some basic business transactions, such as "the choice to enter a transaction or series of transactions that constitute a corporate organization."[47]

Arguably, a CLO's transfer of assets to a newly formed subsidiary in a transaction described in section 351 is a basic business transaction. In any event, some tax practitioners believe that contributing assets to a new subsidiary following the discharge of the CLO's indenture satisfies the objective and subjective tests. They reason that the contribution segregates the assets from the CLO's historic business, thereby reducing the risk that the CLO's historic creditors could assert a claim over the assets.[48]

[46]Section 7701(o)(1).

[47]H.R. Rep. No. 111-443, at 296 (2010); JCT, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,'" JCX-18-10, at 97 (Mar. 21, 2010). The House report is based on an earlier proposal to codify the economic substance doctrine, and Congress did not write JCX-18-10. However, because the House report is the most recent legislative history regarding the doctrine's codification before the enactment of section 7701(o), and the JCT released JCX-18-10 before either chamber of Congress voted on the Healthcare and Education Reconciliation Act of 2010, both sources arguably are helpful in interpreting section 7701(o).

[48]*See supra* note 33. However, all those letter rulings predate the enactment of section 7701(o).

Moreover, when the IRS successfully applies the economic substance doctrine, the transaction generally is disregarded for all U.S. tax purposes, not recast as a different transaction.[49] So when the doctrine has applied to a series of transactions that include a transfer of property, the courts generally have either disregarded or respected the effects of the transfer in its entirety.[50] The doctrine therefore arguably should not constitute an appropriate antiabuse mechanism for a CLO's transfer of assets to a subsidiary, because disregarding the transfer would be incongruous with the nontax reality that following the transfer, the CLO no longer holds the assets.

The economic substance doctrine also arguably should not apply to tax elections because they inherently lack economic substance.[51] Accordingly, the doctrine arguably would not apply to the CLO and subsidiary's joint election under section 362(e)(2)(C) for the subsidiary to take a carryover basis in the contributed assets.

V. Conclusion

This article is written with the hope that its utility will be limited by global efforts to mitigate the severity of the COVID-19 pandemic's economic fallout. If that hope proves futile, the strategy described could help inject some needed liquidity into the capital markets. ■

[49]*See, e.g.*, *Coltec Industries Inc. v. United States*, 454 F.3d 1340, 1352 (Fed. Cir. 2006); *ACM Partnership v. Commissioner*, 157 F.3d 231, 261 (3d Cir. 1998); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993).

[50]*See, e.g.*, *Coltec*, 454 F.3d at 1360; *ACM Partnership*, 157 F.3d at 260-263.

[51]*See* Rev. Rul. 2003-125, 2003-2 C.B. 1243; H.R. Rep. No. 111-443.