Cross-border Tax Implications in the U.S. CLO Equity Investing by the Qualified Korean Investors*

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Abstract

On February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit held that U.S. managers of collateralized loan obligations (CLOs) are not required to retain a financial interest in the CLOs under the U.S. risk retention rules. In its decision, the court noted that CLOs are not susceptible to the moral hazard inherent in the "Originate to Securitize" model that Dodd-Frank was intended to curtail. CLOs are actively managed and their fee structure aligns the interests of the collateral manager with those of the investors by providing for payment of the significant management fees only after the CLO has paid off its debt and has achieved a specified hurdle rate of return on its equity tranche. The capitalized manager vehicle (CMV) structure facilitates this alignment of interests as well as the additional risk retention requirements. Tax leakage on the cash flowing from the underlying borrowers of the CLO's leveraged loans through the CLO issuer and into the hands of the noteholders can also occur at the level of payments by the CLO issuer, potentially decreasing their after-tax returns. We make comments about the Dodd-Frank risk retention issues in connection with the D.C. Circuit Court ruling and related

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impacts from the latest U.S. Tax Cuts and Jobs Act ("Tax Act") of 2017 in terms of tax compliances. We also discuss some various cross-border tax issues between Korea and the U.S. relevant to qualified Korean individual and institutional investors. While retaining their anonymity, Korean investors would rather avoid paying foreign taxes or at least entitled to the tax treaty benefits. A typical solution to this issue is to make Korean investors put their contribution through an offshore blocker corporate entity established primarily for non-U.S. investors. This offshore blocker corporation will ensure that the Korean investor's identity will not have to be disclosed to the U.S. tax authority, regardless of the outstanding FATCA rules.

Key words : *Collateralized Loan Obligations, Capitalized Manager Vehicle, Effectively Connected Income*

[1] Introduction

Traditionally alternative investment funds such as U.S. onshore hedge funds adopt a flow-through model of taxation to minimize entity level U.S. tax with applicable federal income taxes on investor level only. In a cross-border aspect, U.S. hedge funds and structured financial products continue structuring investments in a flow-through manner mainly concerned with anti-deferral regimes that may create additional tax and reporting burdens on the participating investors.

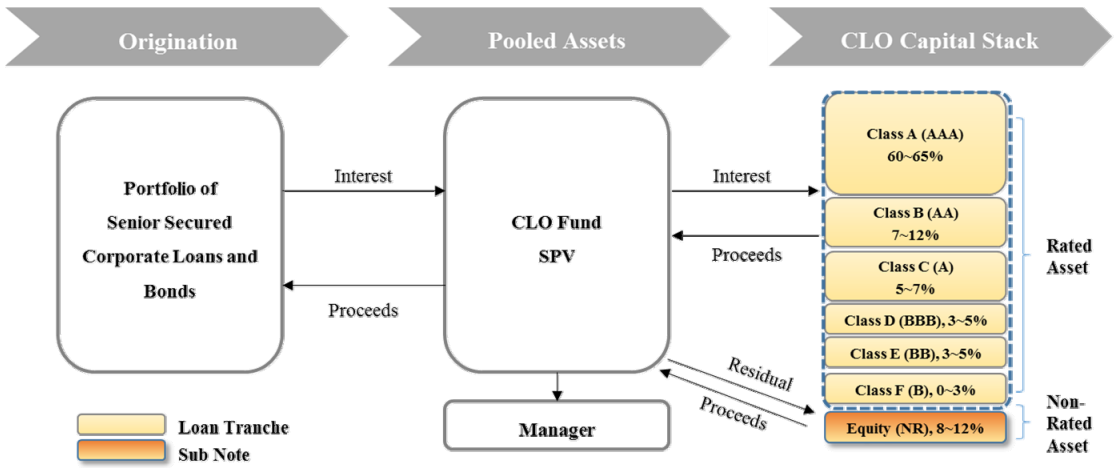
A CLO is a financial tool used to re-package commercial loans into a product sold to investors in the secondary market - often organized as a foreign corporation - that holds a pool of collateralized debt. The U.S. tax consequences to a noteholder depend upon whether the notes it owns are debt or equity for U.S. federal income tax purposes. In a CLO transaction, the cash flow from a pool of assets is carved up to support different tranches of securities. The most senior tranche is rated AAA being an absolute priority as to payments of interest and principal over the holders of all other tranches, below that there are other investment grade tranches, followed by one or more below investment grade tranches and finally an unrated tranche. The unrated tranche is typically in the form of subordinated notes and is treated as equity for U.S. federal income tax purposes. The CLO equity investors bear all of the risks associated with the collateral pool but enjoy through the leverage any realized upside potential. U.S. tax counsel in a CLO generally provides opinions that certain classes of rated notes "will be" or "should be" treated as debt for U.S. federal income tax purposes. Classes of rated notes that receive only a "should" level opinion or no debt-for-tax opinion at all are at greater risk of being recharacterized as equity and typically are ERISA restricted. Exhibit 1 shows the flow of loan

origination, asset pooling, and the creation of a capital stack of a typical CLO deal.

U.S. CLO exposures offer both cross-border investments and flows of capital to Korean investors. How U.S. and Korean tax rules changes may impact Korean investors into U.S. CLO offerings and how it may affect their off-shore CLO cash-on-cash recoveries are issues of critical importance. Since dividend payouts from CLO equities may constitute a substantial portion of return of capital realized on their investments, many exchange-listed U.S. business development corporations are utilizing their 30 percent non-conforming buckets to allocate to first-loss CLO equities. As a non-resident-alien investor with the only business in the U.S. are in positions such as stocks, mutual funds, hedge funds[1] and etc., it is generally believed that the Korean investors may not subject to the U.S. capital gains tax and no money will be withheld by the U.S. withholding agents. Instead, the gains from the investment will be subject to capital gains and/or dividend income taxes, in case invested through an on-shore-registered collective investment vehicle (CIV), in Korea.

Tax counsel in CLO transactions considers the usual debt/equity factors in opining whether a class of notes will or should be debt for U.S. federal income tax purposes, including term or legal maturity, the existence of creditor's remedies, interest rate, position in the

Exhibit 1. CLO Capital Stack



(Source: Simone Investment Managers Research)

1) According to Barclays Hedge, the third quarter end figures of assets under management in 2018 of global hedge fund industry is estimated at U$3.06 trillion, excluding U$279 billion balance of fund of hedge funds. Since the very first Korean equity hedge fund was launched on December 28, 2011, over 1,300 different funds are managed by 140 domestic asset managers with varying strategies and aggregate assets under management at KRW 23 trillion, equivalent to U$ 204.4 billion, as of August 17, 2018. While certain individual hedge fund managers are simultaneously watching opportunities of cross-border trades as well, the majority of Korean hedge funds are anchored to domestic equities and fixed income markets. For better diversification, National Pension Service allocated KRW 1.21 trillion (equivalent to U$ 1.09 billion at the fixed KRW/USD 1,111) as of the end of September 2018. The allocation to the global hedge fund strategies by other domestic pensions and endowments should be much less than those of National Pension Service but growing continuously.

capital structure, likelihood of repayment, debt to equity ratio, overlapping ownership between debt and equity classes, and designation of the instrument as debt or equity. Investment grade classes of notes usually receive a "will" level debt for tax opinion and tranches in the B range generally do not receive any debt for tax opinions. The tax issues Korean investors need to consider as a non-U.S. investor also depends on whether being invested in debt or equity tranche.

The key related tax issues addressed herein are (1) U.S. reporting obligations; (2) Effectively Connected Income; and (3) Tax treaty benefits. Our study differs from to the existing literature in three ways. We first examine what taxation of Korean investors in offshore investment companies is. We subsequently make some comments about the latest U.S. Tax Cuts and Jobs Act ("Tax Act") of 2017 in terms of tax compliances. And, based on the newly evolved facts and circumstances in the U.S. regulatory environment, we elaborate seven different but highly relevant potential tax leakage risk points and the implications for Korean investors.

The remainder of this article is structured as follows: In section 2 we describe the U.S. and non-U.S. tax blocker subsidiaries and their current utility. In section 3 we describe the Korean Regulatory Treatment of the U.S. CMV partnerships and LLCs. In section 4 we document the Tax Act of 2017 in CLO investors in Korea and section 5 concludes.

[2] The Tax Blocker Subsidiaries

2.1 Taxation for CLOs

The major source of cash of the CLO issuer is payments on its underlying loans and subsequent net trading gains. The CLO issuer needs those cash flows to make payments on its own securities. It is important to structure the system with the minimum possibility of suffering material tax leakage, which could arise either from the imposition of gross basis withholding tax on payments to the CLO issuer, as a result of the imposition of net income tax on the CLO issuer, or any issuer's gross-up payment obligations. Deals are coming with a tax redemption provision if the CLO issuer suffers tax leakage in excess of certain thresholds. A further level of tax leakage could arise as a result of withholding taxes on payments to the debt tranche holders. Debt holders typically are subject to net basis tax on the income they receive or accrue on their CLO securities. The way of debt holders to be taxed depends upon different factors such as, either U.S. persons or not; either tax-exempt entities or not; either holding debt or equity securities; whether debt classes were issued with original issue discount[2] (OID) or not;

2) Investors in a CLO's debt tranches should consider the tax implications of discounts and premiums. For example,

whether the issuing entity may deem to be a passive foreign investment company (PFIC) or a controlled foreign corporations (CFC), and if the issuer is a PFIC, whether an equity holder made a qualified electing fund (QEF) election or not.

In some deals, collateral managers do not wish to be constrained by detailed U.S. trade or business guidelines. For example, a manager may engage in loan origination or it may acquire affiliate originated loans under circumstances in which there is a risk that the origination activity would be attributed to the CLO issuer. Any profits in respect of the origination activities could be treated as U.S.-source service income, which attracts U.S. tax. Accordingly, if there is any possibility that the capitalized manager vehicle (CMV) will earn profits with respect to its origination activities, these profits are allocated, in both economically and for U.S. tax purposes, to any on-shore entity such as Delaware blocker corporation and pays U.S. corporate-level tax on the profits.

If these CLOs are structured as entities that are transparent for U.S. federal income tax purposes, the CLO issuer should not be structured as a publicly traded partnership, which would be treated as a corporation for U.S. federal tax purposes. Since it is unclear whether the CLO issuer would have "qualifying income" under the U.S. Internal Revenue Code (IRC or "Code[3]") Sec. 7704, the CLO issuer will seek to avoid treatment as a publicly traded partnership by imposing transfer restrictions on the classes of notes treated as equity or with respect to which only a "should" level or no "debt for tax opinion" is given. Any note subject to such transfer restrictions is in a certificated form to allow for policing of the transfer restrictions.

If the CLO issuer is a partnership that is engaged in a U.S. trade or business, it would be required to withhold on income allocable to foreign partners under the Code Sec. 1446[4]. Since the obligation to withhold and remit tax under the Code Sec. 1446 would be imposed on the CLO issuer and would cut into the cash flow waterfall in the deal, it is important to ensure that no foreign persons are deemed partners in the CLO issuer. Again, this is done by limiting holders of classes of notes treated as equity or with respect to which only a "should" level or no "debt for tax opinion" is

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a debt instrument with an issue price that's less than its maturity value generally has OID. OID is a form of interest and the debt investors would include OID in their income as it accrues over the term of the debt tranche. A CLO debt tranche generally has OID when the tranche is issued for a price that is less than its stated redemption price at maturity. The CLO issuer of the debt tranche should provide the investors Form 1099-OID if the total OID for a calendar year is $10 or more. Therefore, OID portion of CLO debt tranche is treated as interest income, with a portion included in the investor's income each year over the life of the instrument. This is true regardless of the timing of actual interest payments, so an investor in a deferrable interest class may owe taxes on income that hasn't been received. When an investor acquires a debt instrument on the secondary market for a price less than its maturity value, the accrued portion of the market discount may be treated as ordinary income, rather than capital gain, if the investor gains on the sale of the CLO debt. Alternatively, an investor may elect to include market discount in income as it accrues. If an investor acquires a debt tranche at a premium, he or she may elect to amortize the premium and use it to offset taxable interest income. The premium amortization reduces the investor's tax basis in the tranche, which may trigger additional capital gain taxes when it's sold.

3) Unless otherwise stated, section references in this article are to the IRC.

4) Treas. Reg. Sec. 1.1446-2(b)(2)(ii) ("If a partnership receives a valid Form W-8ECI from a partner, the partner is deemed, for purposes of the Code Sec. 1446, to have effectively connected income subject to withholding under the Code Sec. 1446 to the extent of the items identified on the form.").

given to U.S. persons. If there is only a single holder of the CLO's equity, the CLO issuer is classified as a disregarded entity and is not subject to withholding obligations under the Code Sec. 1446.

For the brief discussion of gross basis income taxation, if payments on underlying loans or short-term eligible investments are subject to withholding tax, the CLO issuer will suffer a cash flow shortfall and may be subject to a tax redemption. The primary source of income for a CLO issuer is interest income on loans it holds. U.S.-source interest income on these types of collateral obligations is generally exempt from U.S. withholding tax under the portfolio interest exemption with the registered-form collateral. Eligible investments usually qualify for the exemption for short-term debt. However, U.S. withholding tax may be imposed on commitment fees received with respect to delayed draw, revolving loans, and similar fees. Deals that permit synthetic letters of credit or letter of credit reimbursement obligations often provide for a reserve account in case the agent bank does not withhold on fees received on such assets.

U.S. withholding tax generally will apply to equity securities of U.S. borrowers the CLO issuer receives as a result of commercial loan workouts. The issuer in a U.S. CLO transaction is typically established outside of the U.S. principally to avoid being liable to pay U.S. federal income tax on its global income. When a portfolio asset is exchanged for equity or other assets in connection with bankruptcy or workout proceedings, this may nonetheless cause the CLO issuer to be deemed to be engaged in a trade or business in the U.S. which would subject the entire CLO portfolio to U.S. federal tax. If CLO indentures provide for the formation of tax subsidiaries to hold such equity, it helps to avoid the forced disposal of distressed assets at the worst timing and gives the CLO the benefit of any workout upside. In the U.S., there has been a growing acceptance in the formation of tax blocker subsidiaries for existing U.S. CLO issuers with the experience of recently failed oil and gas companies. A blocker subsidiary is the U.S. or a non-U.S. entity treated as a corporation for U.S. federal income tax purposes. It will be subject to U.S. net income tax and file U.S. tax returns. The blocker entity structures work because the IRS respects an entity that is deemed a corporation for U.S. tax purposes as an entity separate from the underlying shareholders and the blocker can transform income it receives into a different type of income for the shareholders' purposes. These blocker entities can hold equity or other workout assets issued in connection with the restructuring of problem loans. This mitigates any tax risk that the associated CLO will be engaged in a U.S. trade or business. The rating agencies impose detailed requirements relating to the structure and governance of blocker subsidiaries. Assets can be transferred from the blocker subsidiary back to the CLO issuer if a legal opinion that holding the asset directly will not cause the issuer to be engaged in a U.S. trade or business is obtained.

The formation of Delaware limited liability companies (LLCs) and Delaware corporations as subsidiary tax blocker vehicles of CLO issuers are more commonly adopted. Upon formation, the relevant defaulted assets can be

transferred by or on behalf of the CLO issuer to the subsidiary LLC or corporation. However, U.S. tax structuring requirements, including the jurisdiction of choice for the tax subsidiary, will be dictated by matters such as the nature of the defaulted asset or activity in question. In addition, provisions in the CLO indenture typically restrict the formation of subsidiaries unless specified conditions precedent[5] are triggered and prescribed remedies are followed.

Korean equity investors in CLOs organized as non-U.S. corporations must consider rules related to CFCs. A non-U.S. corporation is a CFC if more than 50 percent of its value or voting power is owned by U.S. investors who own at least 10 percent of the corporation ("U.S. shareholders"). U.S shareholders must include their pro-rata share of a CFC's Subpart F income in their current taxable income, whether distributed or not. Furthermore, a non-U.S. corporation is a PFIC if 75 percent or more of its gross income is passive (e.g., interest and dividends) or at least 50 percent of its assets are held for the production of passive income. Most non-U.S. CLOs are PFICs, and all equity investors in PFICs, including less-than-10 percent shareholders in CFCs, are subject to an anti-deferral regime, which implies rigorous reporting requirements. In addition, capital gain and certain deferred interest income are taxed as ordinary income at the highest federal rate regardless of the individual investor's actual marginal rates bracket. Plus, they're subject to an interest charge on the tax related to the PFIC income as if the income were received ratably over the holding period.

2.2 The CMV Structure

To comply with the risk retention rules[6] as CLO sponsors, collateral managers often have relied on the third-party funding via a capitalized manager vehicle (CMV) as a new collateral manager. A CMV structure would allow the collateral manager itself, its employees and third-party investors such as qualified Korean investors, to inject the cash into it, which will purchase the required risk retention debts and equities (collectively, "risk retention notes"). The structure may impose additional tax concerns for Korean investors that have to invest directly in the CMV, which will benefit from management fees for overseeing the leveraged loan portfolio including day-to-day hands-on cares and earn returns on the risk-retention-compliant equities it held.

The CMV typically is structured as a newly formed Delaware series limited liability company (LLC) or series limited partnership (LP)

5) For example, prior written notice to rating agencies, legal opinions are required to the effect that formation of the subsidiary will not cause the issuer: (i) to be deemed engaging in a U.S. trade or business for U.S. federal income tax purposes; or (ii) to constitute a "covered fund" under the U.S. Volcker Rule.

6) In December 2016, the credit risk retention rule, 79 Fed. Reg. 77.601 (the credit risk retention rule), was effective pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The credit risk retention rule requires the collateral manager or a "majority-owned affiliate" of the collateral manager ("C-MOA") to acquire and retain either (i) 5 percent of the face amount of each class of notes issued by the CLO, (ii) notes of the most subordinated class issued by the CLO representing 5 percent of the fair value of all CLO notes, or (iii) a combination of (i) and (ii) representing 5 percent of the fair value of all risk-retention CLO notes. The rule was designed to align the interests of the securitization sponsors (or the collateral managers) and investors in a CLO deal.

that, in either case, is treated as a partnership for U.S. tax purposes. The CMV typically designates Series-A interests to receive all management fees, Series-B interests to receive all proceeds from the risk retention notes, and Series-C interests to receive all income and gain with respect to any loans that the CMV acquires and sells to qualify as an originator under the European risk retention rules, in net of any related expenses. The legacy collateral manager often through a wholly owned affiliate holds all of the Series-A interests and thus is allocated all of the management fees that the CMV receives, net of related management expenses.

Third-party investors typically invest in the CMV through one or more offshore, such as the Cayman Islands or Jersey blocker ("Cayman blocker") entities that are treated as corporations for U.S. tax purposes[7]. The Cayman blocker invests substantially all of its cash directly into the CMV in exchange for Series-B interests and is allocated a pro-rata portion of any payments that the CMV receives on the risk retention notes. If the legacy collateral manager or its affiliate contributes cash to the CMV, then it holds a pro-rata share of the Series-B and C interests and is entitled to a pro-rata share of any payments that the CMV receives, any gain on loans that the CMV trades on the risk retention notes, net of any related expenses.

The CMV will enter into a sub-advisory agreement with the legacy collateral manager to provide investment research, portfolio management, and back-office services to the CLO. Thus, the CMV will be a "Relying Adviser" to the legacy collateral manager, a registered investment adviser under the Securities Act of 1933. The CMV invests in a horizontal strip of the equity tranche in new issue CLOs in an amount sufficient to satisfy the U.S. and European risk retention requirements, provided that, the CMV will maintain the flexibility to invest in a vertical strip of the CLO at the legacy collateral manager's discretion subject to (i) an x-percent limitation (typically 10 percent, measured using total fund commitments) and (ii) the "Vertical Strip Rebate" being provided. Provide first-loss equity in connection with the legacy collateral manager's warehouse facilities entered into by the CMV, the CMV may purchase the CLO equity positions in the secondary market, which is subject to a y-percent limitation (typically 20 percent, measured using total fund commitments).

While the CMV closes on the 1-year anniversary of the target initial closing date, the investment period extends to the 3-year anniversary of the target initial closing date, and the terms are generally up to the 5-year anniversary of the end of the investment period with two 1-year extensions at the legacy collateral manager's discretion. Following the final closing date and during the investment period, all proceeds received from (i) the CLO equity investments will be distributed to investors and (ii)

7) In practice, a U.S. personnel-managing CLO's credit risk retention-compliant CMV in the Cayman Islands and a non-U.S. personnel-managing CLO's CMV in Ireland, the Netherlands, or Luxembourg are organized. Third-party investors may invest indirectly in each CMV through a feeder organized in Cayman Islands or Jersey. Because the offshore feeder, each CLO, the Cayman blocker, and potentially other entities are PFICs for U.S. tax purposes, U.S. investors in an offshore feeder structure are subject to adverse tax consequences unless they make an election to treat each of these entities as a QEF and to include in income their pro rata shares of each entity's income and gain each year.

the warehouse investments will be reinvested. Typically, there is no CMV-level base management and incentive fees. Management and incentive fees[8] accrued at the CLO, less fees incurred by the management company, will be paid to the legacy collateral manager under the sub-advisory arrangement. Because a CMV is treated as a partnership for U.S. tax purposes and is engaged in a U.S. trade or business, the CMV structure adds some complexity and tax risk for third-party investors.

Korean investors and U.S. tax-exempt investors invest into the Cayman and the Delaware blockers and receive distributions from each of these entities. Dividends that the Delaware blocker pays to Korean investors are subject to 30 percent U.S. withholding tax which may be reduced by the U.S.-Korea Income Tax Convention. Distributions by the Cayman blocker are not subject to U.S. withholding tax.

Potential Risk Consideration 1

U.S. CMV may be able to avoid this tax exposure by making a QEF election, under which they include their pro-rata share of the PFIC's net income (but not losses) in their taxable income. But this election can be risky. For example, if the CLO performs poorly in later years, the Korean investors with direct or indirect CLO equity holdings through the on-shore CMV may end up paying tax on current income but never receive a matching distribution. In case both on- and the Cayman blocker entities were adopted in parallel, there could be a character mismatch over time. The ordinary portion of QEF income may be taxed at the highest marginal rate since there is no tax convention between Korea and the Cayman Islands but, on exit, the individual equity holders may have a capital loss that may not yield the same benefit.

2.3 Returns to Third-Party Investors

2.3.1 Cashflows to the Cayman Blocker

The risk retention notes provide for two types of returns, both of which are allocated to the Cayman blocker: (1) the "scheduled cash flow," which consists of payments made in respect of the risk retention debts pursuant to the payment waterfalls contained in the CLO's in-

8) For illustration, an 'XYZ' Asset Management LLC's C-MOA offering document shows that "(..) in connection with the purchase of a horizontal strip of equity tranche, the CMV's purchase price of equity will be at a price that will result in the applicable underwriting bank's fee being no more than 0.40 percent of the CLO's target par amount. The CMV will pay no more than 0.40 percent per annum in management fees on its portion of CLO equity and will pay 0.025 percent per annum less in management fees than third party equity investors (i.e., if third-party equity is paying 0.40 percent per annum in management fees on their portion of equity. The CMV will pay 0.375 percent per annum on their portion provided that, if the equity is comprised of less than 10 percent third party equity investors, the CMV will pay no more than (i) 0.35 percent per annum in management fees on its portion of equity and (ii) 0.375 percent of the CLO's target par amount to the underwriting bank). Furthermore, to the extent the CMV's investment is via vertical strip, CLO management fees will be rebated to CMV investors via a subordinated fee note in an amount that will get CMV investors to the same expected return as the majority equity investor. To the extent the model-based projected IRR to maturity on a target CLO equity investment is below 12 percent, the CMV will be prohibited from proceeding with the CLO/investment until the earlier to occur of (i) the collateral manager obtains majority consent from third-party CMV investors to proceed with the CLO/investment (or to the extent a limited partner advisory committee at the CMV is formed, majority consent from the committee is obtained) or (ii) the model-based projected IRR rises above 12 percent."

denture, and (2) a "residual cash flow" on the risk retention equity. The residual cash flow is payable as a result of a corresponding reduction in the fees that the CMV charges the CLOs. A CLO pays the residual cash flow to the CMV under a letter pursuant to which (i) the CLO contractually agrees to distribute on the risk retention equities an additional amount, based on a preset formula, (ii) the subordinated management fees are contractually reduced by the same amount, and (iii) the parties agree to treat the additional amount as part of the investment return on the risk retention notes (not as a part of the management fees). The additional amount is payable on the risk retention debts and equities regardless of whether the management agreement is terminated and whether the risk retention notes are held by the CMV or transferred to another person[9].

A CMV generally is treated as a partnership for U.S. tax purposes and is treated as engaged in a U.S. trade or business for U.S. tax purposes as a result of its U.S. management activities. As a partner in the CMV, the Cayman blocker would be subject to U.S. tax liability if any part of its allocable share of income from the CMV were characterized as fee income from the CMV's management activities or were otherwise treated for U.S. tax purposes as effectively connected with a U.S. trade or business. The CMV allocates both the scheduled cash flow on the risk retention debts and the residual cash flow on the risk retention equities to the Cayman blocker.

2.3.2 Scheduled Cashflow

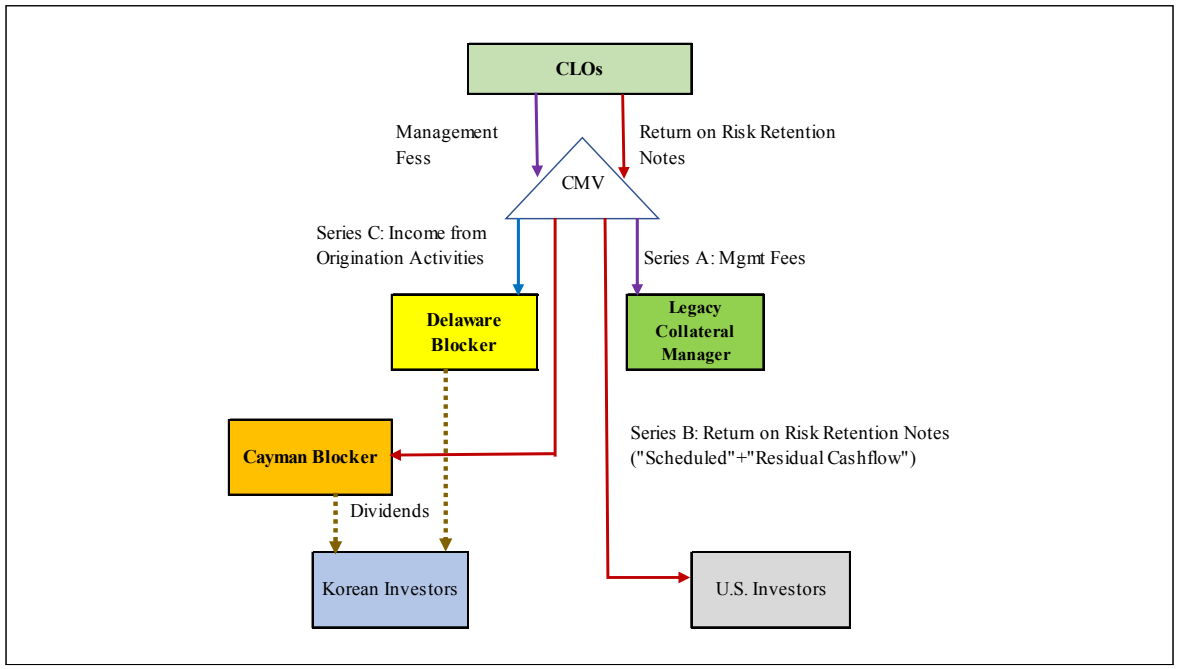
CLOs typically are treated as foreign corporations for U.S. tax purposes. If neither (1) the payments are derived in the active conduct of a banking, financing or similar business within the U.S. nor (2) the principal business of the CMV is trading in stocks or securities for its own account, payments by a foreign corporate CLO to the CMV should not be treated as effectively connected with the CMV's U.S. trade or business. The CMV's principal activities are providing investment management services to CLOs and purchasing notes issued by the CLOs with the intention of holding those notes to maturity. Accordingly, neither of the tests above should be satisfied, and payments by a foreign corporate CLO to the CMV should not cause the Cayman blocker to have income that is effectively connected with a U.S. trade or business.

2.3.3 Residual Cashflow

Because the CMV is entitled to the residual cash flow regardless of whether it enters into the side letter, it is a legitimate concern that the residual cash flow may be characterized as a portion of U.S.-source management fees and the Cayman blocker would have effectively connected income (ECI) with a U.S. trade or business. However, the residual cash flow

9) Some CLOs issue "Class M Notes" to the CMV. These Class M Notes are basically the additional amounts payable pursuant to the side letter but are issued pursuant to the CLO's indenture. The tax disclosure in the offering document typically provides that the CLO intends to treat the Class M Notes as equity for U.S. tax purposes, and that purchasers of risk retention notes that receive Class M Notes on the closing date are required to allocate their purchase price among the subordinated notes treated as equity and the Class M Notes based on relative fair market values for purposes of determining gain or loss upon a disposition.

Exhibit 2. CLO Structuring with CMV and On- and Offshore Blockers



should be treated as an investment return on the CLO equities, because the residual cash flow is payable even if the CMV's management agreement is terminated, and thus is not contingent upon the CMV's performance of services. Since the residual cash flow is payable to the CMV as long as the CMV holds the risk retention equities, it may be transferred only with the risk retention notes. By contrast, the CMV's right to management fees is not subject to the condition of its actual holdings of the risk retention equities. The right is usually fixed under the investment management agreement and is not transferable with the risk retention equities. Exhibit 2 simulates cashflow streams from the CLO issuer to Korean investors with respect to Series-A, B, and C interests via on and offshore blocker structure.

2.4 CLOs Treated as Corporations

Because the CMV's personnel provide collateral management services within the U.S., the CMV is treated as engaged in a trade or business in the U.S. The Cayman blocker is a partner in a partnership that is engaged in a U.S. trade or business, it is also considered to be engaged in a U.S. trade or business by reason of its investment in the CMV and is subject to U.S. federal income tax on its allocable share of the CMV's ECI.

The ECI of the Cayman blocker is taxed in the same manner as the income of a U.S. corporation. A non-U.S. corporation that is engaged in a U.S. trade or business is also subject to a 30 percent "branch profits tax" on its "dividend equivalent amounts," a measure of the foreign corporation's effectively con-

nected earnings and profits that are not reinvested in the U.S. business and are deemed repatriated offshore in any year. In addition, state and local[10] net income tax could also be imposed, which would have a materially adverse effect on the CLO issuer's cash flow and it would also likely result in a tax redemption. Finally, entities that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business (e.g., CMVs) are required to withhold tax at the highest applicable rate on their foreign partners' distributive share of any income that is effectively connected with that trade or business. Then, it is crucial that any earnings and profits that the CMV allocates to the Cayman blocker not to be ECI.

A substantial portion of the income on the risk retention notes would be U.S.-source if the CLOs are treated as partnerships for U.S. tax purposes. By contrast, none of the income on the risk retention notes is U.S.-source if the CLOs are treated as foreign corporations for U.S. tax purposes. Accordingly, CMVs typically ensure that the CLOs that they manage are all treated as foreign corporations for U.S. tax purposes.

For U.S. tax purposes, a foreign corporate CLO is treated as either a PFIC or a CFC. In either case, the CMV[11] generally will be required to include a pro-rata share of the CLO's net income and gain in income each year in respect of the CLO equity. Subsequent distributions in respect of the CLO equity generally will consist of previously taxed income and thus will not be subject to tax again. There are no rules for determining whether income inclusions under the PFIC or CFC rules are treated as ECI. However, foreign-source dividends provide the best analogy for these inclusions, since the inclusions are income in respect of equity.

Because of the serious consequences of the imposition of U.S. federal net income tax would have for investors in a CLO, the rating agencies require a legal opinion that the CLO issuer will not be engaged in a U.S. trade or business for U.S. federal income tax purposes. In order to avoid the imposition of U.S. federal net income tax and to obtain a non-U.S. trade or business engagement opinion, corporate CLO issuers structure their activities to fall within the self-trading safe harbor under the Code Sec. 864[12] and operate to ensure that the issuer is not engaged in loan origination or otherwise treated as conducting a lending or other financial business.

The CMV might also realize foreign-source interest income from CLOs on any risk retention debts. There is no guidance for determining an ECI from foreign-source dividends or interest received by a U.S. domestic CMV partnership. However, the Code Sec. 864(c)(4) generally provides that for-

10) For instance, New York City's 4 percent unincorporated business tax (UBT). Instead, they establish a principal place of business in another state (i.e., Connecticut) that does not impose corporate taxes on pass-through entities.

11) More specifically, if the CLO is a CFC and the CMV is a "U.S. shareholder" with respect to the CLO, then the CMV will be required to include its pro rata share of the CFC's Subpart F income as ordinary income each year.

12) Treas. Reg. Sec. 1.864-2(c)(2). Some sensitive areas include forward purchase commitments, delayed draw and revolving loans and letters of credit. Typically, there are also restrictions on ownership of certain types of equity securities.

eign-source dividends or interest received by a foreign corporation are not ECI unless (i) either (A) the dividends or interest are derived in the active conduct of a banking, financing, or similar business within the U.S. or (B) the principal business of the foreign corporation is trading in stocks or securities for its own account[13] (the "activities test"), and (ii) the foreign corporation has an office or other fixed place of business within the U.S. to which the dividends or interest are attributable (the "nexus test").

Code Sec. 864(c)(4) should apply equally to foreign-sourced dividends or interest received by a partnership that has one or more foreign corporate partners; otherwise, foreign corporations would be able to use partnerships to block ECI with respect to businesses that satisfy the activities test or nexus test. The IRS has advised that even if income derived by a partnership is not effectively connected with that partnership's U.S. trade or business, the income may still be treated as effectively connected with a partner's U.S. trade or business. Accordingly, to conclude that a CMV's income is not ECI to the Cayman blocker, the test in the Code Sec. 864(c)(4) should be applied separately to each of the CMV and the Cayman blocker. Neither the CMV nor the Cayman blocker should satisfy the activities test such as (A) being in the active conduct of a banking, financing or similar business within the U.S. or (B) trading in stocks and securities for its own account as its principal business.

Furthermore, a foreign corporation will be treated as engaged in the active conduct of a banking, financing, or similar business in the U.S. only if (i) at some point during the taxable year, the foreign corporation is engaged in business in the U.S., and (ii) the activities of that business consist of making personal, mortgage, industrial, or other loans to the public, issuing letters of credit to the public and negotiating drafts drawn under those letters of credit, or other specified activities. The CMV provides collateral management services to CLOs, purchases and holds notes issued by the CLOs, and, when qualifying as an originator under the European risk retention rules, purchases loans on the secondary market and sells the loans to the CLOs. The Cayman blocker purchases and holds interests in the CMV and is allocated dividends and interest from the risk retention notes. Neither the CMV nor the Cayman blocker makes loans, issues letters of credit to the public, negotiates drafts or engages in any of the other activities constituting a banking, financing or similar business. Accordingly, the dividends and interest that the CMV receives and allocates to the Cayman blocker should not be treated as derived from a banking, financing or similar business in the U.S.

The Code Sec. 864 and the regulations thereunder do not define what it means for the principal business of a foreign corporation to be "trading" in stocks and securities for its own account. However, the regulations do differ-

13) A CMV might also recognize gain on a sale of risk retention notes and any such gain would not be ECI to the Cayman blocker. Code Sec. 865(a) (gain from a partnership's sale of personal property (such as risk retention notes) is sourced by reference to the residency of the selling partners); Code Sec. 864(c)(4)(A) (subject to limited exceptions, foreign-source gain is not ECI, even to a foreign person that is engaged in a U.S. trade or business (such as the Cayman blocker)).

entiate between trading and investing that dividends derived from incidental investment activities are not ECI[14]. A trader aims for rapid portfolio turnover in a more frequent, continuous, and regular manner, whereas an investor tends to hold securities for a longer duration, more isolated and passive manner. The Cayman blocker purchases and holds interests in the CMV and does not transfer the interests to any person. Similarly, the CMV purchases CLO notes with the intention of holding them to maturity and not primarily for sale to others. Thus, the Cayman blocker will engage "frequent, continuous and regular" buying and selling of neither the CMV's interests nor the CLO notes.

2.5 CLOs Treated as Partnerships

A substantial amount of a CLO's assets typically consists of commercial loans issued by U.S. borrowers. Accordingly, if a CLO is treated as a partnership for U.S. tax purposes, then a substantial amount of income allocated to the CMV with respect to the CLO's equity is likely to consist of U.S.-source interest income. A non-U.S. partner is subject to tax on its allocable share[15] of partnership income as if the income were realized directly from the source or incurred in the same manner by the partnership.

U.S.-source interest income is ECI if (1) the income is derived from assets used, or held for use, in the conduct of a trade or business in the U.S. (the "asset use test") or (2) the activities of the U.S. trade or business are a material factor in the realization of the income (the "business activities test[16]"). The asset use test is satisfied if the relevant asset is (i) held for the principal purpose of promoting the present conduct of the trade or business in the U.S., (ii) acquired and held in the ordinary course of a U.S. trade or business such as receivables from the activity, or (iii) otherwise held in a direct relationship to the trade or business conducted in the U.S. by giving principal consideration to whether the asset is needed in that trade or business[17].

If a CMV failed to hold a CLO's risk retention notes in accordance with the risk retention rules, it could be subject to regulatory actions or proceedings. Accordingly, the risk retention notes are held for the principal purpose of promoting the conduct of the CMV's collateral management business and/or are held in a direct relationship to the business. Then, U.S.-source interest in the risk retention notes would satisfy the asset use test and would be ECI. For this reason, the CLOs that CMV manages are preferred to be treated as foreign corporations for U.S. tax purposes.

14) Treas. Reg. Sec. 1.864-5(b)(2)(iii) (a foreign holding company owning significant percentages of stocks and securities issued by other corporations generally would not be considered to be in the principal business of trading stock and securities for its own account even if it sporadically purchased and sold stocks or securities to adjust its portfolio).

15) Code Sec. 702(b); Treas. Reg. Sec. 1.702-1(b). Interest on a CLO's assets generally will be treated as U.S.-source if it is paid by (1) a U.S. corporation, (2) a U.S. branch of a foreign corporation or partnership, or (3) a U.S. partnership that is engaged in a U.S. trade or business at any time during the applicable tax year (Code Sec. 861(a)(1); Treas. Reg. Sec. 1.861-2(a)(1), (2)).

16) Code Sec. 864(c)(2); Treas. Reg. Sec. 1.864-4(c).

17) Treas. Reg. Sec. 1.864-4(c)(2)(ii).

2.6 Tax Advantages of the Offshore Blockers for Korean Investors

Korean government recently rolled-up its tax-benefits at the end of 2017 which temporarily offered up to 10 years of tax exemptions for overseas equity investment funds since February 29, 2016. Taxes will be exempted on portfolio's marked-to-market and currency evaluation gains in newly established funds that put more than 60 percent of assets in overseas stocks. In addition, Korean investors of U.S. CLOs may face a new tax on their investments as deals compliant with U.S. risk-retention rules are issued.

As many managers opted for setting up a CMV as a new stand-alone CLO management entity[18], which may lead Korean investors to be taxed on the CMV's management fees, potentially decreasing their after-tax returns. Korean investor may face a withholding tax rate of 30 percent on dividends paid out by U.S. companies. However, they will be excluded from this tax if the dividends are interest-related or short-term capital gain-based. This 30 percent rate can also be lower[19] to 10~12 percent upon the tax treaty between Korea and the U.S. By investing offshore, Korean investors may avoid the scrutiny of the U.S. Internal Revenue Service (IRS) but are still subject to the possible queries from domestic tax authorities. Korean investors may have the obligation of investing in a registered collective investment vehicle (CIV) to receive beneficial tax treatment at home. Furthermore, identifying the entity type of offshore feeder funds in the U.S. federal tax purpose as well as the legal forms of domestic CIV may be crucial to the eligibility of the U.S.-Korea Income Tax Convention benefits.

While a CLO is typically structured as a corporation and designed not to be engaged in a trade or business so that it is not subject to the U.S. taxes, CMVs are typically structured as partnerships, pass-through entities that have no entity-level taxation, with the partners taxed on the income of the partnership. Since the CMV is engaged in a trade or business in the U.S. as managing CLOs, the management fee income generated from that business would be considered ECI for a Korean investor as a foreign partner of the CMV as well. If a Korean investor has ECI, it is taxed at U.S. graduated rates and must comply with all applicable U.S. tax filing and reporting requirements. To avoid the administrative and reporting-related burdens attached to ECI, Korean investors may adopt blocker corporations.

Most alternative investment funds such as private equity or hedge funds are organized as partnerships to allow income to pass through the entity directly to the partners for tax purposes. Thus, if any of the CIV's investments constitute ECI, all partners including the Korean investors investing in the CIV will be deemed to have ECI. Although most fund man-

18) As an alternative to the CMV structure, some collateral managers have set up a C-MOA, which can satisfy the European risk retention rules because it is the named collateral manager as the retaining entity and qualifies as an originator. A C-MOA is not regulated under the U.S. law as a new collateral manager, and the personnel responsible for managing the CLOs can continue to be employed by the collateral manager. The collateral manager contributes at least 20 percent of the C-MOA's capital, which is enough for the collateral manager to establish a "controlling financial interest," within the meaning of GAAPs, and third-party investors contribute the remainder.

19) Article 13(1), the U.S.-Korea Income Tax Convention.

agers carefully structure their partnership CIV in minimum danger of being considered engaged in a U.S. trade or business and even the actual chances of the CIV having ECI are remote, some legitimate concerns regarding filing U.S. federal, state, local tax returns, paying the associated liabilities, and potential application of the branch profits tax always come into play.

Potential Risk Consideration 2

In selecting a Delaware blocker corporation, the income ultimately received by the Korean investor will be reduced because of the double taxation imposed on the U.S. corporations first at the entity level and second at the shareholder level. A Cayman blocker corporation will be subject to the U.S. graduated tax rates to the extent it has ECI and 30 percent withholding to the extent it has U.S.-source investment income. Also, the Cayman blocker may be subject to a 30 percent tax on "dividend equivalent amounts" received by the entity from its U.S. branch, which can result in a higher all-in tax liability than that incurred by a Delaware blocker. Fund managers usually facilitate Korean investors' such fears by setting up blocker corporations, which transforms ECI into an effectively disconnected investment income. From the IRS's perspective, shifting liability from a Korean investor to another Cayman or Delaware blocker entity is expected to impose little erosion of the corporate tax base. If the fund manager is able to acquire a buyer for the right price, the sale of a Cayman blocker itself can potentially avoid U.S. taxation altogether. However, most buyers would not purchase the blocker corporation itself at par given its inherent tax liabilities and the receipt of a transferred basis in the underlying assets without a step-up treatment potential. In other cases, Korean investors through the Delaware blockers could incur higher U.S. taxes than if they had simply invested through the partnership CIV itself since all of the distributions from the U.S. blocker would be U.S. source, whereas only a portion might be ECI.

[3] Korean Regulatory Treatment of the U.S. CMV Partnerships and LLCs

As the first step to assess the probable and possible complications with regard to the Potential Risk Consideration 3 to be discussed shortly, the cross-border tax consequences between the U.S. and Korea is focused to defining LLC and partnership in both jurisdictions. Probably one of the most comprehensive economic entities designated in the U.S.-Korea Income Tax Convention is "person" but every "person" are not always a taxable entity. Article 2(d) (General Definitions) defines that the term "person" includes an individual, a partnership, a corporation, an estate, a trust, or any body of persons. And Article 2(e)(i) defines "United States corporation" or "corporation of the United States" as a corporation which is created or organized under the laws of the U.S. or any state thereof or the District of Columbia, or

any unincorporated entity treated as a U.S. corporation for U.S. tax purposes; and (ii) the term "Korean corporation" or "corporation of Korea" means a corporation (other than a U.S. corporation) which has its head or main office in Korea, or any entity treated as a Korean corporation for Korean tax purposes.

Since the definitions of the U.S. and Korean corporations do not include the concept of partnership or company, it is reasonable to include neither LLC nor partnership into a "corporation" in either contracting states. In general, U.S. corporations are established based on state charters such as General Incorporation Laws or Professional Corporation Statutes but partnerships are primarily based on Partnership Statutes, which are the separate state's charters versus those incorporated entities are based on. Therefore, it is impracticable to establish a corporation with reference to state partnership statutes, and vice versa. For instance, Delaware LLCs are registered by the Delaware Limited Liability Company Act, limited partnerships are registered by Delaware Revised Uniform Limited Partnership Act, but neither Act is applicable to the registration of Delaware corporations.

Article 3(a) defines "resident of the United States" as (i) a U.S. corporation and (ii) any other person (except a corporation or an entity treated under U.S. law as a corporation) resident in the U.S. for purposes of its tax, but in the case of a person acting as a partner or fiduciary only to the extent that the income derived by such person is subject to U.S. tax as the income of a resident. And Article 3(b) defines "resident of Korea" as (i) a Korean corporation, and (ii) any other person (except a corporation or any entity treated under Korean law as a corporation) resident in Korea for purposes of its tax, but in the case of a person acting as a partner or fiduciary only to the extent that the income derived by such person is subject to Korean tax as the income of a resident.

Again, the scope of the resident has limited to a corporation and "other person" that it is logical to conclude that partnership may not be deemed a corporation. And the "other person" is obviously defined to be outside a corporation or an entity treated under the U.S. and Korean laws as a corporation, the partnership may have less chance to be classified into the "other person". Article 3(a)(ii) also elaborates that any person acting as a partner or fiduciary only to the extent that the income derived by such person is subject to the U.S. and Korean taxes as the income of a resident. Since partnership and the partner of the partnership cannot be the simultaneous tax-levying objects, whenever a partner is a resident of the state, it is reasonable to conclude that the partnership cannot be viewed as a resident at the same time. On the other hand, the scope of "other person" is limited to the resident of the contracting states' income tax purposes and the Code classifies partnership only a pass-through conduit, not a taxable entity, the partnership is less likely to be a taxable entity in either states' tax purposes.

The resident of a partnership which makes a payment is defined in Article 3(c) such that a payment-making partnership is considered a resident of the State under the laws of which it was created or organized. Since a partnership is not a taxable entity for the U.S. and Korean

income tax purposes, any U.S. partnership making a payment to a Korean taxpayer should be viewed as the payment made by an individual partner(s), not at the partnership level. Then, the partnership's organized state residency will apply to each partner's residency, instead of each partner's current taxable residency identifications.

While Article 2 generally discusses both a corporation and a partnership, Article 3 further differentiates a resident person from a corporation and the "other person". Any U.S. corporation provides services to Korean taxable entity, the entitled payments are not taxed in Korea and therefore is not a withholdable payment in Korea. However, when a U.S. partnership without a permanent establishment in Korea provides services to Korean taxable entity, the entitled payment may be withholdable in Korea at an individual partner level.

According to Article 2(1) of Korean Income Tax Act, when calculating the amount of income derived from a joint business under the provisions of Article 43 of the Act, each relevant resident shall be liable to pay the relevant tax, provided, that where the income of any related persons is summing up to the income of the major joint business proprietor under the provisions of Article 43(3) ("major joint business proprietor") for taxation, the related persons shall be jointly liable to pay the tax on the sum of the relevant income with the major joint business proprietor within the extent of the income corresponding to his profit-and-loss distribution ratio under the provisions of paragraph (2) of the same Article.

Article 87(1) of Korean Income Tax Act states that the tax withheld from the income accruing from a joint business place shall be distributed in accordance with the profit-and-loss distribution ratio of the respective joint business proprietors. Article 87(2) states that the additional tax as prescribed in Articles 81(1) and (3) through (11) and Article 158 which is related to a joint business place shall be divided according to the profit-and-loss distribution ratio of the respective joint business proprietors. And Article 87(3) states that the provisions of Articles 160(1) and 168 would apply to a joint business place by deeming it as a place of business operated by one business proprietor

An Established Rule No. 46017-177 (December 16, 2002) of the Ministry of Finance states that for an LLC established in the U.S. elected to be taxed as a partnership, not as a corporation for U.S. federal income tax purposes, the entitled payment to the LLC is not subject to Article 18 of the U.S.-Korea Income Tax Convention, rather is subject to the income tax treaties between Korea and each LLC member's resident state (and maybe withholdable in Korea at an individual resident member level). In parallel, another Established Rule No. 46017-178 on the same date states that even though a partnership established in the U.S. elected to be taxed as a corporation for U.S. income tax purposes, the provisions in Article 18 of the U.S.-Korea Income Tax Convention (Independent Personal Service) is still not applicable either. However, if a U.S. partnership elected to a partnership taxation, the entitled payment is subject to Article 18 of the U.S.-Korea Income Tax Convention (and maybe withholdable in Korea at the U.S. resident individual partner level).

OECD's Informal Consultative Group on the

Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors ("ICG") Report on "the Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles of 2009" suggests the potential vulnerability of investment trusts as a "person" recognized in the U.S.-Korea Income Tax Convention. ICG Report argues that the determination of whether a CIV is a person begins with the legal structure of the CIV. CIVs take different legal forms in OECD member countries. In Korea and the U.S., both companies and trusts are commonly used but the trust is the predominant form of CIVs in Korea. Paragraph 2 of the Commentary on Article 3 states that the definition of the term "person" that is found in the OECD Model Convention is not exhaustive and should be given a very wide sense. Applying this guidance to the case of CIVs, a company CIV clearly would constitute a person. However, in the absence of specific provisions, a CIV that is treated merely as a form of joint ownership, and not as a person, under the Korean tax law in which it is established clearly would not constitute a person for purposes of tax treaties.

The issue may be less clear in the case of a trust CIV. Under the domestic tax law of most common law countries, the trust, or the trustees acting collectively in their capacity as such, constitutes a taxpayer. The fact that the tax law of the country where the trust is established would treat it as a taxpayer would be indicative that a trust is a person for treaty purposes. On the other hand, Korea, despite being one of the civil law countries, does recognize the concept of both a trust and an investment trust in the domestic law but would treat an investment trust as a transparent would counter indicate that a trust is a person for the U.S.-Korea Income Tax Convention purposes. If a trust CIV is not qualified to the Income Tax Convention benefits, Korean investors of a domestic trust CIV should be able to claim benefits on its own. Otherwise, Korean investors who invest through a trust CIV would be put in a worse position than if they had invested directly.

Potential Risk Consideration 3

If a CMV structured as a newly formed Delaware Series LLC is regarded as a non-transparent entity by the Korean tax authorities and taxed as a corporate entity, which may lead to mismatches with regard to the identity and residency of Korean investor who recognizes revenues and expenses, as well as the timing of income recognition and a possible double taxation situation or a non-eligibility of tax treaty benefits, with respect to U.S.-sourced income earned by the LLC. On the other hand, newly formed Delaware limited partnerships are less likely to result in such opaque mismatches.

Potential Risk Consideration 4

In reality, administrative difficulties will effectively discourage individual claims by CIVs' investors. Given the number of investments by a typical trust CIV, each individual claim for exemption or refund of withheld taxes would be relatively small amounts and there is also a practical difficulty for individual investors to prove their payment of the withholding taxes in the U.S, which likely would result in un-

claimed benefits in most cases. This is an outstanding risk factor potentially decreasing after-tax returns to be considered when the cross-border investment is made through a Korea-registered trust CIV, especially those by the qualified Korean individual investors. In practice, few countries have denied benefits to CIVs in the form of trusts solely on the grounds that the trust is not a person. This may be because those countries in which trusts are common make it a point to resolve this question by modifying the definition of "person" to specifically include trusts. However, if the fact that few countries have denied the benefits to the trust CIVs so far does not provide enough comfort at night, it is preferred to structure the investment with a company CIV, which clearly would constitute a person and residency conditions to the benefit entitlement.

Potential Risk Consideration 5

If the CLO issuer is a partnership with some passive Korean partners that are engaged in a U.S. trade or business, it would be required to withhold on income allocable to non-U.S. partners under the Code Sec. 1446. Since the obligation to withhold and remit tax under the Code Sec. 1446 would be imposed on the CLO issuer and would cut into the cash waterfall in the deal, it is important to ensure that no foreign person-treated entities are deemed partners in the CLO issuer, which potentially decreases Korean partners' after-tax returns due to unexpected tax leakage. Again, this is done by limiting holders of classes of notes treated as equity or with respect to which only a "should" level or no "debt for tax opinion" is given to U.S. persons by limiting its CMV to on-shore U.S. entity only. If there is only a single holder of the CLO's tax equity, the CLO issuer is classified as a disregarded entity and is not subject to withholding obligations under the Code Sec. 1446.

Potential Risk Consideration 6

In some deals, collateral managers do not wish to be constrained by detailed U.S. trade or business guidelines. For example, a manager may engage in loan origination or it may acquire affiliate originated loans under circumstances in which there is a risk that the origination activity would be attributed to the CLO issuer. In practice, the CMV earns no economically meaningful profits and gains with respect to its loan origination activities. However, any profits in respect of the origination activities could be treated as U.S.-source services income, which attracts U.S. tax. Accordingly, if there is any possibility that the CMV will earn profits with respect to its origination activities, then these profits should be allocated (both economically and for U.S. tax purposes) entirely to a Delaware blocker entity that is treated as a corporation for U.S. tax purposes and pays U.S. corporate-level tax on the profits.

[4] Current Development in CLO Regulatory Environment

4.1 Latest Court Decisions

In 2014, the Loan Syndications and Trading Association filed a lawsuit against the Federal Reserve and the Securities and Exchange Commission (SEC), arguing that the credit risk retention rule was arbitrary, capricious, and an abuse of discretion. In December 2016, a D.C. District Court held that collateral managers of both open-market and middle-market CLOs[20] were considered securitizers[21] for purposes of the credit risk retention rule.

However, according to a recent ruling[22] by the DC Circuit Court issued on February 9, 2018, the credit risk-retention rules may no longer apply to the open-market CLOs, which do not fall under the definition of securitizers and need not to comply with risk retention. Clearing the regulatory hurdle is positive for CLO managers and could support more primary market activity and also likely create some spread widening pressure on CLO debt tranches. In the meantime, the majority of middle-market CLO managers still under the definition of securitizers and will continue to comply with risk retention. The Federal Reserve and SEC have 45 days to seek en banc review of the decision before the D.C. Circuit Court and 90 days to seek *certiorari* from the U.S. Supreme Court. If regulators do not appeal the decision, open-market CLO managers can then begin structuring new deals without obligation of the "skin on the game."

On April 5, 2018, the District Court for the District of Columbia vacated the risk retention rule after the 2 April deadline for the agencies to appeal the decision had passed. As a result, open-market CLOs are now no longer subject to the risk retention requirement. Although it is possible that the agencies could request a review from the Supreme Court, this seems unlikely. The Circuit Court focused on Dodd-Frank's definition of a securitizer as being an entity that transfers assets to an issuer of securities, and it noted that open-market CLO managers typically do not own the assets underlying the CLO and therefore do not transfer them to the issuer. Rather, these managers select assets to be purchased by the issuer from third parties on the open market. Because open-market CLO managers are not securitizers, they are not obligated to retain any credit risk[23] in the CLOs they manage. The D.C.

20) CLOs are generally classified into open-market and middle-market CLOs. While open-market CLOs acquire their assets from third parties on the open market, middle-market or balance sheet CLOs are created by a CLO manager or a related party transferring the loans off its balance sheet and into the securitization vehicle. Until the latest D.C. Circuit Court decision on February 9, 2018, the credit risk retention rule applied to managers of both types of CLOs.

21) Loan Syndications & Trading Association v. SEC, 223 F. Supp. 3d 37 (D.D.C. Dec. 22, 2016).

22) The Loan Syndications & Trading Association v. SEC, No. 17-5004, 2018 WL 798290 (D.C. Cir. Feb. 9, 2018).

23) If the risk-retention capital requirements are no longer a hurdle for new issue CLOs and refi/resets going forward, smaller and/or new managers for which the constraining factor was sourcing the risk-retention capital are expected to opt to the primary market. Deals out of their non-call period that had similar constraints and is still

Circuit Court's decision effectively groups open-market CLO managers with other asset managers rather than with securitizers of asset-backed securities.

4.2 Broadly Syndicated and Middle-Market CLOs

Middle-market CLOs are a subset of CLO issuers. Most CLOs acquire broadly syndicated loans on the secondary market. These broadly syndicated CLOs usually are treated as foreign corporations for U.S. tax purposes and typically are organized in the Cayman Islands, which does not impose an income tax, or in Ireland, the Netherlands or Luxembourg, which permit interest deductions on the CLO notes to effectively eliminate any home jurisdiction income tax. U.S. collateral managers of broadly syndicated CLOs comply with "U.S. tax guidelines" that allow the CLO to satisfy a safe harbor that ensures that the CLO is not engaged in a U.S. trade or business, thus is not subject to U.S. net income tax.

By contrast, middle-market CLOs invest primarily in middle-market loans. Because the secondary market for middle-market loans is less developed than that for broadly syndicated loans, middle-market CLOs often act as original lenders on the loans instead of buying loans on the secondary market. Since any activities of regularly lending money through a U.S. collateral manager as an agent constitutes a U.S. trade or business for U.S. tax purposes, a foreign corporate CLO that is engaged in a U.S. trade or business potentially is subject to U.S. corporate-level tax.

By contrast, entities that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business generally are not subject to entity-level tax so long as their equity is held exclusively by U.S. persons. Accordingly, to avoid U.S. entity-level tax, most middle-market CLOs are structured as partnerships for U.S. tax purposes and require any notes they issue to be held by U.S. persons unless the notes receive a legal opinion that they will be treated as debt for U.S. tax purposes. Tax counsel is known to give such a "will be debt" opinion only with respect to a middle-market CLO's investment-grade notes.

Potential Risk Consideration 7

In the combined event that (1) a middle-market CLO's notes are treated as equity, (2) a purchaser does not withhold on a seller, and (3) the seller turns out to be a non-U.S. person, the IRS might assess a liability on the middle-market CLO for failing to withhold on the purchaser and this liability would be payable as an administrative expense and likely would be borne economically by the holders of the middle-market CLO equity, which potentially decreases Korean equity investors' after-tax returns due to unexpected tax leakage.

eligible for refi/reset with shortened investment horizons could also be repricing their liabilities without holding up risk-retention capital. Approximately the option of retaining a horizontal risk-retention slice was used by 57 percent of 2017 vintage CLOs, which limited the available equity investments beyond targeted funds or partnerships, more CLO equity supply in both primary and secondary markets is likely. With risk-retention repealed for open-market CLOs, a higher proportion of equity tranches could now be available in the primary market at the same time. For managers holding retained equity tranches, they also have the option of supplying their holdings to the secondary market unless otherwise prohibited by the indentures.

The proper provision should restrict the non-investment grade noteholders' liquidity within the legal maturity of CLOs.

[5] Conclusion

Cash moves through the structure with minimal tax leakage to ensure no withholding tax is imposed on payments on collateral obligations is one of the key issues in a CLO design. From the newly evolved facts and circumstances in the U.S. regulatory environment, our seven potential tax leakage risk considerations for Korean investors are believed to be highly relevant from the initial investment structuring to the on-going tax compliances.

We have reviewed the potential dangers of Korean institutional investors with respect to a QEF election, which might imply some serious cashflow and character mismatches. There exist some economic pros and cons between on- and off-shore blocker entities as well as an implicit ambiguity of a newly formed Delaware Series LLC versus a newly formed Delaware limited partnerships in terms of timing of income recognition and the eligibility of treaty benefits from the Korean tax authorities' perspectives. While the most common form of trust CIV is rather vulnerable to be entitled as a "person", a company CIV is a better alternative to be considered from the initial planning stage. Additionally, the treatment of the U.S. Code Sec. 1446, the middle-market CLO equities, and the relevant origination activity-linked income cast some further insight into the CLO equity investment structure.

One feasible illustration of tax planning solution for individual investors is an investment in CLO equities through variable annuities offered by insurance companies. Variable annuities provide a retirement annuity. They have a limited tax-deductibility and distribution is taxed, but they are tax-deferred, much like an Individual Retirement Pension[24] (IRP). Variable annuities also guarantee non-taxable gains treatment once held after 10 years. That way, the investment in alternative investment funds such as hedge funds and CLO equities

24) Under the Enforcement Decree of the Korean Income Tax Act, Article 116-2 (Calculation Method of Dividend Amount of Income Subject to Deduction of Dividend Tax) "In applying Article 62 of the Korean Income Tax Act, the amount of dividend income exceeding the standard amount for aggregate taxation on interest income, etc. under Article 56 (4) of the Act, shall be governed by the amount obtained by successively aggregating the amount of interest income, etc. in the order of the following subparagraphs: 1. Where there concurrently exist the interest income and the dividend income, the interest income shall be added first; and 2. In applying subparagraph 1, if there concurrently exist the dividend income subject to the proviso to Article 17 (3) of the Act and other dividend income, the other dividend income shall be added first." Instead of currently levying withholding tax of 15.4 percent on the dividend and interest income up to the annual contribution limit of KRW 18 million, a domestic IRP allows deferred tax benefits as well as lower pension income tax rate between 3.3 percent and 5.5 percent (a 30 percent reduction from pension income tax schedule) when the retirement benefit is withdrawn after age 55. Furthermore, the tax credit will be allowed up to the annual contribution limit of KRW 7 million per individual taxpayer (16.5 percent for those adjusted gross income less than KRW 55 million, 13.2 percent for those above the adjusted gross income-equivalent threshold).

grows tax-free. By "income-type shifting" from a taxable income to tax-free distribution, the investor gets beneficial treatment. By analogy, if an individual investor buys a life insurance policy that dedicated to investing the premiums in hedge funds and CLO equities, the investment grows tax-free because insurance policy gains aren't taxable. The gains are distributed in the form of a death benefit, which illuminates an orthodox way of "pocket-shifting" from a high tax-vulnerable into a tax-free instrument.

Korean life insurance companies may develop personal wealth management offerings such as retail hedge funds and CLO equity funds as an investment choice for variable annuity contracts if the fund manager agrees to establish a new CIV available exclusively through insurance products. Insurance fund managers may consider setting up separate accounts to maintain the tax-deferred or tax-free status. Contract holders should make payments to the insurer, the net proceeds of which are allocated to the separate account and then in turn to the alternative retail wealth management pools. The contract might be able to provide a death benefit that will be some multiples of the original investment values. The National Tax Service may be positive for the use of insurance-dedicated hedge funds and CLO equity funds as extended as well as alternative investment options in variable life and annuities.

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한국 적격투자자의 미국 CLO 투자에 따른 Cross-Border Tax Implication 연구

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Abstract

2018년 2월 9일 미국 워싱턴 D.C. 연방순회 항소심법원은 미국 Collateralized Loan Obligations (CLOs)의 운용사에 대해 Dodd-Frank Credit Risk Retention Rules ("도드-프랭크법")에 따른 CLO지분투자 규정이 적용되지 않음을 선고했다. 본 심 판결에서 법원은 Dodd-Frank법안을 통해 제한하고자 의도한 미국 법인에 대한 상업대출의 Originate to Securitize (대출과 동시에 대출자산 True Sale을 통한 대출채권유동화) 모형에는 Broadly Syndicated CLO (대출규모 $2억5천만불 이상, 혹은 차주의 EBITDA규모 $5천말불 이상인 대출을 기초자산으로 편입한 CLO)는 해당하지 않는다는 것이다. CLO는 Active하게 운용되며 보수 구조 역시도 CLO부채의 선변제와 변제 순위 최하단인 Equity Tranche ("주식 트렌치") 투자자들이 미리 합의된 투자수익률을 달성한 이후에 CLO운용사에 대한 성과보수가 지급되는 방식으로 운용사와 투자자 이익의 상충을 제한하고 있다.

Capitalized Manager Vehicle (CMV), Effectively Connected Income ("ECI"), Tax-Deferral Regime 관련된 최근 미국의 세법개정사안에 대하여 CLO 부채 및 주식 트렌치 투자자 관점에서의 세금으로 인한 현금흐름 누수 가능성 부분에 대한 분석에 중점을 두며, 특히 합자회사형태인 파트너쉽, 유한책임회사 (LLC), Cayman Blocker Corporation등의 법인체별로 미국 세법상 납세의무 노출을 최소화시켜 예상된 투자수익을 실현시킬 수 있는 현실적인 방안도 함께 고려한다. 따라서 CLO, CMBS 등 국내 기관투자자들의 투자검토가 많은 상품에 대한 종합적인 분석을 제시하여, 실무활용도를 높이고자 한다.

본 연구는 최근 연방순회법원 항소심판결에 따른 도드-프랭크법 적용의 향후 예상되는 변화에 따른 CLO 현금흐름의 세금누출 발생가능성에 대한 고려에 더해 2018년1월부터 시행되는 미국 개정세법 (U.S. Tax Cuts and Jobs Act of 2017)의 CLO 부채 및 주식 트렌치 투자자의 납세순응 관련 사항을 논의하며, 한국의 적격 개인 및 기관투자자가 미국 CLO에 투자할 경우 발생할 수 있는 다양한 국제조세문제에 대한 잠재적 위험을 사안별로 고려한다. 한국 투자자의 경우 미국 국세청에 개인의 신분노출 및 주기적인 신고-납부를 포함하는 납세순응절차를 회피하고 한-미조세협약 혜택의 대상이 되는 것이 기본적인 투자 포지션이라고

JEL 분류기호 : K34, H26

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할 때, 통상 Cayman Islands나 Jersey 등 조세피난처에 설립되는 역외 Blocker Corporation을 통한 미국 CLO부채 및 주식 트렌치 투자 구조를 선호하며, 동 Blocker구조를 통해 FATCA 규정에도 불구하고, 미국 국세청에 대한 한국투자자의 신분노출과 투자회수 현금흐름이 미국 과세당국에 의해 ECI, Fixed or Determinable, Annual and Periodic (FDAP) Income 분류 가능성을 최소화하여 납세순응절차의 회피를 도모하는 것이 일반적인 해법이었으며, 본 연구에서는 7가지로 분류한 투자자의 잠재적 위험요인에 대한 금융투자업계의 관행적 해법의 잠재적인 위험성을 분석하는 것에 주안점을 둔다.

주제어 : *Collateralized Loan Obligations, Capitalized Manager Vehicle, Effectively Connected Income*
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