TAX BLOCKERS FOR US CLOs: **BEST PRACTICE FOR RESTRUCTURING DISTRESSED ASSETS**

Andrew Dean | Senior Vice President
Jeffrey Everhart | Senior Vice President

Tax Blockers and US CLOs: Best Practice for Restructuring Distressed Assets

Amidst the significant change in the global credit environment, with certain sectors of the economy still under severe stress from the COVID-19 pandemic, the potential for defaulted assets within CLO portfolios has drawn the attention of collateral managers, who in many cases are turning to a familiar solution.

In line with the practice in prior downturns, like the 2008 financial crisis and the oil price crash in the past decade that caused a wave of bankruptcies in the energy sector, we have recently seen a significant rise in the formation of "tax blocker" subsidiaries for existing US CLO issuers with exposure to affected assets. These entities can hold equity or other workout assets issued in connection with the restructure of distressed assets, which mitigates tax risk that the associated CLO, typically established in the Cayman Islands, will be engaged in a US trade or business, subjecting the entire portfolio to US federal tax. It also allows the CLO to avoid having to dispose of the assets at distressed levels and benefit from any recovery. The Maples Group recently connected with Joelle Berlat, a Managing Director in Deloitte Tax LLP's Houston office. Joelle has focused on the tax consequences of issuance of and investment in CLOs and other securitisation vehicles for over 30 years.

Andrew Dean: In the current market we are seeing a considerable increase in the number of tax subsidiaries being formed. Why are these tax blockers being set up and what is driving the momentum?

Joelle Berlat: Certain types of assets received in a restructuring – primarily equity in entities that are either treated as partnerships for US tax purposes or that have significant US real estate holdings – are placed into blockers to protect the CLO from the risk of being subjected to US tax on its income. We see the volume of blockers increase with the number of restructurings that result in receipt of equity, especially in real estate intensive businesses such as energy and retail.

Andrew Dean: From a CLO structuring perspective, what are the reasons that a CLO cannot hold these types of assets?

Joelle Berlat: US tax law distinguishes between assets that are held as passive investments and those that are held as part of a trade or business. Holding an interest in a partnership that does business in the US causes the owner of that partnership interest to be deemed to be engaged in that business as well. The situation is made even more complicated by a set of rules known as FIRPTA, an acronym for Foreign Investment in Real Property Tax Act, that cause holding even stock in a company that is deemed to be a real estate holding company to be treated as being engaged in a trade or business. As a result, holding certain types of equity interests could put the CLO at risk of owing US tax because it is deemed to be engaged in a US trade or business. A CLO puts any asset that it believes may create that risk into a separate corporation that "blocks" the character of those assets from being ascribed to the CLO by keeping them separate from the CLO's other assets.

Andrew Dean: From a foundation of tax analysis, what are the tax implications for the parent CLO of employing tax blockers and operationally speaking, how do they work?

Joelle Berlat: The fundamental goal of creating a blocker is to keep all the tax implications of the subject asset isolated in the blocker – meaning that the blocker will likely pay US tax on some or all of the income of that asset, including any gain on the sale. The CLO will usually transfer the loan that is going to restructure into the blocker immediately prior to the restructuring, so that the asset is received by the blocker and not ever held by the CLO. The blocker will then file annual tax returns reporting its income from the blocker asset. After the asset is sold and the tax filings are completed, the blocker can be liquidated, with any cash distributed back to the CLO in liquidation. There are important differences between cash distributed to the CLO during the blocker's life and the cash distributed as the blocker is liquidating, with the former potentially bearing an additional layer of tax compared to the latter.

Jeffrey Everhart: What are the key reasons and differences between using onshore and offshore tax blockers, which would come down to Delaware versus Cayman?

Joelle Berlat: An offshore blocker is subject to US tax only on its US trade or business income, and therefore may be beneficial in situations where it is perhaps unclear if a type of income is subject to tax, or if the restructuring will result in the receipt of assets that produce both business and investment income. An offshore blocker can hold a questionable asset, insulating the CLO from risk, and file a protective tax return, not paying tax on the income. However, offshore blockers are potentially subject to an additional tax known as the branch profits tax, which can result in additional tax on cash distributions to the CLO. Onshore blockers will pay tax on all income, but are less expensive to establish and maintain, and are not subject to the branch profits tax.

Jeffrey Everhart: What are the potential implications and advantages or disadvantages of using different types of entities such as an LLC or corporation?

Joelle Berlat: There is no practical difference from a US tax perspective assuming the LLC elects to be taxed as a corporation – which a blocker always would – that difference is solely a legal entity matter.

Andrew Dean: Cost, of course, is always a factor in these situations. In your experience, what sort of cost analysis will a manager tend to do and what are the implications of different structures? I am thinking of an example where perhaps a manager has the same non-performing asset across their book. Would they need to set up say 25 vehicles? Would a structure feature one blocker for one asset with multiple tax subsidiaries underneath or would one vehicle hold multiple workout scenarios?

Joelle Berlat: Most commonly, a manager will set up a separate blocker for each CLO for each asset. While this may seem burdensome and expensive, it often is considered to be the cleanest way to operate. There are two different ways one could think about trying to consolidate – multiple assets for one CLO in a single blocker, or multiple CLOs with the same asset in a single blocker. The former is challenging because as I mentioned earlier there is a potential tax benefit to cash distributions received by the CLO in liquidation versus as a periodic distribution. If you have multiple assets in a blocker, it would be difficult to leave cash undeployed while it sits in the blocker waiting for other assets to be sold. The alternative is to go ahead and move the cash up to the CLO, but that could result in up to 30% tax leakage on that distribution. Putting the same asset for multiple CLOs in a blocker would seem to work if you were confident you would sell out of the position for all the CLOs at the same time at the same price. If you sell at different prices, it is difficult to properly allocate the cash to the appropriate CLO, since each CLO holds the stock of the blocker pro-rata to its assets contributed. Of course, it is also key to remember that while tax issues drive the need for blockers, legal entity and business issues also come into play in determining the blocker structure, and from a legal entity perspective it is difficult for multiple CLOs to hold assets in one blocker.

Andrew Dean: Given these structural issues, it is also worth noting how CLO documentation has evolved in this area, particularly since the financial crisis. In 2009 there were certain issues where some of the governing documents did not allow subsidiaries to be established. Documents for 2.0 vintage CLOs, which took shape after the financial crisis, do allow such subsidiaries and often go one step further as some managers have pushed for the ability to remain in these workout situations. Rather than exiting at a depressed value, more capital can be invested, so the market has certainly evolved to give managers more flexibility to hold onto these assets.

Joelle Berlat: Agreed, the industry has focused on the tax issues associated with workouts and how best to allow for maximum improved recovery while minimising tax risk. Managers have actively engaged with counsel to make sure they understand the extent to which the CLO can invest new money to improve recovery in these distressed situations.

Jeffrey Everhart: Another big question that tends to crop up relates to the process of making the tax return for the blocker vehicle. Typically we see assets with a US nexus, generally real estate, going into the blocker, so tax is payable on that asset and not the entire CLO. Can you outline who is responsible for completing this tax return and whether you think the process can be improved in any way? While it sounds fairly simple, I would think that there are things people need to watch out for, such as making sure bank accounts are not commingled and having segregated bank accounts for offshore deals.

Joelle Berlat: Absolutely – it is critical to be sure that the operational aspects are handled, and they can be challenging, especially when a manager is correctly focused on deploying cash as effectively as possible. The blocker itself is responsible for both federal and state (if needed) tax filings, which as a practical matter means that the manager will need to have the annual returns prepared, most commonly by the tax preparer for the CLO. The blocker may be required to wait for the restructured company to prepare its tax filings and provide a Schedule K-1 before the blocker's tax return can be prepared, even after the asset has been sold and the manager wishes to wrap up the blocker. Also, the timing of taxable income and cash do not always align. There are times that the blocker will owe tax when it has not yet received cash sufficient to pay the tax – or has to defer cash distributions to the CLO in order to make sure there is sufficient cash available to pay the tax. It is critical that the blocker is not legally dissolved until it has filed its final tax returns and paid its final tax liability, as it is difficult to get the return signed and filed if the directors of the blocker are no longer directors because the entity has dissolved.

Andrew Dean: To wrap up, perhaps you could give us your top five tips on tax blockers, from forming the entity through to completion.

Joelle Berlat: I will go with:

1) Any time you have a restructuring and are receiving any kind of equity interest, consider if a blocker is required or advised – US tax counsel or your tax accounting firm should be able to help.

2) Get the blocker its own cash account and respect its cash as its own.

3) Do not take that cash out of the blocker without working through the potential tax impact with your tax team – most commonly it will be advantageous to retain all cash in the blocker until it can be liquidated.

4) Be sure to consider potential state tax filings when thinking about the total costs of tax and administration for the blocker entity.

5) Keep the blocker legally active until the US tax filings are complete.

About the Authors

Andrew Dean

Andrew Dean is a Senior Vice President in the Maples Group's Cayman Islands structured finance team. He works on a range of structured finance transactions including, a significant number of cash-flow and synthetic CLO / CDOs, securitisations and note programmes in both the US and European markets. Prior to joining the Maples Group in 2006, he worked for Deutsche Bank and Lloyds TSB in London and at Westpac Banking Corporation in New Zealand. He graduated with a Master of Business degree in Management and a Bachelor of Commerce in Marketing from Otago University in New Zealand.

Jeffrey Everhart

Jeffrey Everhart is a Senior Vice President based in the Maples Group's Delaware office. He has over 15 years of experience in US fiduciary services providing director / manager services for various boards and structures in a diverse portfolio of sectors. In addition to this, he has worked on Delaware statutory trusts, asset-backed securitisations, longevity products and custody / escrow transactions. Prior to joining the Maples Group in 2018, Jeff worked at Christiana Trust as a Senior Corporate Trust Administrator for eight years. He also worked as a Corporate Trust Administrator for Bank of America and Delaware Trust Company. Jeff holds a Master of Business degree from the University of Delaware and a Bachelor of Science degree in Paralegal Studies. Jeff is also a certified Corporate Trust Specialist and is a member of the American Bankers Association.

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