CLEARY GOTTLIEB

ALERT MEMORANDUM

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New PFIC Reporting Requirements for Investors in CLO Subordinated Notes, Preferred Shares and Income Notes

U.S. taxpayers that own subordinated notes or preferred shares of a CLO issuer, or income notes reflecting an ownership interest in CLO subordinated notes, currently have an obligation to file a U.S. tax form (Form 8621) with their U.S. tax returns if the relevant issuer is treated as a passive foreign investment company ("PFIC"), which is usually the case, and certain other conditions are met. As a result of temporary regulations published on December 31, 2013, failure to file a Form 8621 generally will suspend the statute of limitations for assessment on the related income tax return indefinitely. These rules took effect upon issuance, meaning that they apply to tax returns for the 2013 calendar year, which are required to be filed in 2014, and all future years.

- If a U.S. investor is required to but fails to file a Form 8621 with its U.S. tax return for a particular year, that year generally will be open to audit with respect to any item (even if it has nothing to do with the CLO investment) on that tax return by the Internal Revenue Service at any time in the future, until three years after the form is filed. These rules already applied to investors that made a QEF election (described below) with respect to a CLO investment. They will now apply to investors that do not make the election, regardless of whether the investor is required to report any income from the CLO for a particular taxable year.

- This rule applies even if the taxpayer has correctly reported all of the income from the CLO investment.

- This rule applies even if the taxpayer does not own the CLO shares directly, but instead has invested in a fund or other investment vehicle that invested in the CLO, under the circumstances described below.

- If the taxpayer had "reasonable cause" for not filing the return, then the statute of limitations remains open, but only for CLO-related items. Reasonable cause for non-filing applies only in very limited situations. A situation in which the investor does not know there is a filing requirement, for example where it is an indirect owner of a PFIC, would seem to be a good candidate.

- Taxpayers therefore may consider filing protective Forms 8621 in cases of uncertainty about whether an investor is treated as equity in a PFIC – for example, low-rated classes of CLO securities where there may be uncertainty as to whether the security is treated as debt or equity for tax purposes. If a CLO issuer is organized as a tax partnership, there may also be uncertainty whether the CLO issuer could be treated as a corporation (and therefore a PFIC) under the "publicly traded partnership" rules.

These rules are described in more detail below.

CLO issuers typically are organized in the Cayman Islands or similar offshore jurisdictions, and are classified as corporations and as PFICs for U.S. federal income tax purposes. Subordinated notes or preferred shares issued by a CLO issuer typically are treated for U.S. tax purposes as equity in the PFIC. Similarly, income notes issued by an income note issuer treated as a corporation for U.S. tax purposes generally also are treated as equity in a PFIC. If a CLO issuer holds stock of a foreign corporation, for example a foreign "blocker subsidiary" or stock received in a workout, that foreign corporation also may be treated as a PFIC. The PFIC reporting requirements apply to all of these types of equity. U.S. taxable investors that make a "qualified electing fund" ("QEF") election with respect to their PFIC equity investments generally are already required to file a Form 8621 with their tax return on an annual basis. In addition, other investors are already required to file a Form 8621 in years when they receive an direct or indirect distribution from a PFIC, recognize gain on a direct or indirect disposition of PFIC stock, or make certain elections in respect of a PFIC.

The new temporary IRS regulations, published on December 31, 2013, do not change this basic framework, although they require all PFIC equity investors, and not only those that have made a QEF election, to file a Form 8621 on an annual basis. They do, however, provide more specific rules in addition to affecting the running of the statute of limitations described above.

- ***Indirect owners may be required to file.*** The temporary regulations generally track the old rules for indirect ownership. Perhaps most significantly:
    - *CLO securities held through foreign vehicles.* An investor that holds equity in a CLO issuer through a foreign partnership or through a foreign corporation that is a PFIC generally will be required to file Form 8621 as if it held a pro rata share of the equity in the CLO issuer.
    - *CLO securities held through domestic vehicles.* An investor that holds equity in a CLO through a domestic entity taxed as a partnership will be required to file a Form 8621 if it has any taxable income from the CLO investment, unless the partnership makes a QEF election and files a Form 8621 as to the CLO.
- ***De minimis exceptions generally unavailing.*** While the temporary regulations provide new exceptions for de minimis interests that partially offset the expanded scope of reporting, the de minimis rules do not apply if the investor makes a QEF election as to the PFIC. Even if the investor does not make a QEF election, the de minimis thresholds typically will not apply to direct investors in equity tranches of CLOs.
    - The de minimis rules apply only if the aggregate value of all direct or indirect equity in PFICs held by the investor does not exceed $25,000 (or $50,000 for joint return filers), which is lower than most minimum denominations for equity tranches in CLOs (typically $100,000). In practice, the de minimis rules generally would only apply to certain investors holding CLO equity indirectly through a partnership.
    - For a PFIC owned indirectly through another PFIC or through a controlled foreign corporation, the de minimis rules apply only if the value of the investor's pro rata share of the indirectly held PFIC does not exceed $5,000, so the de minimis rules usually won't apply to a PFIC owned by a CLO.

- ***No filing required for tax-exempts.*** These reporting rules generally do not apply to U.S. tax-exempt investors.

Investors should consult their own tax advisers regarding the application of these rules in their specific circumstances.

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If you have any questions, please feel free to contact James M. Peaslee (+1 212 225 2440), Erika W. Nijenhuis (+1 212 225 2980) or any of our other U.S. partners and counsel listed under “Tax” located in the “Practices” section of our website at http://www.clearygottlieb.com.

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