

# Current tax issues in the collateralized loan obligation markets

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## In brief

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Over the last decade, the issuance of corporate and leveraged loans has grown to record levels. A large percentage of these loans are currently owned by securitization structures called collateralized loan obligations (CLO). CLO entities issue several tranches of senior and subordinated securities. Payments on these securities are made from cash flows generated by the underlying collateral (i.e. the loan investments). The CLO securities typically are held by institutional investors, such as insurance companies, pension funds, mutual funds, and hedge funds, among others.

During the 2008 financial crisis, CLO securities often performed better than other securitized debt products. With the anticipated downgrades of corporate loans in today's markets, the performance of CLOs could face pressure. Specifically, the performance of CLO securities is dependent on the performance of the CLO's underlying loan collateral. Defaults, forbearances, recoveries, restructurings and other events that affect the cash flow of the CLO collateral impact the performance of CLO securities. In addition, some events that do not affect cash flow can impact the performance of CLO securities. For example, downgrades of the issuers of underlying loans can cause payments to be diverted from holders of lower tranche CLO securities to senior CLO tranches.

The taxation of CLO securities is tied to the CLO tranche structure. In most CLOs, all but the most subordinated securities are treated as debt for tax purposes (in this Insight, the term for such securities, Senior Notes, includes senior, mezzanine, and junior CLO tranches). These various tranches of Senior Notes have varying degrees of credit risk, with the most senior tranches having the lower risk and the junior tranches having higher risk. The most subordinated, and riskiest security, is typically called the subordinated notes (Subordinated Notes) and is treated as equity ownership in the CLO for tax purposes.

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**In detail**

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**Implications to cash and liquidity for mismatched taxable income****Senior Notes**

In economic downturns, defaults, forbearances, restructurings, and modifications on underlying loans can all slow payments on lower tranche Senior Notes. Given that most holders of CLO Senior Notes are on the accrual basis of accounting and/or certain CLO Senior Notes are often issued or purchased with discount, holders will often be required to recognize taxable income before they receive cash. This is typically referred to as phantom income. This dynamic can be exacerbated in CLO structures when interest and principal proceeds from the underlying loans are diverted to prioritize payments to the higher tranche Senior Notes and result in phantom income to the holders of the lower tranche Senior Notes. The diversion of cash flows can occur for many reasons, ranging from normal payment priorities to market events, such as the downgrades of loans held by the CLO.

In most situations, phantom income is a timing issue; although cash is not received, it is expected to ultimately be paid. In truly distressed situations, payments may not be expected. In these cases, a whipsaw can occur, in addition to phantom income. A whipsaw is where phantom income from the Senior Notes is recognized at the ordinary rate, but losses are ultimately taken at a lower capital tax rate in the future.

It is important to note that even in stable economic conditions, the recognition of income and losses on CLO Senior Notes is different from GAAP. In distressed periods, the difference between GAAP and tax widens. For example, GAAP may allow for losses at a time that is impermissible for tax or reduce interest accruals in a way that is impermissible for tax. In addition, if Senior Notes are acquired in the secondary market at a discount, unlike GAAP, tax has a provision that allows the discount to not be recognized until principal payments are actually received. Consequently, following GAAP as a tax accounting method may not be permissible or beneficial to holders. Similarly, utilizing GAAP income projections to model after-tax liquidity and distributions may produce misleading results.

**Observation:** *CFOs, tax departments, and portfolio managers sensitive to liquidity and cash constraints of their portfolios and investors should be aware that specific to the CLO market, the liquidity and rating of corporate loans have implications to a CLO structure and its performance. As corporate loans are restructured, downgraded, or subjected to default, there can be cash-tax ramifications to investors with respect to their CLO positions. Mobilizing a systematic process with a watch for defaults, restructurings, and waterfall shortfalls can help plan for such unwanted surprises to all stakeholders.*

**Subordinated Notes**

Subordinated Notes generally are treated as equity ownership in an entity for tax purposes. Most CLO entities are treated as passive foreign investment companies (PFIC) or controlled foreign corporations (CFC). The PFIC and CFC rules have several complexities that will not be addressed in this Insight, but one notable consideration is that the PFIC and CFC rules work fairly well during stable economic periods to match taxable income to economics and limit phantom income to holders of Subordinated Notes. However, the structures create additional complexities during economic downturns. For example:

- Net losses are not passed through to holders of Subordinated Notes and are not allowed to be carried forward or back by the CLO. Thus, losses can be deferred until termination or sale of the Subordinated Notes.
- Income on assets may precede cash payments creating phantom income to subordinated holders. In addition, if phantom income is recognized by a holder and such holder sells its interest, a character whipsaw can arise because the loss on sale generally is a capital loss for tax purposes.
- Unlike REMICs or other securitizations where losses on assets are offset by a reduction in amounts owed on the issued liabilities, in CLOs, losses on assets can occur years before the liabilities are reduced. Consequently, cancelation of indebtedness (COD) income can become an issue upon liquidation of the CLO, since losses do not carry forward.

### Considerations for a time of limited liquidity

The tax issues noted above can impact holders of Senior and Subordinated Notes in a time when holders are looking for more liquidity. Needed liquidity for operations may be diverted to tax paid on phantom income, thereby impacting balance sheets, margin calls, and distributions. The following are some general considerations to help mitigate or alleviate some of the issues:

- Prospective Subordinated Note investors in new and existing CLOs should model out whether making a Qualified Electing Fund (QEF) election would be beneficial if any of the foregoing issues are expected to occur.
- Holders of Subordinated Notes should discuss with their tax providers if a distressed debt policy is being or could be implemented to improve tax and operational efficiency. In certain instances, such policies can reduce the phantom income and whipsaw scenario discussed above.
- To help determine the tax impact of holding Subordinated Notes, multiple scenario cash-flow and taxable income modelling can be performed.

**Observation:** Large institutions and asset managers who hold sizable balance sheets of fixed income, including structured securities such as CLOs, must contemplate the consequences to their provisions and financial statement reporting. In volume, the tax issues associated with holding the Senior and Subordinated Notes of CLOs can have implications in the following ways:

- Subordinated Note holders must heed cash shortfalls described above as they can result in cash-tax mismatches that are exacerbated when compared to Senior Noteholders.
- For portfolios that invest in CLO securities with regularity, it would be important to implement a framework that systematically identifies and validates the treatment of debt versus equity as well as address differences between the accounting and tax classification of these securities.
- Finance, operations, and tax teams will face specific challenges as loan documents and tax policies must be reviewed with speed while ensuring relevant systems are aligned with the classification and corresponding tax method of recognition.
- In times of uncertainty, as accounting and tax continue to deviate and the differences in income recognition for Senior and Subordinated noteholders become more pronounced, character of income, net operating losses, and ultimately tax provisions on financial statements will be impacted.
- The underlying loans in CLOs are often modified or restructured. This can range from forbearance or reduction of interest rates to equity for debt exchanges. Depending on the facts, the tax treatment of the various transactions can range from no tax impact to taxable gain or loss being recognized. If appropriate, collateral managers to the CLOs should take the tax treatment of debt restructuring into account.

Additionally, to the extent loan prices continue to decline, CLO managers and first loss providers may be asked to post additional collateral as alternative warehouse financing arrangements are contemplated. In scenarios where certain economics are not achieved (such as margin calls) lenders may force the sale or liquidation of warehouse arrangements, resulting in adverse loss positions for warehouse participants.

Finally, certain provisions of the recently enacted Coronavirus Aid, Relief, and Economic Security Act, or the CARES Act (not addressed in depth in this article), and the search for liquidity may also drive changes in the formation of CLO managers, and certainly the potential for new CLOs to be formed; in such scenarios, there may be tax considerations around mergers and acquisitions as well as considerations specific to such new formations.

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### The takeaway

Tax accounting for CLO Senior Notes and Subordinated Notes during difficult economic times creates complex tax issues, only some of which are briefly highlighted in this Insight. The issues are broad and impact operations, after-tax returns, liquidity, and distributions. Although the markets are moving fast, being prepared with the appropriate policies, operations, and systems may help to alleviate some of the issues and reduce tax risks.

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## Let's talk

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For a deeper discussion of how this issue might affect your business, please contact:

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