This chapter provides a general description of the US tax operating guidelines used in collateralised debt obligation (CDO) transactions and how such guidelines are designed to ensure that the actions of a collateral manager do not cause the CDO issuer to be:

- engaged in a trade or business in the United States;
- subject to tax on a net-income basis in the United States; or
- subject to the US branch profits tax.

In any securitisation transaction it is critical that the vehicle through which the securitisation is carried out is not or does not become subject to tax, as tax liabilities imposed at the entity level will impede the flow of funds from the underlying collateral to the purchasers of the rated securities. In the context of a classic domestic securitisation transaction, such as a residential mortgage-backed securities or commercial mortgage-backed securities transaction, or a credit card securitisation, tax neutrality is achieved by qualifying the special purpose vehicle as a grantor trust, real estate mortgage investment conduit or other vehicle which is treated as fiscally transparent for US federal income tax purposes. The particular features of a CDO transaction, and specifically the fact that it is actively managed, make it difficult (and, depending on the nature of the underlying collateral and certain other factors, perhaps even impossible) for a CDO to be structured so that it is fiscally transparent for US tax purposes. Instead, CDOs are virtually always structured as corporations organised under the laws of a low or no-tax jurisdiction, such as the Cayman Islands, Ireland, Luxembourg or the Netherlands. The use of a foreign corporation to carry out
a CDO results in the need to impose restrictions on the actions of the CDO collateral manager in order to be certain that tax neutrality is achieved.

Although this chapter focuses on US tax status, collateral managers with international operations should be aware that similar rules exist in various jurisdictions outside the United States. Hence, a collateral manager with significant activities in, for example, the United Kingdom may face similar restrictions with respect to its activities there.

**Issuer must not be engaged in US trade or business**

In most CDO transactions an offshore issuer is organised in a jurisdiction in which it is exposed to minimal or no tax on its net income. The United States taxes the net income of a foreign corporation that is effectively connected to a US trade or business (Section 882(a)(1) of the Internal Revenue Code). The United States, with some exceptions, does not tax the net income of a foreign corporation that does not have income effectively connected with a US trade or business.

The United States also imposes a tax on foreign corporations that are deemed to conduct business in the country through a branch (Section 884 of the code). This branch profits tax is levied at a rate of 30 per cent and is imposed in addition to the ‘effectively connected to a US trade or business’ tax described above. For purposes of the branch profits tax, taxable profit includes only the amount that is deemed repatriated from the branch to the foreign corporation or the dividend equivalent amount (Section 884(e)(3) of the code). The dividend equivalent amount equals the foreign corporation’s earnings and profits that are effectively connected to the conduct of a trade or business in the United States, subject to certain specified adjustments (Section 884(b) of the code).

If a foreign CDO issuer can operate without being engaged in a US trade or business, the issuer will be subject to neither US tax on a net income basis nor branch profits tax.

**Activities of collateral manager can cause issuer to be engaged in US trade or business**

The relationship between a foreign CDO issuer and a US collateral manager is usually viewed as that of a principal and an agent. Under common law principles of agency, a foreign corporation may be engaged in a US trade or business through the activities of its agents in the United States. The standards governing the existence of an agency relationship and the circumstances under which imputation from an agent occurs, however, can be difficult to surmise from the case law. The case law indicates that activities of persons subject to a high degree of control by a foreign corporation (e.g., employees and dependent agents acting exclusively or almost exclusively for the corporation) are properly imputed to the corporation (e.g., see Lewenhaupt v Comr, 20 TC 151 (1953), aff’d 221 F2d 227 (9th Cir 1955), revoked Rul 70-424, 1970-2 CB 150).

It is generally more difficult to impute the activities of independent agents to foreign persons and the case law is less clear regarding when such imputation will occur. Courts have occasionally imputed the activities of independent agents to foreign persons for the purpose of determining whether those persons are engaged in a US trade or business when the relationship between the independent agent and the foreign person is characterised by some degree of regularity (e.g., see Amodio v Comr, 34 TC 894, 906, 909 (1960), aff’d 299 F2d 623 (3d Cir 1962); Investors’ Mortgage Security Co v Comr, 4 TCM 45 (1945); Handfield v Comr, 23 TC 633 (1955)). In certain situations the Internal Revenue Service has also imputed the activities of independent agents to foreign persons (e.g., see Rev Rul 55-617, 1955-2 CB 774).

In the CDO context, the collateral manager is arguably viewed as an independent agent of the issuer, because the manager most likely manages assets for various foreign issuers and is not exclusively retained by one issuer. However, as mentioned above, even the actions of independent agents have, on occasion, been imputed to foreign persons. In general, the CDO market has not relied on characterising the collateral manager as an independent agent of the issuer in order to avoid imputing the activities of the collateral manager to the issuer for purposes of determining whether the issuer is engaged in a US trade or business. Instead, the CDO
market uses US tax operating guidelines as a means of restricting the activities of the collateral manager and ensuring that such activities, even if imputed to the issuer, will not cause the issuer to be engaged in a US trade or business.

Securities trading safe harbour

The collateral manager can, on behalf of the issuer, invest in US assets without being engaged in a US trade or business by relying on the securities trading safe harbour (Section 864(b)(2) of the code). The safe harbour provides that trading in stocks or securities for a taxpayer's own account, whether by the taxpayer or its employees or through a resident broker, commission agent, custodian or other agent, and whether or not any such employee or agent has discretionary authority to make decisions when carrying out the transactions, does not constitute a trade or business within the United States (Section 864(b)(2)(A)(i)). The term ‘security’ for this purpose is broad and includes loans (Section 1.864-2(c)(2)(i) of the Treasury Regulations promulgated under the code). However, under Section 864(b)(2)(A)(ii) of the code (and Section 1.864-2(c)(2)(i) of the Treasury Regulations), the safe harbour does not apply to a dealer in stocks and securities, even if the trading at issue is unrelated to the dealer activities (Section 864(b)(2)(A)(ii) of the code, Section 1.864-2(c)(iii) of the Treasury Regulations).

The regulations differentiate between a dealer and a person who “buys and sells, or holds, stocks or securities for investment or speculation” (Section 1.864-2(c)(2)(iv) of the Treasury Regulations). A ‘dealer’ is defined as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom”.

The securities trading safe harbour does not apply to the following activities:

- operating a commercial lending business;
- engaging in insurance activities; and
- providing financial guarantees.

Although trading in derivatives is not expressly exempted from US trade or business treatment under the code, in 1998 the Treasury Department issued proposed Treasury Regulations Section 1.864(b)-1, which exempts trading activity of ‘eligible non-dealers’ in derivatives from trade or business treatment. An ‘eligible non-dealer’ is a person that is not a US resident, a dealer in stocks, securities or commodities or a person that regularly offers to enter into, assume, offset, assign or otherwise terminate positions in derivatives with customers in the ordinary course of a trade or business (Section 1.864-1(a) and (b) of the Treasury Regulations). The proposed regulations apply to activities with respect to a notional principal contract or another derivative financial instrument with respect to any debt instrument. Accordingly, if the issuer enters into hedging transactions in connection with a CDO transaction, whether these swaps are viewed as one or more notional principal contracts or as another type of derivative financial instrument, the proposed regulations would prevent the issuer’s activities with respect to these swaps from giving rise to a trade or business. In its notice of proposed rulemaking with respect to the proposed regulations, the Treasury Department stated that: “These regulations are proposed to be effective for taxable years beginning 30 days after the date final regulations are published in the Federal Register... For periods prior to the effective date, taxpayers engaged in derivatives transactions may take any reasonable position with regard to the Section 864(b)(2)(A)(ii) or (B)(ii) safe harbors. Positions consistent with these proposed regulations will be considered reasonable.” (63 FR 32164 (June 12 1998).)

This language indicates that any reasonable position, and in particular positions consistent with the proposed regulations, can be relied on for derivatives transactions entered into prior to the issuance of regulations in final form. Although the Treasury Department could change the proposed regulations prior to their finalisation, or issue different final regulations, in such circumstances the issuer could claim reliance on the Treasury Department’s statement as a defence to payment of the resulting US income tax, at least for transactions entered into prior to the effective date of any such finalisation. As a result,
the proposed regulations have been relied upon by counsel to conclude, for example, that credit default swaps entered into by a CDO issuer benefit from the securities trading safe harbour.

**Contractual restrictions on manager**

**General**
The collateral manager manages the issuer and selects investments on its behalf subject to the constraints imposed by the CDO documentation, including the tax operating guidelines. The collateral manager’s objective is to ensure that it has as much discretion as possible in making investment decisions on behalf of the issuer. To that end, the collateral manager typically wants to negotiate guidelines that allow it to invest in the broadest range of assets under the least restrictive conditions. The collateral manager needs assurance that it will not be liable for causing the issuer to be engaged in a US trade or business if it complies with the tax operating guidelines.

**Need for restrictions if no activities undertaken from the United States**
The purpose of the tax operating guidelines is to support a conclusion that the collateral manager’s activities will not cause a CDO to be treated as engaged in a trade or business within the United States. It seems highly unlikely that this would be the case in circumstances where the collateral manager has no presence in the United States and agrees that it will not create such a presence during the life of the transaction, even if the CDO is investing in US source collateral; in such cases it seems likely that, even if the CDO were treated as engaged in business activity, it would not be considered to have a trade or business within the United States, and hence would not become subject to US net income tax. Nevertheless, certain (cautious) advisers may insist on the imposition of US tax operating guidelines in such cases due to concern that a collateral manager may be deemed to have exercised discretion or otherwise undertaken actions in the United States with respect to its US source collateral.

**Specific restrictions**

**Restrictions designed to prevent ‘dealer’ activities**
The securities trading safe harbour does not apply to a dealer in stocks, securities or derivative instruments. A dealer regularly engages as a merchant that purchases securities and sells them to customers in the ordinary course of business with a view to profiting from the gains and profits that may be derived from making a market in securities. In contrast, an investor buys and holds its securities solely for investment with the expectation of realising a profit from income earned on such securities and/or any rise in their value during the interval of time between purchase and sale. The tax operating guidelines are designed to ensure that the issuer will not be deemed to be a dealer in stocks, securities or derivatives by engaging in dealer-type activities. In any given CDO transaction, there are often several overlapping provisions designed to prevent ‘dealer’ activities. These provisions will typically prevent a CDO from holding itself out as a market-maker in stocks, securities or derivatives, and may contain other, more specific restrictions, such as:

- requiring that the CDO purchase all its collateral from a dealer; and
- prohibiting the CDO from issuing bid lists of securities it proposes to purchase or sell.

Although the dealer-related restrictions in a given CDO may appear lengthy and should be viewed carefully by collateral managers and their counsel, traditional CDO activities rarely create a serious risk that the CDO will be considered a ‘dealer’ for US tax purposes.

**Restrictions designed to prevent issuer from being considered engaged in commercial lending activity**

**General**

It is generally understood that the scope of the securities trading safe harbour, although broad, does not cover income earned in connection with a commercial lending enterprise (Sections 1.864-4(c)(5) and 1.864-6(b)(2)(ii)(b) of the Treasury Regulations). This income is considered attributable not to trading, but rather to
loan origination – historically a more service-oriented activity than trading. Although at one time the difference between trading and lending was quite pronounced, with the development of an active market for loans it has become increasingly difficult to draw a distinction and there is little recent legal precedent. In the absence of definitive guidance from the Internal Revenue Service or the courts, guidelines have been developed to constrain the activities of the collateral manager in order to support a conclusion that the issuer’s activities should be considered to be trading rather than lending.

**Issuer cannot be a bank**
The tax operating guidelines typically prohibit the issuer from registering as, or holding itself out to the public as, a bank, finance company or any other similar deposit-taking or loan-originating institution. The guidelines also do not permit the issuer to be treated as a bank or finance company for purposes of:

- a tax or securities law or other filing or submission made to a governmental authority;
- an application made to a rating agency; or
- qualification for an exemption from tax or securities law or any other legal requirements.

**No direct acquisitions from obligor**
Subject to the exception described below, the tax operating guidelines typically bar the issuer from acquiring a debt instrument directly from the obligor (ie, debtor) under such instrument because such a transaction may be treated as a loan origination activity that would not qualify for the securities trading safe harbour. The issuer is further restricted from purchasing an obligation from a seller that has not purchased and funded the obligation for its own account. An obligation is funded when the creditor thereunder has advanced the entire principal amount due under such obligation. This prevents the issuer from acquiring through a ‘straw man’ or accommodation party something that the issuer could not acquire directly. In addition, if it acquires an asset from a person that has not purchased and fully funded such asset for its own account, there is a risk that such person might be disregarded and the issuer might be treated as having acquired the asset directly from the obligor in a lending transaction or extended a loan to such obligor.

Although, in general, collateral managers are prohibited from causing CDOs to acquire obligations at origination, it is generally understood that certain purchases at origination are consistent with investor activity and do not give rise to concerns that the CDO may be engaged in origination activity. Thus, for example, it is common to permit CDOs to purchase collateral at origination pursuant to a public offering or a placement from an underwriter, or otherwise pursuant to customary circling procedures, provided that neither the CDO nor any affiliate was directly involved in the structuring of the collateral obligation and, in certain cases, that the collateral was purchased by unrelated parties on similar terms.

**No other commercial lending activities**
Where there is a risk that the issuer could be viewed as making a loan as opposed to purchasing it on the secondary market, the guidelines bar the issuer from purchasing such loan. Therefore, the issuer typically is prohibited from purchasing a loan if:

- the loan is not tradable – that is, of a type that bank and non-bank purchasers regularly commit to purchase in secondary market transactions;
- the terms of the related credit agreement, note, indenture or other documentation require that any such purchase be made only by a bank savings and loan, thrift or trust company or other similar deposit-taking or loan originating institution;
- as a result of the purchase or commitment to purchase such loan, the issuer would own more than 50 per cent of the aggregate principal amount of the borrowing that includes such loan;
- either the issuer or the collateral manager has participated in the negotiation of the terms of such loan;
the issuer would execute the loan as an original lender;

the legal closing of such loan and its full funding to the obligor have not yet occurred, unless the issuer is permitted to enter into a forward commitment and satisfies the restrictions with respect thereto; or

the loan constitutes a revolving loan facility or delayed-draw loan (an exception discussed below is available if the CDO transaction contemplates the purchase of revolving and delayed-draw obligations).

Restrictions on forward commitments to purchase loans and securities

In the syndicated loan market a bank will make a large loan to a borrower with the intent to sell participations in such loan or assign the entire loan to market participants shortly after funding it. To ensure that the bank will have sufficient purchasers available to acquire the loan participations, the bank will attempt to obtain forward commitments from market participants. These commitments are generally documented on standard form Loans Syndication and Trading Association documentation. Ideally, the bank would like to obtain forward commitments to acquire those portions of the loan that the bank does not want to retain on the date of the funding of such loan, with as little chance as possible that the party making the forward commitment will not follow through on its commitment.

The challenge here is to give the collateral manager as much flexibility as possible to compete for loan assets via forward commitments without causing the issuer to engage in a US trade or business. The risk is that if the issuer commits to buy a loan prior to its closing and complete funding, the issuer may be viewed as engaging in loan origination activities that do not qualify for the securities trading safe harbour, and could cause the issuer to be viewed as engaging in a US trade or business. To mitigate such risk, restrictions along the following lines are often imposed on the issuer’s purchase of forward commitments as follows:

- The loan to which the forward commitment relates cannot be purchased from the collateral manager or an affiliate thereof, and neither the collateral manager nor any affiliate may have participated in negotiating or structuring the terms of such loan. Since the collateral manager is the agent of the issuer, an acquisition of the loan or participation in its structuring by the collateral manager or its affiliate could be attributed to the issuer.

- The seller of the loan to which the forward commitment relates must have already made a legally binding commitment to fully fund the loan. Such commitment may be subject to customary market conditions but may not be conditioned on the issuer’s ultimate purchase of the loan from the seller. This restriction is designed to ensure that the seller of the loan bears true risk of default with respect to such loan, however temporary. If the seller bears no risk and will extend the loan only if the issuer commits to buy it, the seller may be viewed as merely the agent of the issuer.

- The collateral manager, on behalf of the issuer, may not negotiate any of the terms of the loan to which the forward commitment relates because if it does so the issuer may be viewed as making the loan.

- The forward commitment must contain such conditions as are customary for a market purchase of the loan to which it relates by persons such as the issuer. This is in order to ensure that the issuer is acquiring a loan in a manner typical of secondary market purchasers.

- The terms of the forward commitment must provide for a fixed price for the loan. This guarantees that the issuer will not negotiate a provision with the seller of a loan that allows the seller to transfer the risk of default under the loan to the issuer sooner than the other restrictions with respect to forward commitments would allow.

In addition, certain US tax counsel may require that any forward commitment not close for a specified period after the funding of the loan and that the issuer’s
commitment be subject to a no ‘material adverse change’ clause or similar contingency. A typical waiting period would be 48 hours – the value of a ‘material adverse change’ clause or other contingency for such a short period of time is debatable.

**Restrictions on affiliate-originated loans**

Most tax practitioners agree that, if an affiliate of the collateral manager has originated collateral that the CDO could not have acquired directly consistent with the foregoing provisions, then the CDO should not be able to acquire such collateral until some significant ‘seasoning’ period has elapsed. The appropriate period is a matter of negotiation, but typically is between 30 and 90 days. During this period, tax operating guidelines will typically prohibit the collateral from being identified as held for sale to the CDO. In certain cases, such as where an affiliate of the collateral manager undertakes extensive origination activities for third-party customers in the ordinary course of its business, and where it can be established clearly that the affiliate is not acting on behalf of the CDO in originating the obligation, this seasoning period may be shortened or eliminated altogether.

**Restrictions relating to revolving loan facilities and delayed-draw loans**

The participation of a CDO in a revolving loan facility or delayed-draw loan presents particular issues because it requires the CDO to advance funds directly to the borrower in circumstances which present a risk that the CDO may be viewed as performing a service typically performed by a bank or other commercial lender. However, it is often viewed as critical from a commercial perspective that the CDO have the capacity to acquire an interest in such loans. Moreover, it seems unlikely that the mere ownership of a revolving or delayed-draw loan, together with its associated obligations, would cause a foreign corporation to be treated as engaged in a trade or business within the United States, provided that neither the corporation nor anyone acting on its behalf has participated in the negotiation or structuring of the obligation and the obligation to make advances is fixed or subject to clearly identifiable objective conditions, so that the CDO is not in a position to exercise discretion or renegotiate terms when a draw is requested. Tax operating guidelines will typically permit investments in such loans subject to conditions along the lines described above.

**Restrictions on synthetic securities**

If the purchase of synthetic securities is contemplated in a CDO transaction, the tax operating guidelines typically stipulate that certain restrictions, including the following, must be satisfied:

- The issuer can purchase a synthetic security only if it would otherwise be permitted to purchase the reference obligation thereof. This ensures that the issuer cannot be exposed to an asset synthetically that it is forbidden from being exposed to directly through purchase.
- The synthetic security cannot be used as a means of making an advance, which is essentially a disguised loan, to a synthetic security counterparty. As explained above, lending activities are not covered by the securities trading safe harbour.
- The net payment from the issuer to the synthetic security counterparty cannot be determined based on an actual loss incurred by the synthetic security counterparty or any other designated person. This reduces the risk that the synthetic security will be treated as an insurance or financial guarantee by ensuring that the protection buyer has no obligation to prove that it has suffered a loss. As explained above, insurance activities are not covered by the securities trading safe harbour. Deciding whether a financial instrument is insurance or a guarantee involves the analysis of several factors, including:
  - risk aggregation;
  - risk distribution;
  - whether the protection buyer has an insurable interest; and
  - whether proof of loss is a condition precedent to payment.
There must be no agreement that the synthetic security counterparty be required to own or hold the related reference obligation while the synthetic security remains in effect. This is to make sure that the synthetic security does not compel the protection buyer to have an insurable interest as a condition of purchasing protection.

The issuer cannot treat the synthetic security as an insurance or a financial guarantee for any purpose. This guarantees that the issuer cannot treat acquired synthetic securities as insurance or financial guarantees for non-tax purposes. Practitioners are concerned that financial instruments treated as insurance or financial guarantees for non-tax purposes might receive identical treatment for tax purposes in the future.

The issuer can enter into a synthetic security only with a synthetic security counterparty that is a dealer. This prevents the issuer from being perceived as selling credit protection to customers – that is, being engaged in an insurance business, which does not qualify for the securities trading safe harbour.

**Other restrictions**
A number of other restrictions are customarily imposed on collateral managers, including restrictions on:

- the acquisition of equity interests in fiscally transparent entities doing business in the United States;
- the acquisition of US real property interests which are subject to certain special and generally adverse tax treatment in the hands of a foreign corporation; and
- the acquisition of collateral which may otherwise be subject to US withholding taxes or withholding taxes imposed by any other taxing jurisdiction.

These restrictions are likely to be imposed whether or not the manager undertakes activities from within the United States, as the tax they seek to avoid is not dependent upon the presence of such activities.

**Conclusion**
Tax-related restrictions on collateral manager activities are often lengthy and complex and, to the uninitiated, may appear to contain obscure and unnecessary provisions prohibiting activity that was not realistically within the contemplation of the collateral manager in the first place. However, when viewed in the light of their purpose, such restrictions are often easily explained and accepted as rational (or, at the very least, benign).