Equity investment in collateralized debt obligations (CDOs) is an enormously complex endeavor. As primary bearers of the risks associated with CDO collateral, persons contemplating investments in CDO equity must weigh myriad factors, both qualitative and quantitative, that may potentially affect their returns. Chief among these are a variety of non-tax considerations involving, among others, the evaluation of the capabilities of the CDO manager and the assessment of possible returns under different cash flow scenarios. Crucial as these considerations may be, savvy investors also must engage in sophisticated tax planning to maximize the after-tax returns on their investments.

Depending on the circumstances, U.S. equity investments in CDOs may be governed by the Passive Foreign Investment Company (PFIC) rules, the Controlled Foreign Company (CFC) rules, or both. The PFIC and CFC tax regimes are exceptionally nuanced and, consequently, proper tax planning depends on a careful analysis of the individual circumstances of the investor and its analysis of the risks of the investment.

This article focuses on tax aspects of equity investments in CDOs by taxable U.S. persons and the strategies that may effectively be used to maximize certain U.S. tax benefits. The discussion focuses on the characteristics of a typical offshore CDO structure, on advantages that U.S. investors in CDO equity may obtain by making a Qualified Electing Fund election (QEF election), the circumstances in which a QEF election is not advisable, and the interplay of the CFC rules.
A. THE STRUCTURE OF A TYPICAL CDO FUND:

**i) Choice of Venue for the SPV**

A typical CDO arrangement (see Exhibit) involves the creation of an offshore special purpose vehicle (SPV) in one of a number of tax-efficient jurisdictions, such as the Cayman Islands, Bermuda, Luxembourg, Netherlands, or Ireland. The goal is to reduce as much as possible the tax owed with respect to amounts flowing into and out of the SPV. To achieve this end, the SPV itself must not be subject to entity-level tax in the location where it is organized. This means that there should be neither tax on income received by the SPV nor any withholding tax liability on interest or dividends from investments in the SPV.\(^2\)

While tax considerations are usually an important element underlying the choice of location for the SPV, other factors occasionally play a role as well. European investors, for example, often prefer investing in issuers that are member states of the Organization for Economic Cooperation and Development (OECD). Consequently, CDOs catering to European investors must anticipate this requirement and establish their SPVs in OECD countries, such as the Netherlands or Luxembourg.

**ii) Choice of Entity for the SPV**

The SPV typically is organized as an entity that is treated as a corporation under default U.S. tax rules, or a “check-the-box” election is made to achieve this end. This is done primarily for the benefit of tax-exempt U.S. investors, which are taxed on income from their leveraged investments.\(^3\) For U.S. federal tax purposes, a corporation is a separate legal entity and, even when it borrows to finance investments, distributions to its tax-exempt shareholders are not considered leveraged and consequently are not taxed.

**iii) Balance Sheet CDOs, Market Arbitrage CDOs and the Collateral Manager**

Traditionally, CDOs have appeared in two flavors: balance sheet CDOs and market arbitrage CDOs. The two differ primarily in the way the assets backing the CDO structure (the “collateral pool”) are assembled. Balance sheet CDOs are initiated by holders of securitizable assets, usually banks or other large financial institutions, to remove certain assets
from their balance sheets in order to meet capital or regulatory requirements. In these types of deals, the originator in effect sells its own assets to the SPV, which finances such purchases by issuing notes and selling preferred shares to investors.

Arbitrage CDOs involve the participation of a collateral manager in the CDO structure. The primary role of the collateral manager is to acquire assets for the collateral pool and to manage them for the duration of the CDO. Prior to the initiation of a typical arbitrage CDO structure, the collateral manager identifies and acquires various assets in the marketplace, placing them on its own books. At the closing of the deal, the collateral manager sells these assets to the SPV for cash, which is raised by the SPV through the issuance of notes collateralized by the collateral pool and the sale of preferred equity in the SPV.

iv) CDO Assets
Any asset with predictable cash flows can be included in a CDO structure. The types of assets historically backing CDOs include, among others, bank loans, emerging-market debt, middle-market loans, project finance debt, real estate investment trust (REIT) debt, high-yield bonds, and trust preferred securities.

v) The CDO Waterfall
Generally, the liability structure in a typical CDO consists of three tranches of debt and equity. At the very top of the chain is the senior tranche of debt (Class A), ordinarily rated “AAA”/“Aaa,” followed by the mezzanine tranche (Class B), rated “BBB”/“Bbb,” and preferred equity, which is unrated. As the collateral pool generates cash flows, the moneys are distributed in order of priority to the debt tranches and then, if anything is left over, to the CDO equity-holders. Holders of Class A debt typically enjoy absolute priority as to payments of interest and principal over the holder of Class B debt, and holders of Class B debt enjoy priority over the CDO equity-holders. This is called a CDO waterfall.

Because assets comprising the CDO collateral pool carry a certain level of risk, and may be affected by defaults over time, different tranches of CDO debt and CDO equity are subject to differing degrees of risk and, consequently, yield different rates of return. The senior tranche of debt is the safest CDO investment, because of its primary position in the CDO waterfall, and is highly rated for this reason. Class A CDO debt, however, generates only a slight premium over LIBOR because of its inherent safety. On the other hand, the mezzanine tranche of CDO debt, which is second in line for cash flows from the collateral pool, is more risky than senior debt, requiring a greater premium over LIBOR, but is not as risky as equity. At the other end of the scale, CDO equity investors bear all of the risks associated with the CDO collateral pool, but, at the same time, enjoy through the leverage a large upside potential in the event that the CDO structure performs well.

B. NAVIGATING U.S. PFIC AND CFC RULES:
i) Is it a PFIC or a CFC?
Generally, because of the nature of CDO income, U.S. equity investments in CDOs may be subject to PFIC or CFC rules (or both). A CDO will be a PFIC if 75% or more of its gross income is passive income (income test) or if the average percentage of its assets that produces passive income is at least 50% (asset test). Unlike the CFC rules, discussed below, PFIC provisions do not have any stock ownership tests, and are aimed at relatively small U.S. stockholdings in foreign corporations. Thus, the PFIC provisions would apply even if a U.S. investor owned a relatively small percentage of CDO equity. As will be discussed further, however, the PFIC rules do not apply to U.S.
investors that are subject to the CFC rules of Subpart F of the Internal Revenue Code (the “Code”).

A CDO will be a CFC if more than 50% of either the total combined voting power or the total combined value of all outstanding stock is owned directly, indirectly, or constructively by U.S. shareholders on any day during the CDO’s tax year. For purposes of the CFC rules, a “U.S. shareholder” is any U.S. person (U.S. citizen, resident alien, corporation, partnership, trust, or estate) owning 10% or more of the foreign corporation’s total combined voting power of all classes of stock entitled to vote.

As discussed above, a CDO may meet the definitions of both a CFC and a PFIC if, for example, it satisfies either the PFIC income or asset tests and the stock ownership rules of the CFC regime. U.S. investors in CDOs, however, will be exempt from the PFIC rules for any portion of their stockholding period (the “qualified portion”) during which the CDO is a CFC with respect to such investors. In other words, if a U.S. investor in a CDO owns 10% or more of CDO stock entitled to vote, the PFIC rules will not apply, and such income from the CDO to such investor will, under the CFC rules discussed below, be subject to current inclusion in gross income of the investor.

**ii) Tax Consequences of PFIC Status**

The purpose of the PFIC regime is to prevent deferral of income earned by U.S. investors from investments in foreign corporations whose income or assets consist predominantly of passive items. In the case of PFIC shareholders that do not elect Qualified Electing Fund (QEF) status, discussed in greater detail below, this is accomplished by requiring U.S. investors owning PFIC shares, including equity in CDOs that are PFICs, to pay a U.S. tax plus interest on amounts constituting what are termed “excess distributions.”

Under the PFIC regime, an “excess distribution” is the amount by which distributions received in respect of PFIC shares in a given taxable year exceed 125% of the average amount received in respect of such stock during the preceding three taxable years. Gain recognized on the sale of PFIC stock is also an “excess distribution” for purposes of the PFIC rules. Thus, any gain recognized in a given taxable year on the sale of equity in CDOs that are PFICs, plus any excess distributions with respect to such equity for that taxable year, will constitute “excess distributions” subject to the onerous U.S. taxation and interest charges of the PFIC regime.

To calculate the tax that may be due under the PFIC regime, excess distributions are allocated pro rata over the period the shareholder has held its PFIC stock. Any portion of excess distributions that is allocated to pre-PFIC taxable years of the CDO, or to the current taxable year of the PFIC shareholder, is included in the income of the PFIC shareholder for the current taxable year as ordinary income. Any portion of excess distributions that is allocated to prior PFIC taxable years is taxed at the highest rate of U.S. tax then in effect for the PFIC shareholder (“deferred tax”). In addition, PFIC shareholders must pay interest on the amounts of deferred tax. The interest charge on the deferred tax is computed using the method and rates applicable to underpayments under section 6621 of the Code.

**Example 1:**

Assume, for example, that a U.S. investor owns equity in a CDO on each day of Years 1, 2, and 3. Further assume that this CDO is a PFIC with respect to the U.S. investor, and that in Year 3 the U.S. investor receives a single $300 distribution with respect to its CDO equity. For the sake of simplicity, also assume that the highest rate of tax applicable with respect to the U.S. investor for Years 1,
2 and 3 is 35%, and that the interest rate on underpayments is 10% compounded annually. If the U.S. investor does not elect QEF treatment in Year 1, all of the $300 received in Year 3 will constitute an “excess distribution” for purposes of the PFIC rules, because distributions for both Years 1 and 2 are zero. The excess distribution of $300 will be allocated ratably over the U.S. investor’s three-year holding period, $100 to each of Years 1, 2, and 3. As a result, $100 of the excess distribution allocated to Year 3 will be included as ordinary income in the U.S. investor’s Year 3 gross income, resulting in a tax of $35. The $200 allocated between Years 1 and 2, on the other hand, will be subject to the deferred tax plus interest, resulting in total liability for tax and interest of $42.35 for Year 1 and $38.50 for Year 2. Thus, at the end of Year 3, the U.S. investor will owe $115.85 in tax and interest, or 38.6% of the total return from its investment.

iii) Taxation of U.S. Shareholders under the CFC Rules:
If the CDO is a CFC in addition to being a PFIC in a given year, U.S. investors that own at least 10% of the voting power of the CDO equity will be “U.S. shareholders” for purposes of the CFC rules. If a U.S. equity-holder in a CDO is a U.S. shareholder, it cannot elect QEF status (discussed below) and is, instead, subject to the CFC tax regime. Generally, the CFC rules require U.S. shareholders in a CFC to include as ordinary income for a taxable year their pro rata share of the CFC’s “subpart F income” and their pro rata share of the CFC’s earnings from assets invested in U.S. property.

iv) Qualified Electing Funds:
To avoid the default tax regime under the PFIC rules, many investors in CDO equity elect Qualified Electing Fund (QEF) treatment, which carries several notable advantages. Under the QEF rules, PFIC shareholders include as ordinary income for a taxable year their pro rata share of the PFIC’s ordinary earnings for that year, and as long-term capital gain their pro rata share of the PFIC’s net capital gain for the year. The shareholders’ basis of PFIC stock is increased by amounts thus included in income.

When PFIC shareholders make the QEF election after the first PFIC year in their holding period, both the default PFIC rules and the QEF rules apply simultaneously. In this event, however, the PFIC shareholder is not taxed under the default regime on amounts included in its income pursuant to the QEF rules. Instead, any built-in gain at the time of the disposition of PFIC stock, reduced for amounts taken into account under the QEF rules, is taxed as an excess distribution under the default PFIC rules.

Amounts included in income in a taxable year by a PFIC shareholder electing QEF treatment, but not distributed in that taxable year, are not subject to double taxation in the year they are finally distributed. Moreover, shareholders may elect to defer tax on such amounts, subject to an interest charge. The tax deferral expires, and the deferred tax, plus interest, becomes payable, in the year that the shareholder sells the PFIC stock to which the QEF election relates, or the PFIC ceases to be a QEF. For purposes of basis adjustments, distributions of amounts previously included in income are treated as non-taxable returns of capital, which reduce basis.

The QEF election is made at the shareholder level, on a shareholder-by-shareholder basis. The election must be made before the due date for filing the shareholder’s tax return for the first tax year in which the election would apply. The QEF election, however, is available only if the PFIC
complies with certain information-reporting requirements. Furthermore, once made, the QEF election is revocable only with the consent of the Internal Revenue Service.

\textit{v) Theoretical Advantages of QEF Status}

Most U.S. equity-investors in CDOs elect QEF treatment for three reasons. First, unlike the default PFIC rules, the QEF election allows PFIC shareholders to preserve the long-term capital gain character of their shares of PFIC income, which may result in significant tax savings for U.S. CDO equity investors if the CDO generates significant capital gains. Second, by permitting the flow-through of a CDO’s earnings and profits, QEF rules create a way for U.S. CDO equity-holders to avoid the interest charges of the default rules.

\textbf{Example 2:}

Assume the same facts as in Example 1, except that the U.S. investor elects QEF treatment in Year 1. Further assume that the U.S. investor’s \textit{pro rata} share of the CDO’s earnings and profits in Years 1, 2, and 3 is $100, and that 10\%, or $10, of this amount constitutes the U.S. investor’s \textit{pro rata} share of the CDO’s long-term capital gain. In this scenario, the U.S. CDO equity-holder will be responsible for $31.50 of tax in Years 1, 2, and 3 (assuming a tax rate of 35\%), on the earnings and profits, and $1 of tax for each of those years on the long-term capital gain (assuming a tax rate of 10\%). Accordingly, ignoring the time value of money, the total tax liability for the U.S. investor in this scenario will be $97.50, or $18.35 less than in Example 1. These tax savings are due entirely to the U.S. investor’s ability to take advantage of lower tax rates for long-term capital gains under the QEF rules and the absence of interest charges on deferred tax amounts.

The third, but very important, reason why U.S. equity investors tend to elect QEF treatment is the economic distortion caused by the default PFIC rule’s requirement that excess distributions be allocated \textit{pro rata} over the shareholder’s entire stockholding period. Under ordinary circumstances, the equity-holder’s share of the earnings and profits of the CDO will increase over time as the CDO structure matures. Accordingly, if a QEF election is in place, the increase in the equity-holder’s tax liability will be proportionate to the increase in its \textit{pro rata} share of CDO earnings and profits. However, in the absence of a QEF election, portions of larger distributions in later years of the CDO structure will constitute excess distributions and will be re-allocated over the shareholder’s entire holding period. Consequently, the equity-holder’s income is effectively shifted to earlier tax years, which results in higher interest charges than would be due if the QEF election and the tax deferral were in place.

\textbf{Example 3:}

Assume that the facts are the same as in Example 2, except that the U.S. equity-holder’s \textit{pro rata} share of the CDO’s earnings and profits for Years 1, 2, and 3, is $0, $100, and $200, respectively. Also assume that the CDO structure generates no long-term capital gains and that the equity-holder receives a single lump-sum payment of $300 at the end of the CDO’s term in Year 3. Under the default rule, the entire lump sum payment received by the U.S. equity-holder in Year 3 will be an excess distribution that, as in Example 1, results in total liability for tax and interest of $115.85. However, if the U.S. equity-investor elects QEF treatment in Year 1 and chooses to defer tax in each of the three years of the CDO structure, it would only owe $108.50 in tax and interest. Thus, the \textit{pro rata} reallocation of income to prior years under the default rules would...
result in the U.S. CDO equity-holder in this example owing $7.35 more in non-deductible interest payments.

C. THE QEF ELECTION IN PRACTICE:

Although U.S. equity investors in CDOs commonly elect QEF treatment, there are two distinct situations in which U.S. equity investors should exercise extreme caution prior to electing QEF status: if the CDO has “excessive turbo” or the CDO may turn into a “bombed out” deal. Turbo occurs in a deal when interest on collateral is used to pay principal on the issuer’s securities. In a bombed out CDO, returns generated by the collateral pool are expected to be impaired significantly by future defaults. In the former situation, U.S. equity investors may want to elect QEF treatment in conjunction with a deferral of tax. In the latter situation, U.S. equity investors may want to avoid making the election altogether. In addition, there are also situations in which a QEF election is not possible. Each of these is discussed below.

i) The QEF Election in Deals with Excessive Turbo

Deals with excessive turbo typically require the interest and/or principal of CDO debt to be repaid before any amounts are distributed to CDO equity-holders. Under the QEF rules, U.S. equity-holders in such CDOs are required to include in current income, and pay tax on, their pro rata share of the CDO’s earnings and profits, including those earnings and profits used to pay principal on CDO debt (interest payments are deductible by the CDO). These current inclusions in income may create a problem, however, in the event that current distributions to equity-holders are insufficient to satisfy their current tax liabilities arising from such inclusions. In such event, the U.S. equity-holder electing QEF treatment may be forced to satisfy such tax liabilities out of its own funds.

Fortunately, U.S. equity-holders can circumvent the problem described above by electing to defer tax under the QEF rules. By deferring tax under the QEF rules, the U.S. CDO equity-holder is able to delay paying tax on current inclusions of earnings and profits until the CDO makes sufficient distributions to satisfy these tax liabilities. The U.S. CDO equity-holder is also able to preserve the long-term capital gain character of its ratable share of CDO income and, more importantly, avoid the distorting effect of the default rules. The amounts of deferred tax, however, are subject to a relatively high rate of interest.12

Example 4:

Assume a CDO deal is funded entirely by borrowing, the amount of borrowed capital is $1,000, the interest rate on CDO debt is 5%, and the collateral pool generates a 15% return. Further assume that this is a prototypical “excess turbo” deal requiring interest and principal of CDO debt to be repaid over a 10-year period before any distributions are made to the equity-holder. Accordingly, if the U.S. CDO equity-holder elects QEF treatment, it will pay tax each year on the principal payments to CDO debt-holders (the interest payments to debt-holders are deductible). In the first year of the structure, the interest payment on CDO debt will be $50, and the principal payment will be $100. Assuming the applicable U.S. tax rate is 35%, the equity-holder will have a U.S. tax liability of $35 in the first year of the deal, but does not receive any distributions from the CDO because all cash flows are used to pay principal and interest on CDO debt.

Accordingly, in this hypothetical, the U.S. equity-holder may want to defer tax under the QEF rules until it receives sufficient distributions of cash to satisfy its tax liabilities. In this hypothetical, electing QEF treatment and deferring tax may be more advantageous.
than not making the election, despite an interest charge on deferred tax under the QEF rules, because the U.S. equity-holder is able to recognize his share of CDO capital gain and avoid the pro rata reallocation of his income to prior years.

ii) Situations Where the QEF Election is Disadvantageous
The QEF election should be avoided in “bombed out” deals because, in certain situations, it may lead to a whipsaw. For example, the QEF regime requires the CDO equity-holder to pay tax on a current basis on its pro rata share of the CDO’s earnings and profits, even if distributions are deferred until sometime in the future. Unfortunately, if the deal sours, the equity-holder nonetheless will be responsible for taxes on current inclusions of earnings and profits, even though it may never receive subsequent matching distributions. To make matters worse, if the U.S. equity-holder suffers a loss because its current inclusions under the QEF regime are greater than the total distributions with respect to its CDO equity, it would be able to recognize only a capital loss on any future disposition of its stock.

iii) Situations Where the QEF Election is Impossible
Many European CDOs hesitate to comply with QEF rules because doing so would require them to give their equity-holders access to their books and records. Consequently, it is common for European CDOs not to provide their U.S. investors with the requisite information for a QEF election. The failure to comply with the information disclosure requirements of the QEF rules frequently bars U.S. equity-holders in European CDOs from making the highly advantageous QEF election. This situation can also arise in CDOs that invest in equity of other CDOs.

Example 5:
Assume the facts are as follows: the CDO deal is funded entirely by CDO debt of $1,000 with an interest rate of 5%, the collateral pool generates a 10% return, and the deal is expected to last 10 years. To simplify matters, assume that in this CDO, the debt-holders receive no payments of principal during the term of the deal, and that the entire principal balance of the CDO debt is expected to be paid off by selling CDO collateral at the end of the 10-year term. Further, assume that the excess interest generated by CDO collateral is kept in a reserve to ensure repayment of principal on CDO debt. In this situation, if the U.S. equity-holder elects QEF treatment in Year 1, it will recognize $500 of income over 10 years, receiving a basis step-up of $500, and paying a total of $175 in tax (assuming a 35% tax rate). However, if at the end of the 10-year term the entire reserve is used to satisfy principal obligations on CDO debt because of defaults in the collateral pool, the CDO equity-holder will receive no payments with respect to its CDO equity stake. Thus, as a result of the current inclusions under the QEF rules, the U.S. CDO equity-holder in this example is effectively whipsawed. It pays tax at ordinary income rates on $500 of phantom income over the term of the CDO, but, at a subsequent disposition of its worthless CDO equity, it recognizes a capital loss of $500 that may be unusable.

D. OTHER TAX TIPS:

i) The Mark-to-Market Election
U.S. owners of CDO equity that is “marketable stock” for purposes of section 1296 of the Code generally should make a “mark-to-market election.”
The mark-to-market election permits U.S. investors to pay tax on the annual appreciation in the value of their stock in lieu of the default PFIC tax regime and the current inclusion of earnings and profits of the QEF election. Thus, with the mark-to-market election, CDO equity-holders pay tax only in the event that the value of their shares appreciates. Moreover, the mark-to-market election permits electing shareholders to deduct annual declines in the value of their stock.

ii) Waiting a Year to Elect QEF Status:
Equity investors in CDOs should consider waiting until the year following their acquisition of CDO stock to elect QEF treatment. By doing so, they in effect have two years to assess the CDO’s performance and to ensure that the QEF election is truly to their advantage. Additionally, even if there are distributions with respect to CDO equity in the first year of the structure, these will not be subject to the default PFIC tax rules, because a shareholder cannot have an “excess distribution” in the year that it acquires PFIC stock.

E. CONCLUSION
This article has highlighted for U.S. equity investors in CDOs some of the often-overlooked nuances in U.S. tax rules governing investment in foreign corporations. As we have seen, these rules require careful consideration, with particular attention paid to the individual circumstances of each U.S. equity investor. In most cases, the interests of a U.S. equity investor subject to the PFIC rules would be best served by QEF treatment. Because this is not true in every case, U.S. equity-investors should carefully scrutinize every facet of their deals to determine whether electing QEF treatment maximizes the after-tax return on their investments.

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1. CDO equity-investors no longer need to worry about the Foreign Personal Holding Company (FPHC) and the Foreign Investment Company (FIC) tax regimes, which were repealed by the American Jobs Creation Act of 2004.
2. Additionally, if the SPV is organized in a jurisdiction that does not have tax treaties with most other jurisdictions, the SPV must purchase assets that are not subject to substantial withholding tax in their country of origin.
3. Generally, under U.S. federal tax law, income from investments by a tax-exempt entity is not subject to tax. However, where the tax-exempt entity borrows to finance its investments, income from such investments is deemed to be Unrelated Business Taxable Income (UBTI) and is subject to tax. This is also the case where the tax-exempt entity invests in a flow-through entity, such as a partnership or an LLC, which leverages its investments. It is not the case when the tax-exempt entity invests non-borrowed funds in a corporation.
4. Differing rates of return on various tranches of CDO debt and equity may also result from the yield curve not being flat.
5. For purposes of the income and asset tests, “passive income” includes dividends, interest, royalties, rents, annuities, and income from swaps and certain property and currency transactions.
6. For purposes of PFIC rules, when a shareholder in a CFC which is also a PFIC ceases to be a “U.S. shareholder,” the shareholder will receive a new holding period for his PFIC stock which begins on the day following the loss of “U.S. shareholder” status. However, the former U.S. shareholder will not get a new holding period if his shares were stock of a PFIC at any time prior to the qualified portion of the shareholder’s holding period, and the shareholder did not make a gain recognition election pursuant to section 1298(b)(1) at the time he ceased to be a U.S. shareholder.
7. The holding period for PFIC stock includes the period up to the date of the distribution. Moreover, the holding period is calculated separately for batches of stock acquired on different dates.
8. For purposes of our discussion, Subpart F income includes passive investment income of the type generated by CDOs.
9. For purposes of the QEF rules, ordinary earnings of a CDO are the excess of such CDO’s “earnings and profits” for a taxable year over its net capital gain for that year.

10. In the case that the QEF election is not made in the first PFIC year, PFIC taint may be “purged” by electing to recognize gain built into PFIC stock pursuant to section 1291(d)(2), as if it were an actual sale.

11. Specifically, the PFIC must provide the shareholder electing QEF treatment with a “PFIC Annual Information Statement” that, among other things, must specify the shareholder’s pro rata share of PFIC earnings and profits and net capital gain for a taxable year and, additionally, include a statement that the PFIC will permit the shareholder to examine PFIC’s books of account, records, and other documents to determine whether the PFIC’s earnings and profits and net capital gain are computed in accordance with U.S. income tax principles.

12. Tax deferred under the QEF regime is subject to non-deductible interest charges equal to the normal rate for underpayments of tax (the federal short-term rate plus three percentage points).

13. Generally, stock constitutes “marketable stock” for purposes of section 1296 if it is regularly traded on a national securities exchange that is registered with the SEC.

14. Amounts included in income pursuant to the mark-to-market election increase basis in shareholder’s stock subject to the election.

15. In the event that upon the making of the QEF election the U.S. CDO equity-holder chooses to adjust its basis in CDO equity pursuant to section 1291(d)(2) of the Code, there should not be any tax due if the value of CDO equity remained constant in the first two years that the U.S. investor held CDO stock.