

# Cross–Border Hybrid Financings

Joint Seminar of the Canadian and U.S. Branches  
International Fiscal Association  
Toronto

May 17-18, 2007

L.G. "Chip" Harter, PricewaterhouseCoopers LLP  
Peter Connors, Orrick, Herrington & Sutcliffe LLP  
Stephen Dunk, PricewaterhouseCoopers LLP  
Abraham Leitner, Davies Ward Phillips & Vineberg LLP  
Bruce Sinclair, Borden Ladner Gervais LLP

## U.S. Perspective on Hybrid Financings -- Public Statements by Bush Administration Officials Emphasizing Primacy of U.S. Tax Principles

IRS Chief Counsel B. John Williams in "*Chief Counsel Statement on Transfer Pricing, International Tax Issues*," 2003 TNT 54-47, para.22.

Nicholas J. DeNovio, Deputy Chief Counsel (Technical), International Revenue Service, at the Spring meeting of the Section of Taxation, American Bar Association, Washington, D.C., May 7, 2004.

Hal Hicks, International Tax Counsel, at tax luncheon hosted by the law firm of Buchanan Ingersoll, January 12, 2006, reported in Tax Notes Today at 2006 TNT 9-H (January 13, 2006).

U.S. Perspective on Hybrid Financings –  
Recent Testimony of Commissioner Everson Before Congress

June 13, 2006 Senate Finance Committee Hearings.

- Written Testimony Released in IR-2006-94.

Everson Addressed "Abusive Hybrid Instrument Transactions" and "Abusive Foreign Tax Credit Transactions."

IRS has Formed an "Issue Management Team" to "Develop a Service-Wide Position on Hybrid Instruments."

U.S. Perspective on Hybrid Financings –  
Recent U.S. IRS Audit Initiatives Re Hybrid Instruments

Hybrid Financings Made an LMSB Audit Priority

- Now a "Tier I" Coordinated Audit Issuer

Significant Recent Increase in Audit Intensity

- Inbound DSS and Repo Hybrid Financings Targeted

Standard IDRs Focusing on Foreign Tax Treatment

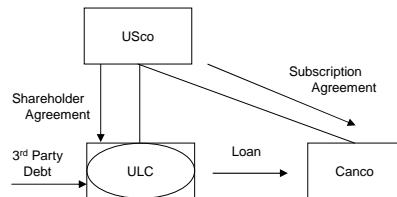
## Canadian Perspective on Hybrid Financings – Overview

“[The SCC] has never held that the economic realities of a situation can be used to recharacterize a taxpayer’s bona fide legal relationships”

- Shell Canada Limited v. The Queen (99 DTC 5669)

Hybrid entities and financial instruments are used in Canada because Canada’s tax law characterizes relationships based on legal substance while the revenue laws of other countries characterize the relationships base on either “economic substance” (debt v equity, step transaction) or in a manner mandated by foreign law (check-the-box)

## 1. Inbound Structure – Canada-US Hybrid Instrument Financing



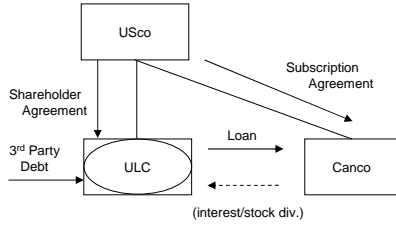
### Summary:

1. ULC uses proceeds of 3<sup>rd</sup> party debt to make a loan to Canco.
2. Simultaneously, USco enters into a forward subscription agreement with Canco to purchase shares for cash equal to the principal amount of the loan on the maturity date.
3. Simultaneously, USco enters into a shareholder agreement with ULC to purchase shares for cash in order to service the interest payments under the 3<sup>rd</sup> party debt.
4. Interest on the loan from ULC to Canco is paid annually either in cash, subject to an immediate reinvestment agreement, or in the form of Canco shares.

### Canadian Tax Consequences:

- Interest expense on the loan is deductible to Canco.
- Interest income and expense in ULC.
- Interest expense in Canco.
  - Proposed section 143.3.
- No Canadian withholding tax on interest payments under the 3<sup>rd</sup> party debt (if properly structured).
- Structuring not as relevant if 2007 proposed reduction in withholding enacted.
- No Canadian thin capitalization restriction.

## 1. Inbound Structure – Canada-US Hybrid Instrument Financing (Continued)

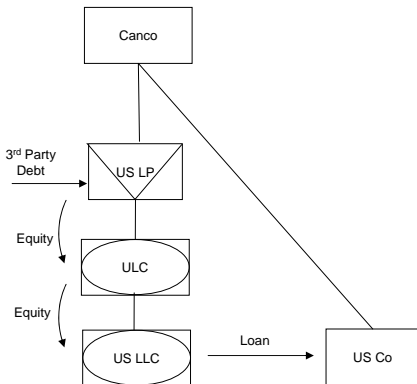


### US Tax Consequences:

- The loan from ULC to Canco and the forward subscription agreement are integrated for US tax purposes and the integrated instrument is regarded as equity for US tax purposes.
- Because the ULC is disregarded, its interest expense is deducted by USCo.
- "Interest" on the "loan" is paid in common shares of Canco. Tax-free stock-on-stock dividend characterization therefore sought for the "interest" payments under section 305(a).
- This structure was the subject of IRS Chief Counsel Advice AM 2006-1, which instructed revenue agents not to challenge the equity characterization of the hybrid financing.
- Final Dual Consolidated Loss Regulations eliminate USCo's ability to deduct ULC's loss. USCo can not make a domestic use election because Canco is considered to make "indirect use" of ULC's loss, under new Treas. Reg. §1.1503(d)-3(a)(2).
- Example 7 under Treas. Reg. §1.1503(d)-7(c) specifically describes this fact pattern.

Page 7

## 2. Outbound Structure – The Tower



### Summary:

1. US LP uses the proceeds of 3<sup>rd</sup> party debt to subscribe for shares of ULC.
2. ULC uses the proceeds to subscribe for units in US LLC.
3. US LLC loans to US Co.

### Canadian Tax Consequences: (Current Law)

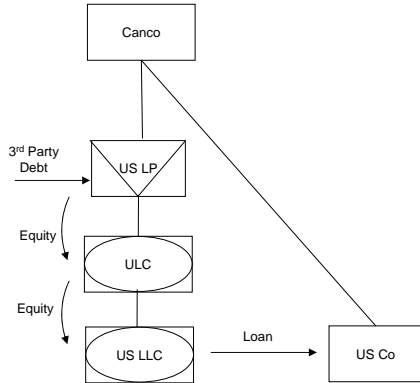
- Interest received by US LLC deemed active – not FAPI.
- Dividends received by ULC from exempt surplus of US LLC – no Canadian tax.
- Dividends ULC to US LP not taxable in Canada.
- No Canadian withholding tax on interest payments under the 3<sup>rd</sup> party debt (if properly structured).
- Structuring not as relevant if 2007 proposed reduction in withholding enacted.

### Proposed Law (differences)

- Interest expense incurred by US LP disallowed
- No ability to deduct interest if US LP has no income from US LLC
- US Co will be a foreign affiliate of ULC in respect of which ULC has a qualifying interest
- Interest income will be exempt surplus of US LLC to ULC

Page 8

## 2. Outbound Structure – The Tower

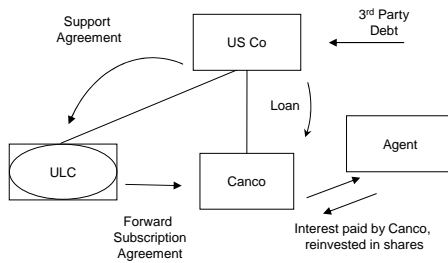


### US Tax Consequences:

- Interest Deduction for financing in USCo.
- USLP is a limited partnership which elects to be taxed as a corporation for U.S. tax purposes.
  - No consolidation with USCo.
- ULC and US LLC elect to be disregarded as entities separate from USLP.
  - USLP pays corporate income tax on a spread between the interest earned by US LLC and its expense on the 3<sup>rd</sup> Party Debt.
- Dual Consolidated Loss Regulations not implicated because domestic reverse hybrid is neither a dual resident corporation or a separate unit,
  - IRS is "continuing to study the issue."

Page 9

## 3. Inbound Structure – Canada-US Hybrid Instrument Financing



### Summary:

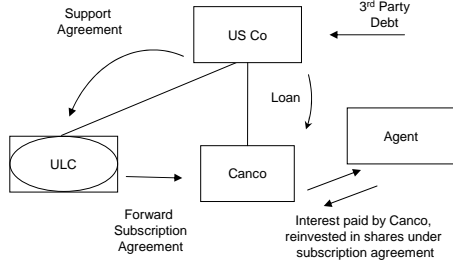
1. US Co uses proceeds of 3<sup>rd</sup> party debt to make a loan to Canco.
2. Simultaneously, ULC enters into a forward subscription agreement with Canco to purchase shares for cash equal to the principal amount of the loan on the maturity date.
3. Simultaneously, US Co enters into a support agreement with ULC to purchase shares for cash in order that ULC can fund its obligation under the forward subscription agreement.
4. Interest is paid by Canco annually in cash to the Agent. Under an irrevocable reinvestment agreement between USCo and Canco, the cash is immediately reinvested in Canco for additional shares. Alternatively the interest may be paid by Canco to USCo in the form of shares.

### Canadian Tax Consequences:

- Interest expense is deductible in Canco.
- Canadian withholding tax on interest payments by Canco (subject to proposed Treaty changes).
- Subject to Canadian thin capitalization limitation.
- If interest is paid in the form of shares will draft section 143.3 apply to deny the deduction?

Page 10

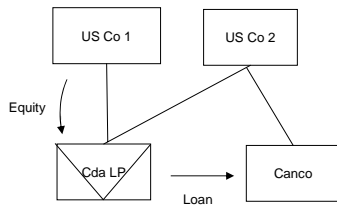
### 3. Inbound Structure – Canada-US Hybrid Instrument Financing (Continued)



#### US Tax Consequences:

- USCo deducts the interest on the 3<sup>rd</sup> party debt.
- The loan and the forward subscription agreement are integrated for US tax purposes, and the integrated instrument is regarded as equity for US tax purposes.
- USCo seeks to integrate the payment of cash interest on loan note with the reinvestment of the cash in common shares of Canco to treat as tax-free stock-on-stock dividend under section 305(a).
- The new, final Dual Consolidated Loss regulations do not appear to apply to this structure, given that ULC, the separate unit, does not have a loss for U.S. tax purposes.

### 4. Inbound Structure – Reverse Hybrid – Direct US Ownership



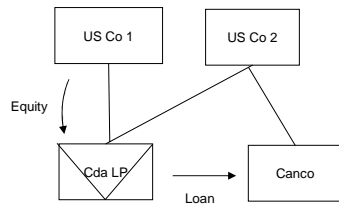
#### Summary:

1. US Co 1 makes an equity investment in Cda LP.
2. Cda LP lends to Canco. Interest payable annually in cash.
3. Cda LP reinvests interest payments in Canco as additional loans or equity.

#### Canadian Tax Consequences:

- Interest expense is deductible in Canco.
- Likely subject to Canadian thin capitalization rules.
- Withholding tax at 10% (under current law) on interest payments by Canco to Cda LP.
- Provided Cda LP does not have any activity in Canada it should not be subject to Part I tax.

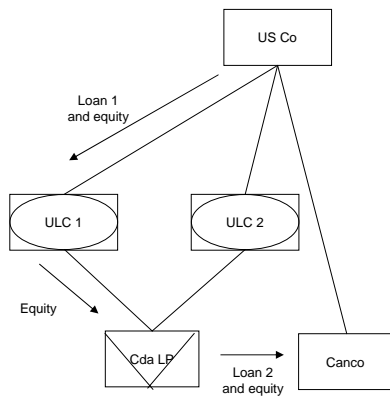
#### 4. Inbound Structure – Reverse Hybrid – Direct US Ownership



##### US Tax Consequences:

- Cda LP elects to be treated as a corporation for U.S. tax purposes, and is therefore a controlled foreign corporation.
- Interest earned by Cda LP on loan to Canco can qualify for exceptions from subpart F income.
  - "CFC look through" rule of §954(c)(6).
  - "Same country exception of §954(c)(3).
- New Prop. Treas. Reg. § 1.901-2(f)(2)(iii) would prevent USCo 1 and USCo 2 from claiming foreign tax credits for taxes paid by Cda LP before Cda LP's earnings are distributed.
  - Proposed to be effective for taxes paid or accrued during years beginning on or after Jan. 1, 2007

#### 5. Inbound Structure – Reverse Hybrid – Indirect US Ownership



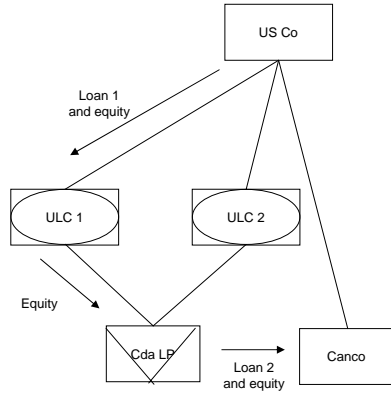
##### Summary:

1. US Co subscribes for shares of ULC 1 and makes a loan (Loan 1).
2. ULC 1 makes an equity investment in Cda LP.
3. Cda LP loans to Canco (Loan 2) and subscribes for shares of Canco. Loan 1 and Loan 2 are for the same principal amount.
4. Cda LP reinvests interest payments in Canco as additional loans or equity.

##### Canadian Tax Consequences:

- Interest expense is deductible in Canco on Loan 2.
- ULC 1 is subject to the Canadian thin capitalization rules.
- Withholding tax at 10% (under current law) on interest payments by ULC 1 to US Co 1.
- Interest on Loan 2 taxed to Cda LP's partners. ULC 1 deducts interest expense on Loan 1 against its partnership income from Cda LP.

## 5. Inbound Structure – Reverse Hybrid – Indirect US Ownership



### US Tax Consequences:

- UCL 1 elects to be disregarded. Therefore Loan 1 is a disregarded transaction and interest paid on Loan 1 is not income to USCo.
- Cda LP elects to be treated as a corporation for U.S. tax purposes and is therefore a controlled foreign corporation.
- Interest earned by Cda LP on Loan 2 can qualify for exceptions from subpart F income.
  - "CFC look through" rule of §954(c)(6).
  - "Same country exception of §954(c)(3).
- New Prop. Treas. Reg. § 1.901-2(f)(2)(iii) would prevent USCo from claiming foreign tax credits for the small amount of tax paid by ULC 1 and ULC 2 before Cda LP's earnings are distributed.
  - Proposed to be effective for taxes paid or accrued during years beginning on or after Jan. 1, 2007.
- New Dual Consolidated Loss regulations do not appear to apply, because the disregarded interest expense on Loan 1 does not give rise to a DCL in ULC 1.