Overview

- Capital structure is important in any business venture and there are two principal sources of capital
  - Equity
  - Debt

- Distinguishing Equity from Debt
  - Although the distinctions between straight common stock and straight debt are relatively clear, in practice many instruments will have some equity and some debt features, often in order to take advantage of differences in:
    - U.S. and non-U.S. treatment of the instrument; or
    - Tax and accounting treatment of the instrument

- Focus here is on tax considerations, but there are also significant legal and business considerations that may favor one form of investment over another
When Does Equity Make Sense?

- **Equity Advantages and Considerations**
  - Need to balance considerations to the **company** with considerations to the **shareholders**:
    - Dividend distributions are non-deductible to the **company**, **but**
    - **Shareholders** may prefer dividends if they are exempt from, or eligible for reduced rates of, tax
      - Dividends received deduction reduces or eliminates the double tax on dividends between U.S. corporations and on certain dividends from non-U.S. corporations (sections 243, 245)
      - Under current law a 15% tax rate applies to “qualifying dividends” received by U.S. investors from most U.S. and certain foreign corporations (section 1(h)(ii))
      - “Participation exemption” regimes are common outside the U.S., particularly in the EU
    - Equity rights, including warrants and options, may be incorporated into larger business transactions
When Does Equity Make Sense?

- **Equity Advantages and Considerations**
  - In the cross-border context, greater potential for withholding tax on dividends
    - Only a limited number of U.S. treaties provide for zero rates of withholding on dividends paid by U.S. companies
    - Distributions within the European Community may be eligible for exemptions from withholding, either statutorily or under treaties
  - Other considerations
    - Dividend distributions received by U.S. corporations can carry foreign tax credits, which can be used to offset U.S. tax on foreign source income
    - Some amount of equity financing is required in all cases, often to meet regulatory or rating agency requirements
  - **NOTE:** The above rules relate to dividend distributions (i.e., distributions of earnings) only; returns of capital are generally tax free but are only possible from a U.S. perspective once all earnings have been distributed
When Does Debt Make Sense?

▪ Debt Advantages and Considerations
  - The principal advantage to debt financing from the corporation’s perspective is that interest expense generally is deductible, subject to limitations, but
  - From the investor’s perspective, interest income generally is less likely to be exempt from current tax
    ▪ In the U.S., interest income generally is fully taxable to the recipient
  - There are material limitations on deduction of interest expense for U.S. and non-U.S. tax purposes
    ▪ General debt/equity principles earnings stripping (section 163(j))
    ▪ Arm’s length rates (section 482 (related party transactions); section 7872 (below market loans))
    ▪ Thin capitalization
    ▪ Debt payable in equity (section 163(l))
    ▪ Interest and carrying charges allocable to certain investments (section 263(g))
When Does Debt Make Sense?

- Debt Advantages and Considerations
  - In contrast to dividends, interest expense generally is exempt from withholding tax, either by statute or treaty
    - “Portfolio interest” is exempt from U.S. withholding tax, but significantly does not include:
      - Related party interest expense;
      - Bank financing; and
      - Certain contingent interest
    - If portfolio interest exemption is not available, many U.S. treaties provide for little or no withholding tax on payments of interest
      - Always confirm treaty eligibility, in particular satisfaction of limitation on benefits clause
    - Conduit financing regulations will disregard intermediate entities in a financing arrangement if there is a tax avoidance motive (section 1.881-3).
How Do You Determine Debt from Equity?

- For U.S. federal income tax purposes, substance over form controls. No single test can be applied for purposes of distinguishing debt from equity—all facts and circumstances must be considered.

- Section 385 authorizes the IRS to promulgate regulations to govern the debt/equity determination, but attempts at regulations failed.

- Under case law, balancing of debt and equity factors is required.
  - As many as 16 factors have been identified in the case law as relevant to the debt equity determination. See *Fin Hay Realty Co. v. United States*.
  - In Notice 94-47, the IRS identified eight factors that should be considered in making the debt/equity determination and that are principally relied upon for this purpose.
What Are the Relevant Factors for Making the Debt/Equity Determination?

- Notice 94-47 — Principal factors in making the debt/equity determination are as follows
  - Unconditional promise to pay a sum certain on demand or at a fixed maturity date
    - Longer term maturities may indicate equity treatment (*Estate of Mixon v. United States*)
    - If issuer has rights to extend, supports equity treatment (*Milwaukee & Suburban Transport Corp. v. Commissioner*)
  - Creditors’ rights
    - Right to enforce periodic payments is indicative of debt (*Hardman v. Commissioner*)
    - Limitation of payments to extent of “available net income” or similar determination is equity factor (*Universal Castings Corp. v. Commissioner*)
What Are the Relevant Factors for Making the Debt/Equity Determination?

- Notice 94-47 — Principal factors in making the debt equity determination are as follows
  - Subordination
    - Subordination of the rights of the holder to creditors is indicative of equity (*Roth Steel Tube*)
    - Existence of subordinated debt and varying levels of preferred equity means that this factor is frequently discounted
  - Voting/management rights
    - Voting rights are indicative of equity treatment, but again are frequently discounted such as preferred equity that does not include management or voting rights, which is not uncommon (*Green Bay and Western R.R. v. Commissioner*)
Special Considerations with Debt: Guarantees

- Parent Guarantees
  - **Under Plantation Patterns**, guaranteed debt can be treated as debt of the guarantor if the borrower is unable to support the obligation independently
    - If not clear that a loan would be made in the absence of a guarantee, additional analysis is required
    - Consider lender confirmation of creditworthiness in appropriate cases
    - If debt is recast, payments by borrower generally are treated as distributions to guarantor, and guarantor is treated as paying interest—reallocation of income and deductions can have significant income and withholding tax consequences
Benefits of Both Worlds: Hybrid Instruments and Arrangements

- Perhaps the most basic of “hybrid” instruments is preferred stock, which typically provides for a fixed return and may have a fixed maturity, but payments are limited by earnings of the issuer
  - Preferred stock is recognized as equity for tax purposes
  - Note that although equity for tax purposes, preferred stock is subject to special rules (e.g., 351(g), 1504 plain vanilla preferred)
  - Guaranteed payments are analogous in the partnership context (section 707(c))

- On the flip side are contingent debt instruments
  - Contingent debt instruments are recognized in the OID regulations (see section 1275), although regulations assume away the issue by assuming that instruments are treated as debt for tax purposes
  - Contingencies as to principal have resulted in an IRS determination that equity treatment is appropriate (Compare FSA 200131015 with Rev. Rul. 2003-97)
  - Even if respected as debt, contingencies can result in special treatment for tax purposes (e.g., section 163(l), limitation on treaty benefits, portfolio interest)
Run for the Border: Cross-Border Financing Arrangements

- Outbound — Financing Non-U.S. Investments
  - Straight debt financing permits repatriation of principal without additional tax and potential for arbitrage if deducting interest at a higher rate than including in income, or in the case of hybrid structures possibly a deduction locally with no additional income.
Run for the Border: Cross-Border Financing Arrangements

- Inbound — Financing U.S. Investments
  - Basic debt financing structure for acquiring U.S. operations:
Basic debt financing structure for acquiring U.S. operations

- Because U.S. Newco and U.S. Target will form a consolidated U.S. group, interest expense of U.S. Newco can be used to reduce U.S. Target’s taxable income in the U.S.—subject to limitations discussed below

- Facilitates repatriation of U.S. Target’s earnings to non-U.S. parent, provided interest is exempt from withholding tax under a treaty and limited or no residual tax in parent’s jurisdiction

- Difficult to insert debt into structure after acquisition without triggering a dividend from U.S. Target (assuming it has earnings and profits)

- This structure with principally related party debt may run afoul of earnings stripping rules
Questions?

Robert S. Chase II
Partner
Sutherland Asbill & Brennan LLP
202.383.0194
robb.chase@sutherland.com