Overview of Presentation

- Discussion of four financing/investment structures:
  - Double dip inbound financing
  - Reverse hybrid LBO financing
  - Double dip outbound financing
  - Mutual fund investment structures to access foreign asset economics

- Comments on US tax consequences, Nova Scotia company law and US insolvency law should be verified with local counsel
Objectives of Inbound Double Dip Structure

- Inbound double dip structure used to finance Canadian subsidiary of US parent
- Interest deductions in both Canada and United States - hence the term “double dip”
- Defer recognition of interest paid by Canco for US tax purposes
Financing Canco: No Double Dip

USCO

Interest Expense

Loan

US Bank

Equity

CANCO

No Interest Expense
Financing Canco: No Double Dip

USCO

2:1 Debt to Equity

Loan

US Bank

No Net Interest Expense

Interest Expense

CANCO

Withholding Tax On Interest At 10%
Financing Canco: No Double Dip

USCO

Interest Expense

CANCO

Loan

Cdn Bank

UNITED STATES

CANADA
Synthetic NRO: Inbound Double Dip

Canadian limited partnership = flow-through entity for Canadian tax purposes, corporation for US tax purposes.
Synthetic NRO: Inbound Double Dip (cont’d)

USCO

Interest

99%

1%

US Bank

USSUB

UNITED STATES

CANADA

CANCO

Interest income reinvested inside or outside Canada
Partnership not taxed in Canada or United States
Partners subject to 10% Canadian withholding tax

CANADIAN LIMITED PARTNERSHIP
Synthetic NRO: Inbound Double Dip (cont’d)

• Called “Synthetic NRO” because replaces previous non-resident-owned investment corporation financing structure

• USco has interest deduction on Bank debt and Canco has interest deduction on loan from Canadian Partnership
Synthetic NRO: Inbound Double Dip (cont’d)

- Canadian tax considerations:
  - US partners not taxed in Canada on interest income because no Canadian permanent establishment (“PE”)
  - Partnership governance to ensure that no Canadian PE:
    - books and records outside Canada
    - management and investment decisions outside Canada
    - all other activities outside Canada
    - often have Canadian bank account and Canadian agent for service of process only (see published rulings)
Synthetic NRO: Inbound Double Dip (cont’d)

• Canadian tax considerations (cont’d):
  • In Technical Interpretation (“TI”) 2003-0039051E5 dated February 11, 2004 Canada Revenue Agency (“CRA”) confirms that:
    • unlikely business carried on in Canada through Canadian PE just because use Canadian bank account to receive interest payments from Canco and re-loan those funds to Canco
    • level of activity required for “business” for partnership law purposes not necessarily same as that required for “business” for tax purposes
Synthetic NRO: Inbound Double Dip (cont’d)

- Canadian tax considerations (cont’d):
  - Interest paid by Canco to Canadian Partnership subject to Canadian withholding tax at 10% treaty rate applicable to US partners
  - TI 2003-0039051E5 (above): CRA reviewing position that 10% rate applies having regard to OECD commentary:
    • OECD says where one State (here, Canada) treats entity as partnership and other State (here, US) treats entity as corporation, partner not able to claim treaty benefits because not allocated income for tax purposes in other State (here, US)
  - CRA will release results of review in upcoming Income Tax Technical News
Synthetic NRO: Inbound Double Dip (cont’d)

- **US tax considerations:**
  - Need entity formed under laws of Canada to check box to treat as controlled foreign corporation - usually use Canadian limited partnership
  - Canadian Partnership not taxed in US on interest income because treated as Canadian corporation and not engaged in US trade or business
  - Interest income earned by Canadian Partnership not taxed as passive income under US subpart F rules because of US “same-country exception”
Reverse Hybrid LBO

- Maximize leverage in Canada to extent permitted by thin capitalization rules
- Defer recognition of interest paid by Canadian company for US tax purposes
- Relative to conventional leveraged buy-out, “benefit” is deferral of interest income for US tax purposes
Reverse Hybrid LBO (cont’d)

Partnership = corporation for US tax purposes, flow-through entity for Canadian tax purposes

BORROWER

Loan

Loan and Equity

Bank Syndicate

NSULC = flow-through entity for US tax purposes, corporation for Canadian tax purposes

AMALCO
Reverse Hybrid LBO (cont’d)

- Bank financing not subject to thin capitalization rules (because arm’s length)
- Loans from:
  - Schedule I banks and Schedule III branches of foreign banks - no withholding tax on interest
  - Foreign banks - will have to qualify under 212(1)(b)(vii) exemption (i.e. 5-year debt)
Reverse Hybrid LBO: Credit Structuring Issues

- Totally Canadian deal on Borrower/Guarantor side; can be totally Canadian deal on Lender side unless size of deal too large for Canadian market to absorb
- Provisions driven by high leverage
  - Sweep excess cash flow, equity proceeds, asset disposition proceeds, etc. to pay down debt - note tension with 212(1)(b)(vii) requirements
  - Loosening of covenants as leverage decreases
  - Decreases in pricing as leverage decreases
Reverse Hybrid LBO: Credit Structuring Issues (cont’d)

• Provisions driven by Borrower being limited partnership and holding company
  • Borrower not taxable entity
  • Borrower permitted to distribute income to partners to pay taxes - consequences of restricting distribution in default situation
  • Secured guarantee of NSULC Amalco to avoid structural subordination
  • Don’t need pledge of equity of Borrower - but still usually request it
Reverse Hybrid LBO: Credit Structuring Issues (cont’d)

• Security issues
  • Acquisition financing - get assignment of benefits of purchase agreement
  • Pledge of shares of NSULC Amalco - special provisions required to avoid unlimited liability (see below)
Objectives of Outbound Double Dip Structure

- Outbound double dip structure used to finance US subsidiary of Canadian parent
- Interest deductions in both Canada and US
- Interest income earned by US Partnership on loan to USco sheltered with interest on Bank debt for US tax purposes
Financing USCo: No Double Dip

CANCO

Interest Expense

USCO

Loan

US Bank

UNITED STATES

CANADA
Tower Structure: Outbound Double Dip

CANCO

CANCO 1

CANCO 2

US LIMITED PARTNERSHIP

NSULC

LLC

USCO

Cdn Bank

Loan

Interest Expense

Equity

Equity

Loan

Interest Expense

UNITED STATES

CANADA

UNITED STATES

CANADA
Tower Structure: Outbound Double Dip (cont’d)

CANCO

CANCO 1

CANCO 2

U.S. LIMITED PARTNERSHIP

NSULC

LLC

USCO

Cdn Bank

Interest

US Withholding Tax At 10%

Dividend

Dividend

Interest
US tax considerations:

- USco pays interest to LLC, which pays dividend to NSULC, which pays dividend to US Partnership; US Partnership pays interest to Lender
- US Partnership, NSULC and LLC taxed as single US corporation for US tax purposes - USco seen as paying interest directly to US Partnership (which is taxed as US corporation) for US tax purposes
Tower Structure: Outbound Double Dip (cont’d)

- US tax considerations (cont’d):
  - US Partnership’s interest income substantially offset by interest expense - minimal taxable income for US tax purposes
  - If Lender is Cdn Bank, US Partnership interest payments subject to 10% US withholding tax
Canadian tax considerations:

- Interest income earned by LLC deemed active business income, not passive income of NSULC under Canadian FAPI rules
- Dividend received by NSULC from LLC = exempt surplus dividend received free of Canadian tax
- Interest paid by US Partnership and tax-free dividends from NSULC create loss for Canadian partners
Tower Structure: Outbound Double Dip (cont’d)

- Canadian tax considerations (cont’d):
  - If Lender is US Bank, interest payments by US Partnership subject to 10% Canadian withholding tax - consider lending through US branch of Cdn Bank to avoid Canadian withholding tax
Taking Pledge of NSULC Shares

• Members or shareholders liable for deficiency on winding-up of NSULC

• Minimizing risks of being member or shareholder = avoid all indicia of ownership of shares
  • Don’t be registered as shareholder or member or apply to be shareholder or member
  • Don’t request or accept powers of attorney to transfer shares
Taking Pledge of NSULC Shares (cont’d)

- Don’t request or assent to notation being made in register of shareholders or members of security interest or pledge
  - Don’t attend shareholder or member meetings
  - Don’t receive or become entitled to receive distributions on shares
Ringfencing Structure to Avoid Leakage

• Since Borrower is partnership, partners of Borrower
  • Grant guarantees of loan to partnership
  • Pledge their respective partnership interests in the partnership
• Partnership pledges NSULC shares
Ringfencing Structure to Avoid Leakage (cont’d)

- NSULC guarantees Partnership’s loan supported by general security agreement
  - Potential solvency considerations
    - if loan financed shares of NSULC, must satisfy solvency criteria - obtain detailed solvency certificate
    - if don’t meet solvency criteria, guarantee and security beyond powers of NSULC and void
Ringfencing Structure to Avoid Leakage (cont’d)

- LLC
  - Guarantee of Partnership loan supported by general security agreement including assignment of loan receivable from USco together with related security securing Usco loan
  - If don’t satisfy solvency criteria, may be fraudulent conveyance and guarantee and security void - obtain detailed solvency certificate
Ringfencing Structure to Avoid Leakage (cont’d)

• USco
  • Guarantee of Partnership loan supported by general security agreement
    • solvency considerations as per LLC - obtain detailed solvency certificate
    • if don’t meet solvency test, LLC loan and security may be equitably subordinated - continuing issue, not just one-time test
Bankruptcy Remote Provisions

- Avoid consolidated US bankruptcy filing of NSULC with USco
- If possible, directors of NSULC should be independent of USco
- Include restrictions in articles of NSULC that
  - Restrict objects or powers of NSULC to those matters which are permitted under credit agreement (i.e. investment in LLC and guarantee and security to Lender)
Bankruptcy Remote Provisions (cont’d)

- Prohibit NSULC from entering into transaction with any person that is affiliate or would become affiliate by virtue of such transaction, except for transactions permitted by credit agreement
- Prohibit disposition or encumbering of interests in LLC, except as permitted in credit agreement
- Prohibit arrangements, reorganizations, consolidations, amalgamations and mergers except as permitted by credit agreement
Prohibit any steps to seek protection or relief from creditors’ claims or wind up affairs of NSULC under the *Bankruptcy and Insolvency Act*, *Companies’ Creditors Arrangement Act* or otherwise

Prohibit any steps to continue under the laws of any other jurisdiction or any other statute

Restrictions are expressed to be made for the benefit of Lender

No restriction in articles may be altered without court order on notice to Lender
Bankruptcy Remote Provisions (cont’d)

- Include similar restrictions in LLC constating documents to extent permitted under US law
- Negative covenants include restrictions noted above
- If no other creditors of NSULC or LLC, reduce likelihood of being drawn into US filing of USCo
Mutual Fund Derivative Structures

- Purpose of structure is to access economic return on foreign assets but avoid investment in “foreign property”
- Want to avoid “foreign property” investment so can market mutual fund trust (“MFT”) units to RRSP’s, pension funds and other tax-exempts, which are subject to 30% foreign property limitation
- Use derivative contract, e.g. forward agreement, total return swap, to access foreign asset economics
Counterparty may, but not obliged to, hedge itself by purchasing foreign reference assets.

Return under Derivative Contract based on value of foreign reference assets.
Mutual Fund Derivative Structures (cont’d)

- MFT makes direct investment in Canadian assets - e.g. common shares of Canadian public companies, Canadian dollar bank deposit with Canadian bank etc.
- October 30, 2003 foreign investment entity (“FIE”) tax amendments carve out cash payments from “participating interest” concept, overruling CRA TI 2003-0008355 dated April 24, 2003 suggesting that derivative contract subject to FIE rules
MFT derivative structures may also result in receipt of amounts by MFT as capital gains that would be income if MFT had made direct investment in foreign reference assets.

October 31, 2003 tax proposals intended to overrule Ludco case, for 2005 and later years:

- “Reasonable expectation of cumulative profit” over life of investment, where “profit” excludes capital gains
- Exclusion of capital gains creates issue re: expense deductibility for structures that generate principally capital gains