Cross-border Debt Restructuring

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GGI World Conference 2016

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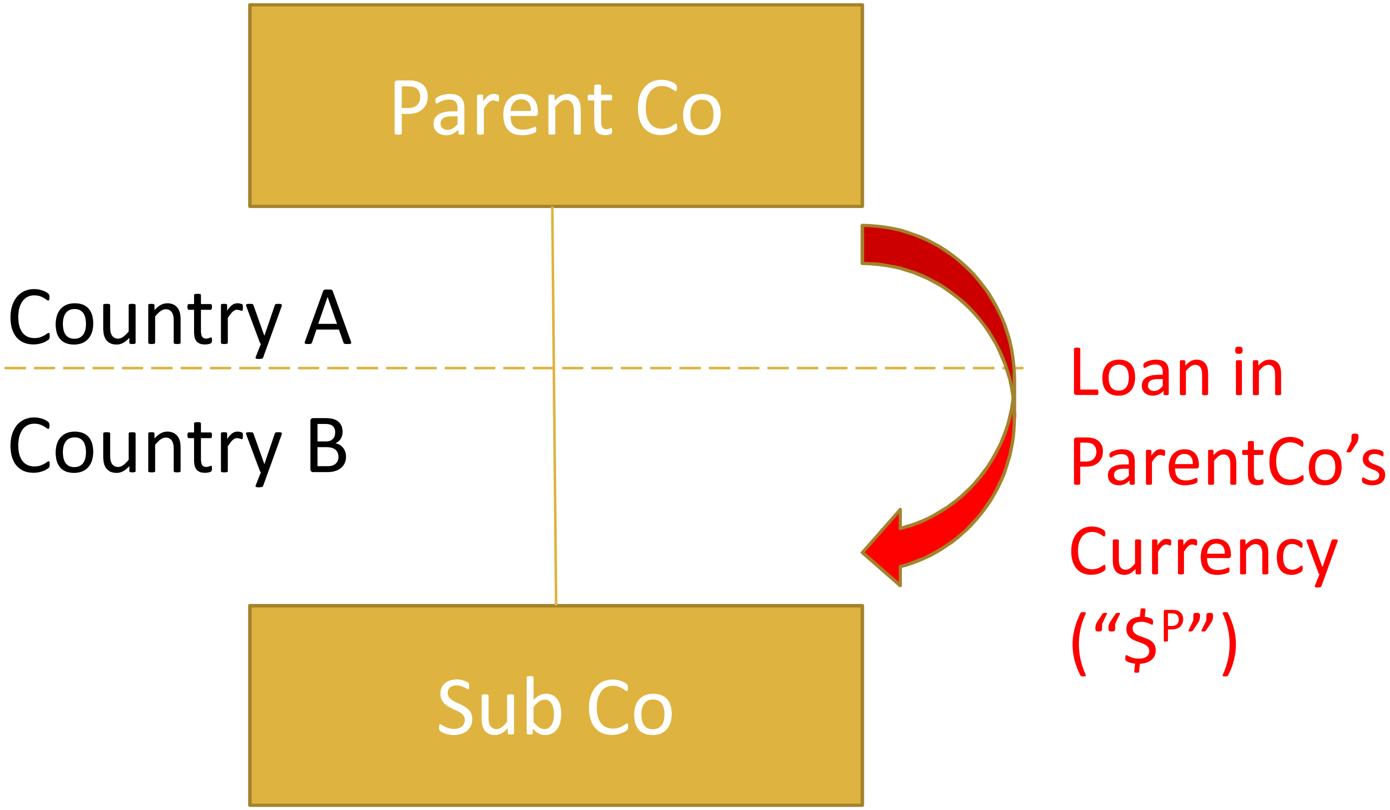
LAW

Cross-Border Debt

- Cross-border debt may be related-party (e.g. inter-company) or unrelated party (e.g. bank) debt
- Intercompany debt is often a means to capitalize a subsidiary
  - Some countries have foreign ownership restrictions
  - Often simpler than issuing shares: related party debt may be simple journal entries; fewer corporate law formalities
- Tax results on cross-border debt transactions not always symmetrical
  - May be a tax cost in one country without a corresponding tax benefit in the other – or the other way around!

Common "Downstream Loan" Structure



Reasons for Cross-Border Debt Restructuring

1. Debtor can’t pay interest or all of principal
   a) Informal debt work-out arrangements with creditors
   b) Formal court proceedings in bankruptcy or insolvency
2. Clean up balance sheet; avoid falling offside lender covenants
3. Manage foreign exchange risk from currency fluctuations

Reasons for Cross-Border Debt Restructuring

Related-party tax planning

4. Avoid deemed interest rules on debt
   - Avoid taxable income to creditor
   - Avoid withholding tax to debtor
5. Avoid tax on accrued interest if debtor is unable to pay
6. Reduce debt to stay onside thin capitalization rules, earnings-stripping rules, or other tax rules that limit interest deductions
7. Avoid tax issues relating to foreign currency fluctuations
8. Creditor may be able to claim a tax loss on debt impairment or foreign currency decrease

Reasons for Cross-Border Debt Restructuring

Related-party tax planning (continued)

9. Some countries have favourable capital gains treatment for share dispositions compared to recapture on interest
10. Creditor may receive exempt dividends under participation or exemption system – better than taxable interest
11. Changes in relative tax rates between jurisdictions
12. Arbitrage on asymmetrical tax results

Forms of Debt Restructuring

- Postponement of interest or principal
- Capitalize interest or principal (convert to equity)
- Full/partial waiver (or forgiveness) of interest or principal
- Subordination
- Change in security
- Assignment/assumptions (to related or arm's length party)
- Change in various features of the debt instrument (e.g. add a conversion right)

Creditor Tax Issues

Possible Tax Reasons to Convert to Equity:

- Receive tax exempt dividends from foreign company
- Unpaid interest may be taxed on an accrual basis
- Foreign currency fluctuations present difficult tax issues (or opportunities!)

Creditor Tax Issues

Conversion to Equity:

- Does change in terms of debt result in a deemed, but unintended, conversion to equity (economic substance theory)
- Is there a change in control, and restrictions on tax losses?
- What is the tax basis of shares received:
  - Valuation of debt: face value theory (e.g. Japan, Netherlands) or fair market value theory (e.g. Germany, US)?
  - Different rules for private and public companies (Korea)?
- If CFC rules in the creditor's jurisdiction have an exemption system, are there any anti-avoidance rules for conversion?

Creditor Tax Issues

- Gains or Losses:
  - Valuation of debt: face value or fair market value?
  - Do changes in the terms of the debt cause a taxable disposition?
  - Functional currency used, or is there an FX gain or loss?
  - If it is a related party tax loss, is it suspended or denied?
  - Characterization of loss: capital loss or income loss? Any loss-streaming rules that limit deductibility?
  - If there is a gain, does the tax law in the creditor's country have a non-recognition or "rollover" provision (on debt-for-debt or debt-for-shares?

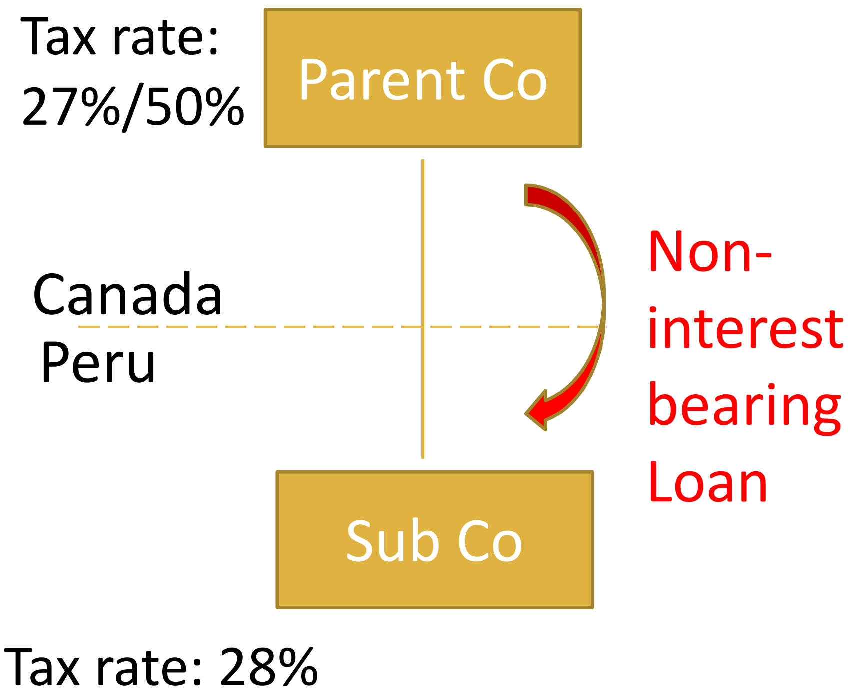
Creditor Tax Issues

- Creditor’s loss from disposition, novation, exchange, impairment, or other restructuring:
  - What proof or documentation required by the tax authorities in the creditor’s jurisdiction?
  - Any transfer pricing issue if the restructuring is a transaction that arm’s length parties would never have agreed to?
- Assignment of impaired debt: typically a non-recognition event, but…
  - Foreign exchange loss?
  - Suspension or denial of loss?

Debtor Tax Issues

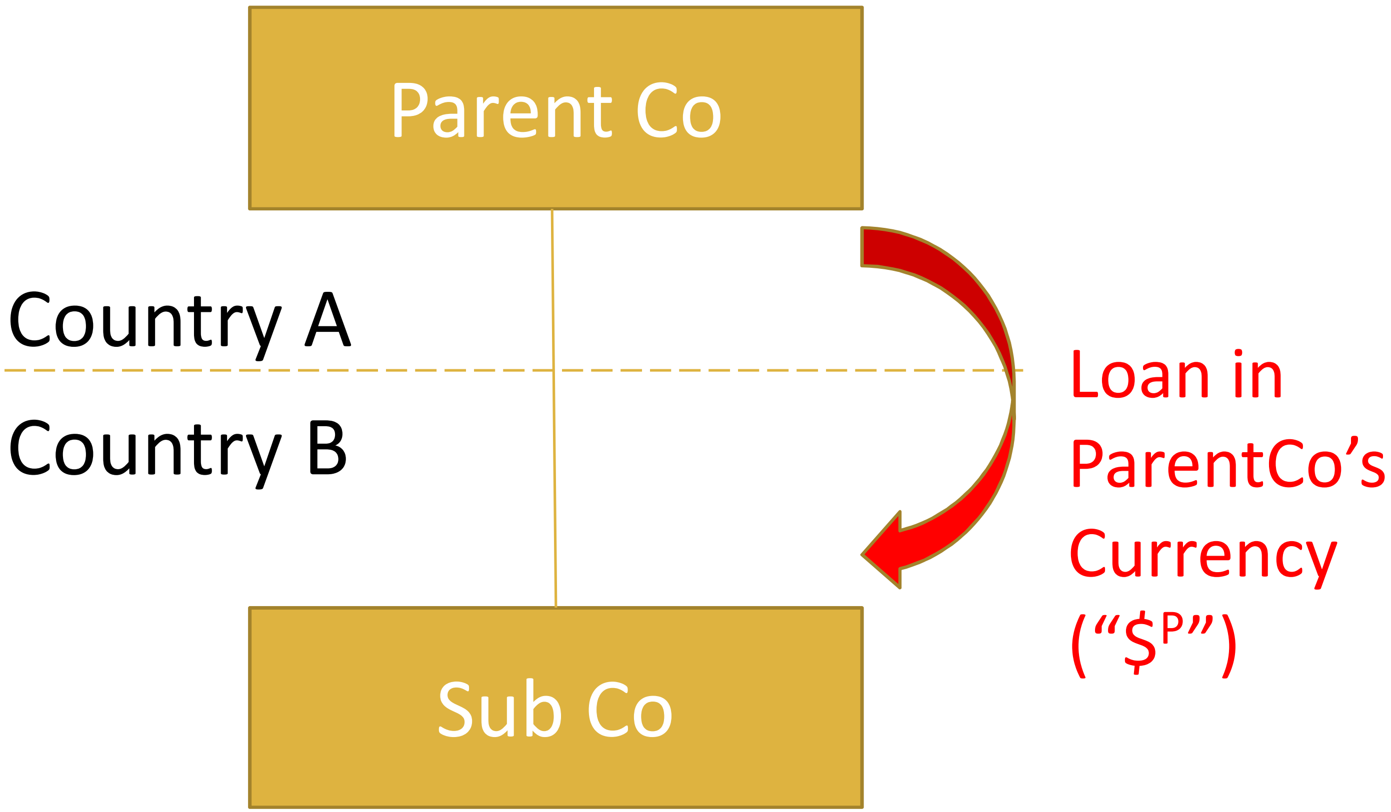
- Waiver or debt forgiveness
  - Any income recognition for debtor for forgiven amount?
  - Some countries have complex rules that reduce various tax pools by forgiven amount (Australia, Canada)
  - Other countries have no specific rules
  - Is there deemed forgiveness of debt from FX fluctuations?
- Interest deductibility (postponement, waiver, etc.)
  - Restrictions for unpaid interest, or deemed recapture income?
  - Thin capitalization, earnings stripping, or other interest deductibility rules applicable in debtor's country?
- Different withholding tax rates/rules on restructured debt?

Beneficial Asymmetry – Example



- No actual interest charged in Canada
- Allow deemed interest to happen under Peru rules, creating deductions
- No taxable interest in Canada
- But if actual interest were charged, tax in Canada would be 50% for a Canadian-controlled private corporation
- BEPS finds this "hybrid instrument" offensive

Tax Issues – Foreign Exchange (FX) Fluctuation



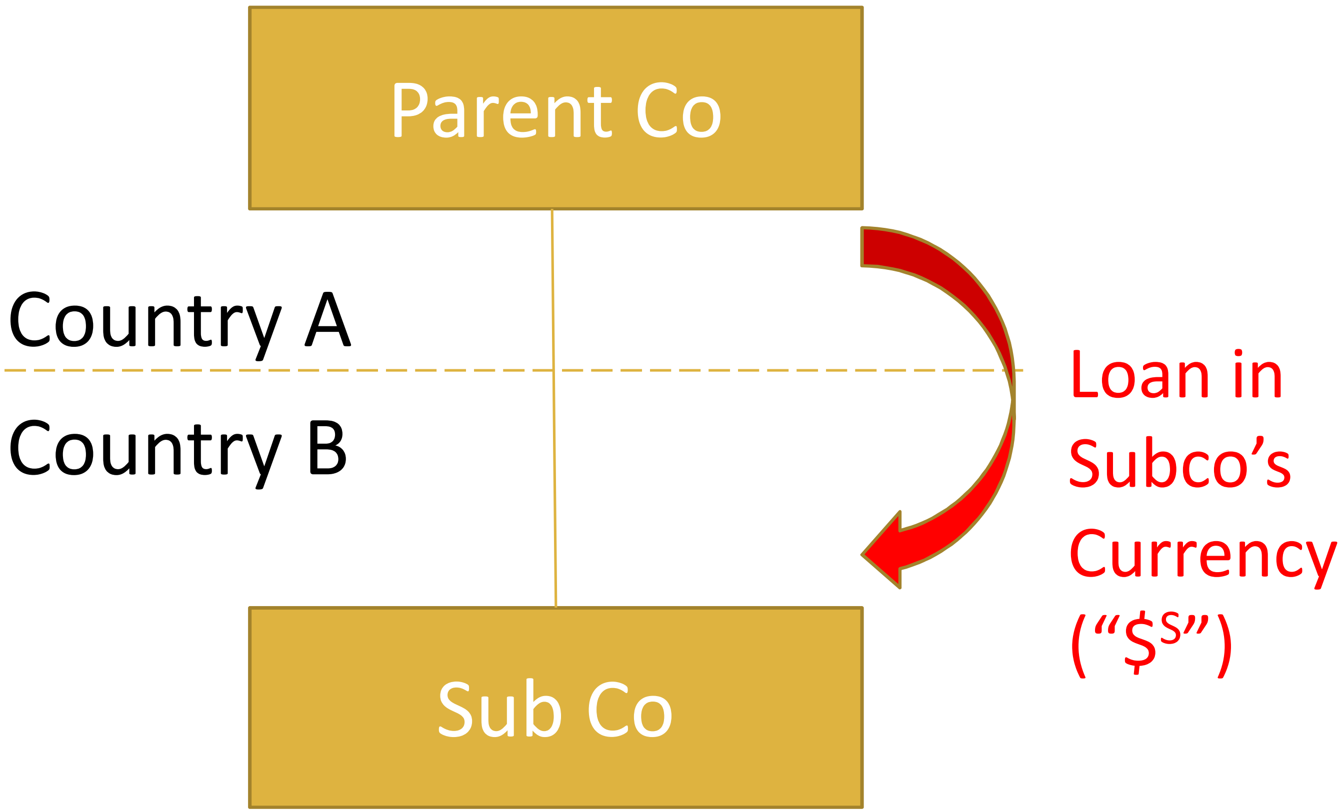
Downstream Loan Tax Issues from FX

Effects If Loan Denominated in Parentco Currency, $\$^P$		
	Effect on ParentCo (creditor)	**Effect on SubCo (debtor)**
$\$^P$ Appreciates	• No tax effect • But may affect available tax-free return of principal to Parent	• Economic loss* • FX Loss deductible for tax, or denied/limited related party loss?
$\$^P$ Depreciates	• *Likely,* no economic or tax effect • But is FX gain in Subco taxed under CFC rules? • Also, no ability to offset taxable gain in Subco	• Economic gain* • FX gain taxable in Subco's country? (e.g. recapture, debt forgiveness)

*Gain/loss at legal entity level, but not on consolidated basis

- Assumes local currency used for computing tax (no functional currency)
- Overriding question is whether debt restructure is a taxable event

Tax Issues – FX Fluctuation



Downstream Loan Tax Issues from FX

Effects If Loan Denominated in Subco Currency, $\$^S$		
	Effect on ParentCo (creditor)	**Effect on SubCo (debtor)**
$\$^S$ Appreciates	• Economic gain* • Likely taxable, but how to characterize FX gain?	• No tax effect • But no ability to offset "phantom" FX gain
$\$^S$ Depreciates	• Economic loss* • FX Loss deductible for tax, or denied/limited related party loss?	• No tax effect

*Gain/loss at legal entity level, but not on consolidated basis

- Assumes local currency used for computing tax (no functional currency)
- Overriding question is whether debt restructure is a taxable event

Conclusions

- Start with the assumption that the tax rules regarding debt restructuring are different in the foreign jurisdiction
- Lack of symmetry between tax costs and tax benefits can create pitfalls and opportunities
- Structured carefully, conversion of debt to equity – or vice versa – can be beneficial, especially in related groups of companies
- Selection of currency to denominate debt is an important decision where the debtor's and creditor's countries use different currencies