

Effective International Borrowing Structures and Vehicles

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Overview

Basic Cross-Border Financing Goal:

REDUCE TAX LIABILITY

Overview

- How to reduce tax liability:
 - Reduce income tax through interest deductions, participation exemptions, etc.
 - Reduce withholding tax rates via treaty networks
 - Limit application of controlled foreign company (CFC) rules and anti-abuse/anti-avoidance rules
- Introduction to hybrid instruments/entities
- Case studies
- Cash management – Treasury Centers

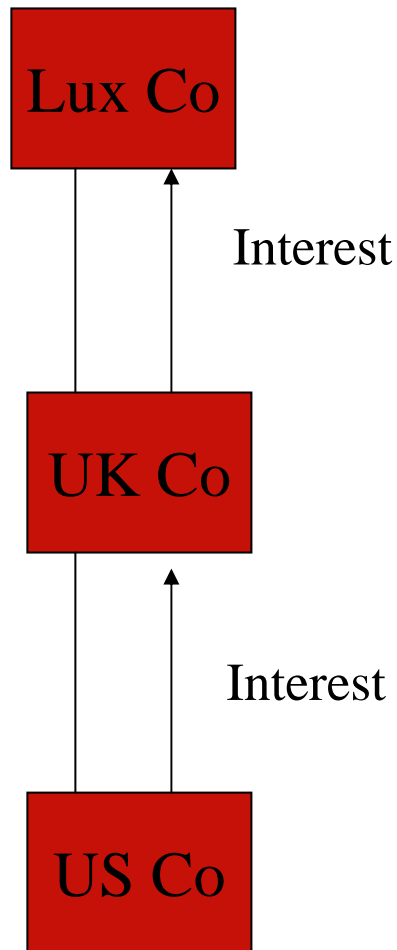
Interest deductions - Considerations

- Lender generally irrelevant --most countries allow deductions for interest on related and unrelated party debt
- Limits on deductibility:
 - Debt/equity rules (classification)
 - Thin capitalisation
 - Transfer pricing (e.g., margin for related party debt)
- Withholding taxes
- Alternatives – rent, royalties, etc.

Treaty Benefits

- Reduced withholding tax rates
- Special considerations:
 - Determining the applicable treaty (residency)
 - Limitation of benefits (LOB) article
 - Conduit

Example of Limitation of Benefits



- US-UK Treaty – No withholding tax on interest paid to qualified residents
- Article 23 of US-UK treaty deprives UK Co of treaty benefits because of foreign ownership

Controlled Foreign Company

- Many countries have rules that subject income of certain corporate subsidiaries (CFCs) to current tax at shareholder level
 - Examples: UK, Germany, Australia, France
 - Deemed dividend mechanism
- U.S. “Subpart F” rules
 - Passive income (interest, dividends, rents, royalties) generally subject to current U.S. tax
 - Exceptions:
 - “Same country” related party debt
 - “Same country” dividends
 - Active financing, insurance, licensing or leasing income (from third parties)

Participation Exemptions

- Distributions from lower tier corporations exempt from tax
- Minimum shareholding requirement

Anti-abuse (anti-avoidance) rules

- Substance over form
 - Step transaction
 - Conduit financing
- Business purpose/economic substance
- U.S. disclosure rules
 - Listed (or substantially similar) transactions
 - Reportable transactions (listed transactions plus those involving FTCs with short holding periods, large loss deductions, book/tax differences)
- Dual Consolidated Loss rules

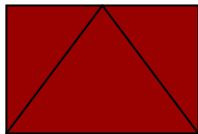
Hybrid Entities

- What is a hybrid entity?
 - Generally a legal entity that is a “taxpayer” for purposes of a foreign jurisdiction and disregarded or a pass-through for U.S. tax purposes
 - “Reverse hybrids” – entities treated as corporations for U.S. tax purposes but as pass-through for foreign tax purposes

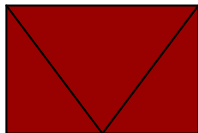
Key to Symbols



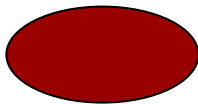
Corporation



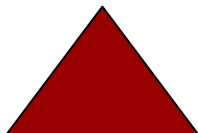
“Hybrid” – Treated as a corporation for foreign tax purposes but as a pass-through/disregard for U.S. tax



“Reverse hybrid” – Treated as a corporation for U.S. tax purposes but as a pass-through/disregard for foreign tax purposes

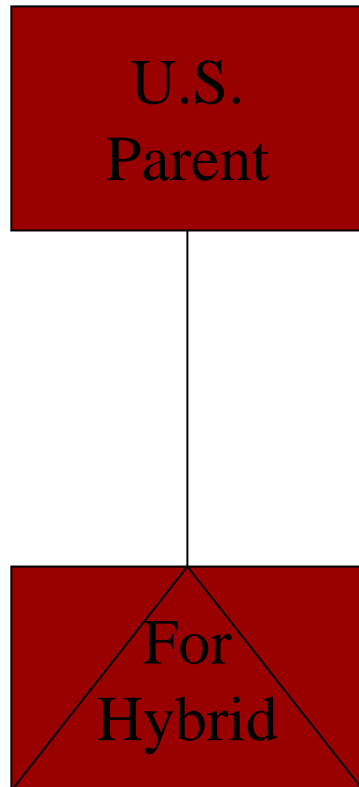


Branch



Partnership

Example: Foreign Hybrid Entity



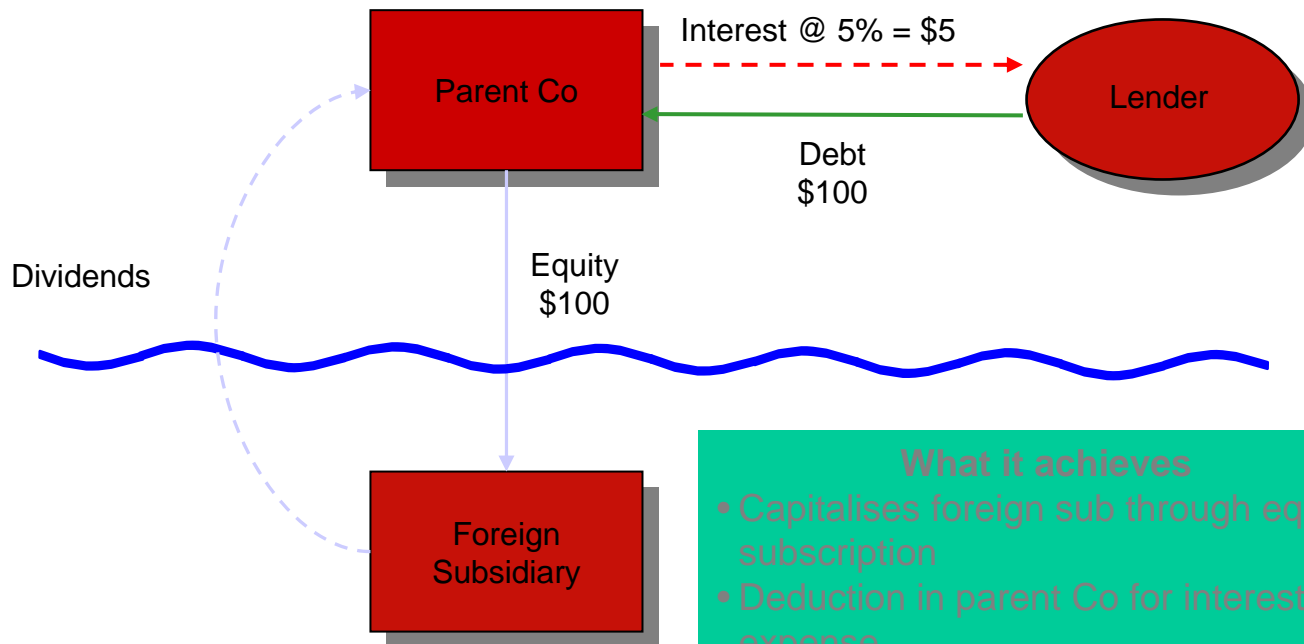
- U.S. tax system “looks through” Foreign Hybrid
 - Not treated as entity
 - Transactions with U.S. parent ignored
- Foreign tax system
 - Treats foreign hybrid as a corporation and a taxpayer
 - Gives effect to transactions between foreign hybrid and U.S. parent

Hybrid Instruments

- Financial instruments that are characterized differently in different jurisdictions
- Examples
 - Instruments viewed as debt in one jurisdiction and equity in another
 - Instrument issued by entities disregarded in one jurisdiction
 - Instruments viewed by different jurisdictions as being owned by different persons

Conventional Base Case Scenario (1)

- Parent borrows to capitalise foreign subsidiary

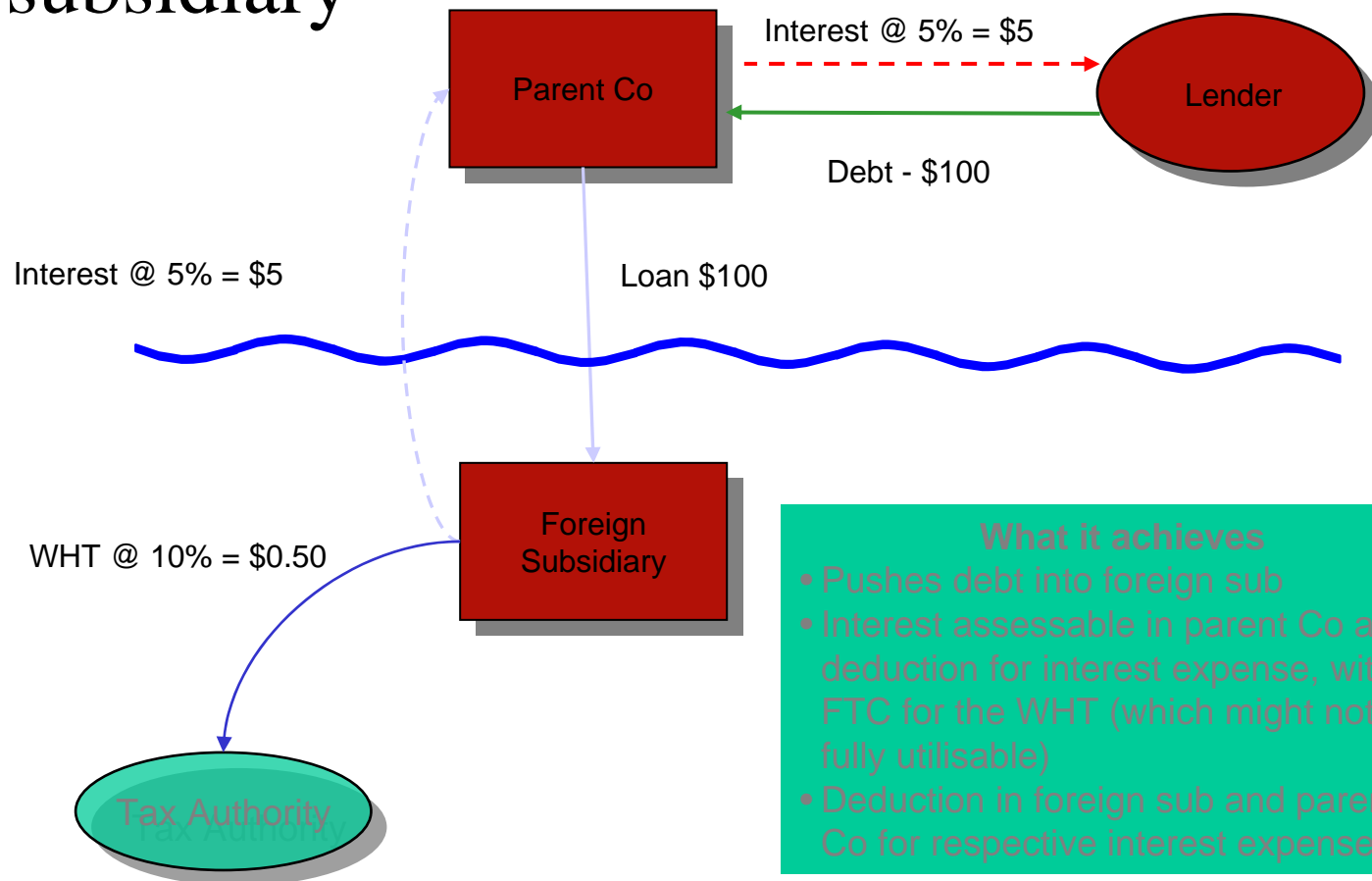


What it achieves

- Capitalises foreign sub through equity subscription
- Deduction in parent Co for interest expense
- Dividends not deductible in foreign sub but assessable in U.S. with FTC for any underlying foreign corporate tax and any WHT

Conventional Base Case Scenario (2)

- Parent borrows and loans to foreign subsidiary

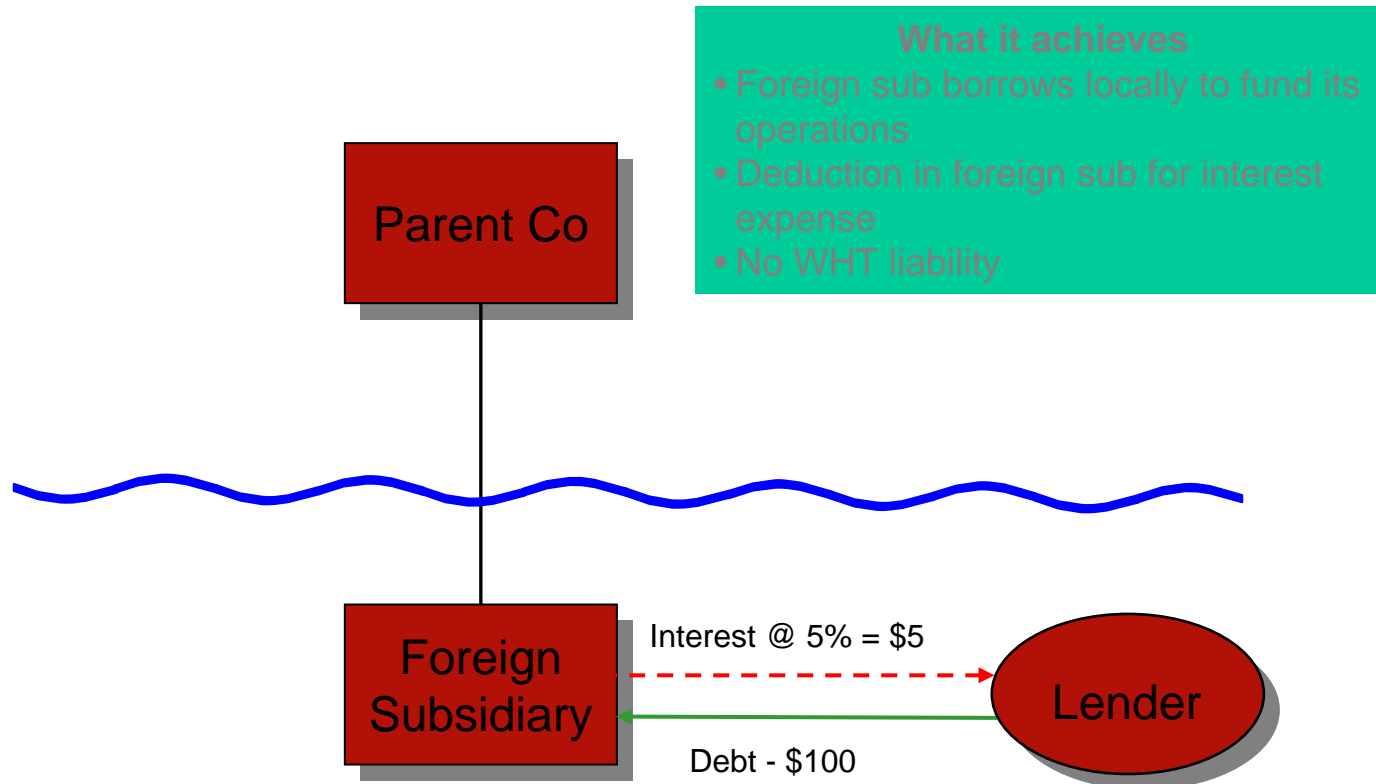


What it achieves

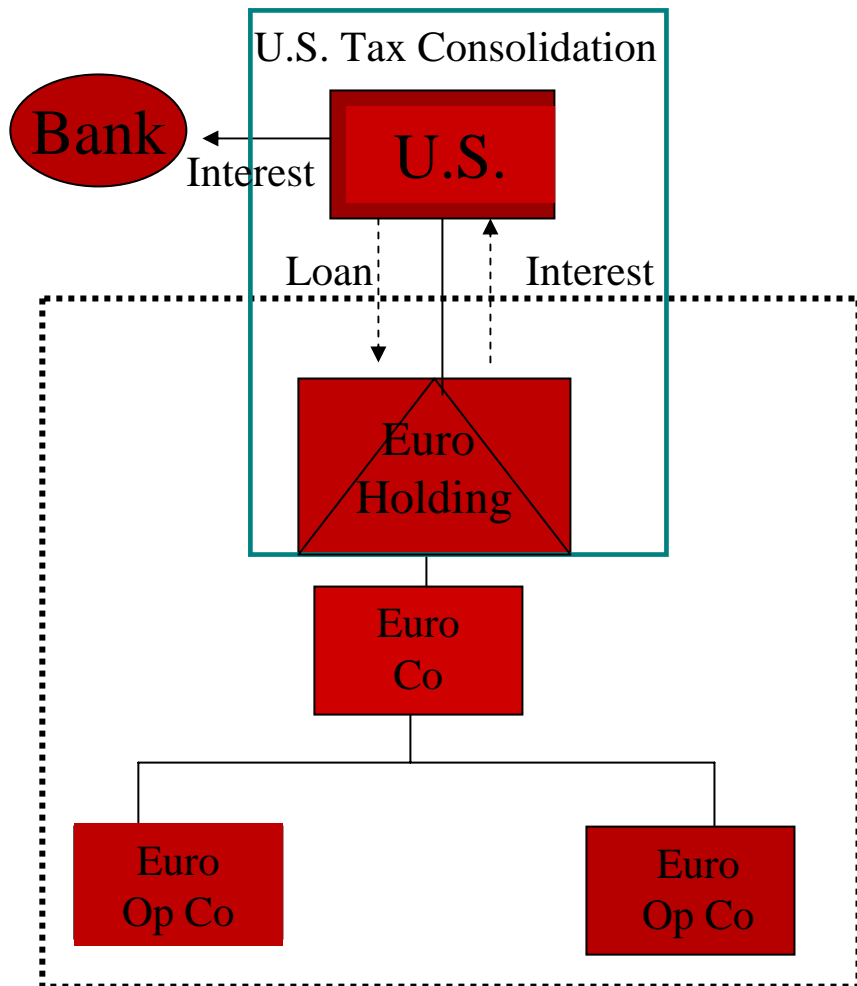
- Pushes debt into foreign sub
- Interest assessable in parent Co and deduction for interest expense, with FTC for the WHT (which might not be fully utilisable)
- Deduction in foreign sub and parent Co for respective interest expenses

Conventional Base Case Scenario (3)

- Foreign subsidiary borrows locally



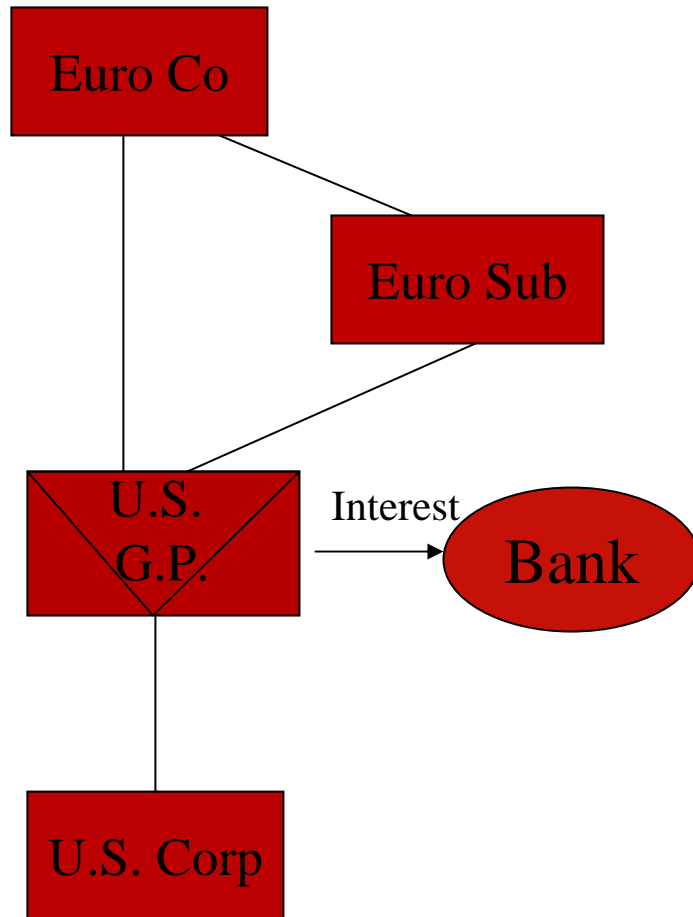
Hybrid Entity Double Dip – US Parent/European Sub



Tax Results

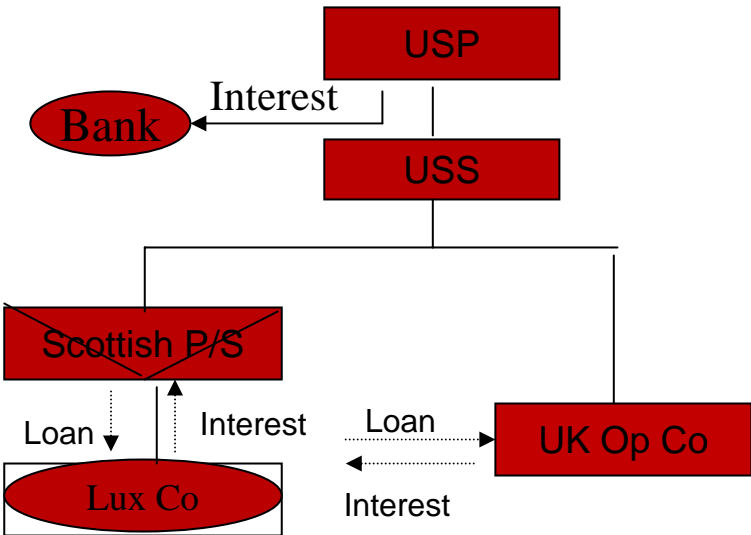
- Europe
 - Euro Holding Co is treated as member of group
 - Has interest expense, no income
 - Surrenders loss to affiliate
 - with taxable income
- United States
 - Third party borrowing by U.S. Corp generates deduction
 - Euro Holding disregarded
 - Loan disregarded
 - No interest income

Hybrid Entity Double Dip-Euro Parent



- Euro Parent and Sub form U.S. General Partnership
- U.S. G.P. elects corp status
- U.S. G.P borrows from bank
 - Deduction as part of U.S. consolidated group
- Interest deducted by partners for Euro tax purposes
- DCL Issues

Hybrid Entity Scottish Partnership



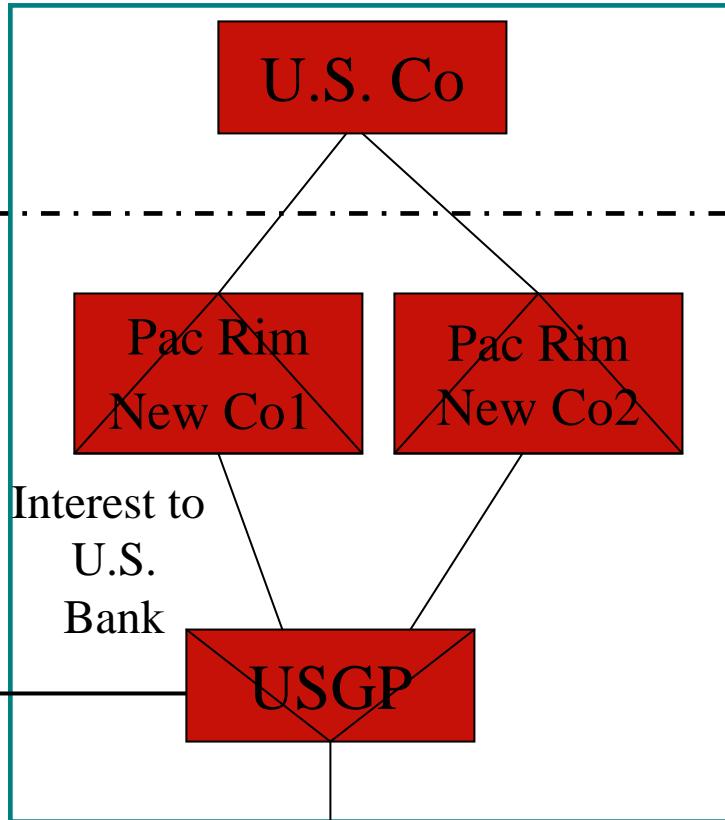
Description of the Transaction

- Scottish P/S elects to be treated as a corporation for US tax purposes
- Lux Co elects to be treated as a disregarded entity for US tax purposes.

- UK OP Co deducts interest paid to Lux Co.
- UK-Luxembourg treaty eliminates UK withholding tax on interest paid by UK OP Co.
- Interest paid by UK OP Co is not subpart F income because of the same country exception.
- Loan by Scottish P/S to Lux Co is disregarded for US tax purposes.
- Lux Co deducts interest paid to Scottish P/S and pays tax on small spread as agreed with the local tax authorities.
- Under Luxembourg domestic law, there is no withholding tax on interest paid by Lux Co to Scottish P/S.
- Scottish P/S is transparent for UK tax purposes and therefore pays no UK tax on interest received from Lux Co, provided that the US partners do not have a UK PE.
- Interest deduction in the UK with no corresponding UK or US taxes.

Hybrid Entity – U.S. Parent Pac Rim Sub

U.S. Tax Consolidation



Transaction Steps

- U.S. Co sets up two new Pac Rim companies
- Pac Rim New Co1 and Pac Rim New Co2 form a Delaware general partnership (USGP)
- U.S. Co makes CTB elections to treat Pac Rim New Co1 and Pac Rim New Co2 as transparent entities and to treat USGP as a domestic corporation
- U.S. Co transfers its shareholdings in Pac Rim Op Co to USGP
- USGP borrows \$100 from U.S. Bank
- USGP uses funds to subscribe for \$100 additional equity in Pac Rim Op Co
- USGP pays interest expense to U.S. Bank from dividends received from Pac Rim Op Co
- DCL issues

Pac Rim Tax Consolidation

Expected Tax results

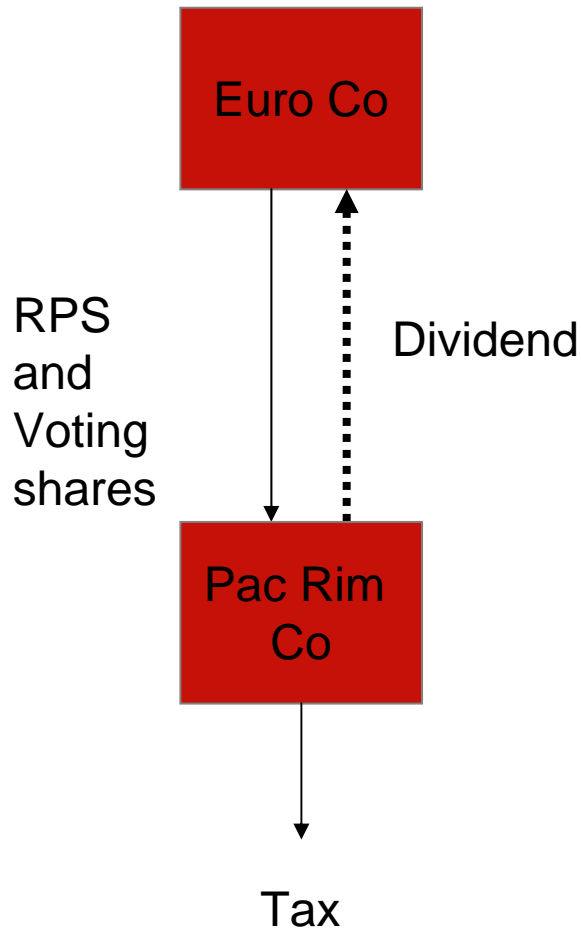
U.S.

- U.S. tax consolidated group effectively includes U.S. Co, Pac Rim New Co1, Pac Rim New Co2 and USGP
- Interest incurred by USGP deductible to U.S. tax group
- Dividends received from Pac Rim Op Co fully assessable with FTC for underlying tax
- No withholding tax

Pac Rim

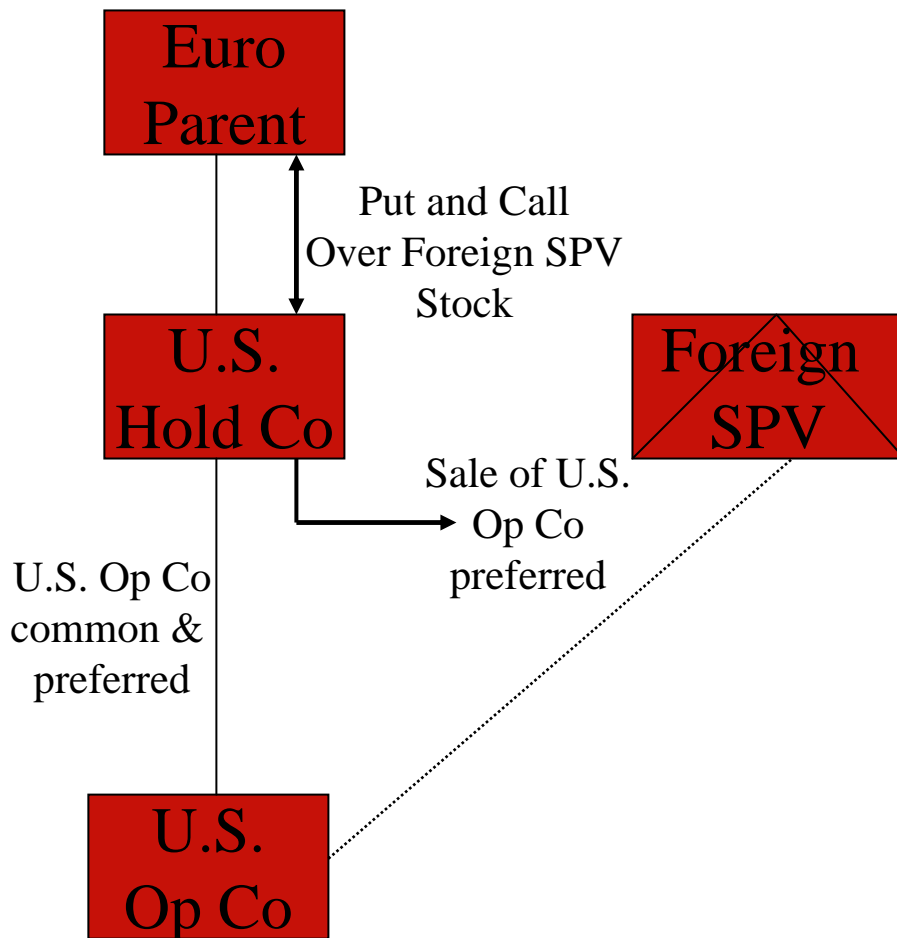
- Pac Rim tax consolidated group includes Pac Rim new Co1, Pac Rim New Co2, USGP and Pac Rim Op Co
- Dividends ignored as payment occurs within the Pac Rim tax consolidated group
- Interest incurred by USGP deductible to Pac Rim tax group
- No withholding tax (due to treaty relief)

Hybrid instruments–Euro Parent/Pac Rim Sub



- Redeemable Preference Shares
 - Debt for Pac Rim
 - Equity for Euro
- Dividend paid by Pac Rim Co
 - Deductible in Pac Rim country
 - Participation or Foreign tax credit in Europe
- Interest withholding tax
 - 0% if paid to UK Financial Inst.
 - 10% in other cases
- Thin Capitalisation
- Euro Issues: Foreign Tax Credit utilization

Hybrid Instrument – Repo (Euro Parent/U.S. Sub)

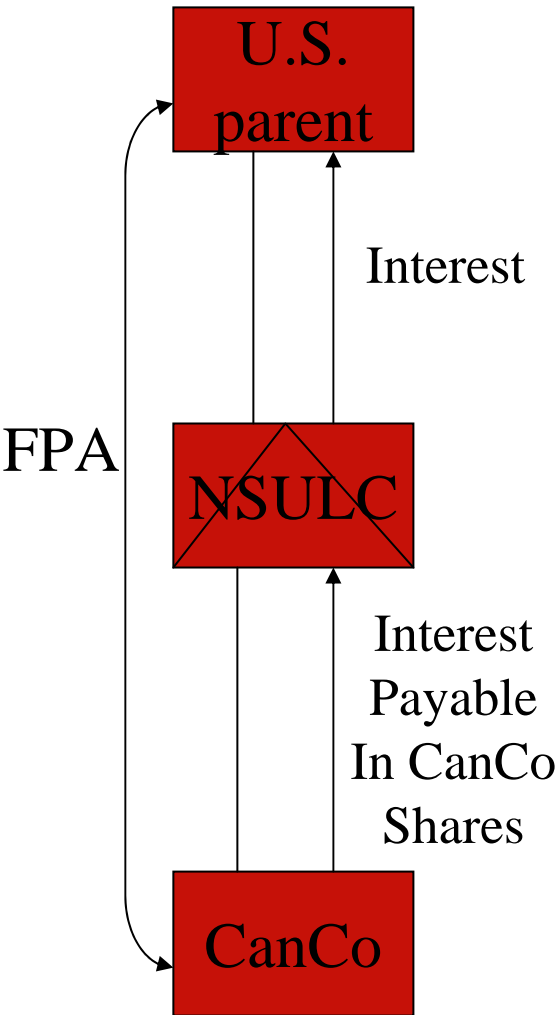


- U.S. Hold Co holds US Op Co common and preferred
- U.S. Hold Co sells Op Co preferred to foreign SPV
- Euro parent holds put over foreign SPV stock
- U.S. hold Co holds call over foreign SPV stock

Intended Repo Tax Results

- U.S. treats the put and call as a creating an interest bearing debt instrument
 - Dividends treated as deductible interest
- Foreign jurisdiction treats foreign SPV as eligible for participation exemption
 - Dividends not taxed

Canadian hybrid Structure



Description of the transaction

- US parent corporation (“US parent” wholly owns a Canadian operation company (“CanCo”) that carries on business in Canada
- US parent forms a new Nova Scotia unlimited liability company (“NSULC”) and elects to treat it as a disregarded entity for U.S. tax purposes
- US parent transfers its shares of CanCo to NSULC in exchange for stock and debt (the “Note”)
- NSULC exchanges its CanCo stock for new CanCo stock and a note with interest payable solely in shares of CanCo and principal payable in cash
- CanCo enters into a forward purchase agreement (“FPA”) with USP whereby CanCo agrees to sell and USP agrees to buy shares of CanCo equal to the principal amount of the Note. The price the shares is set on the date the FPA is entered into

Summary of Tax Consequences

U.S.

- The Note and the FPA are integrated and treated as non-preferred equity of CanCo for U.S. tax purposes. FSA 200206010
- Interest paid by CanCo to NSULC in shares is treated as non-taxable stock dividends. Interest paid by NSULC to US parent is disregarded
- US parent may claim foreign tax credits for Canadian withholding tax on NSULC's interest payments

Canada

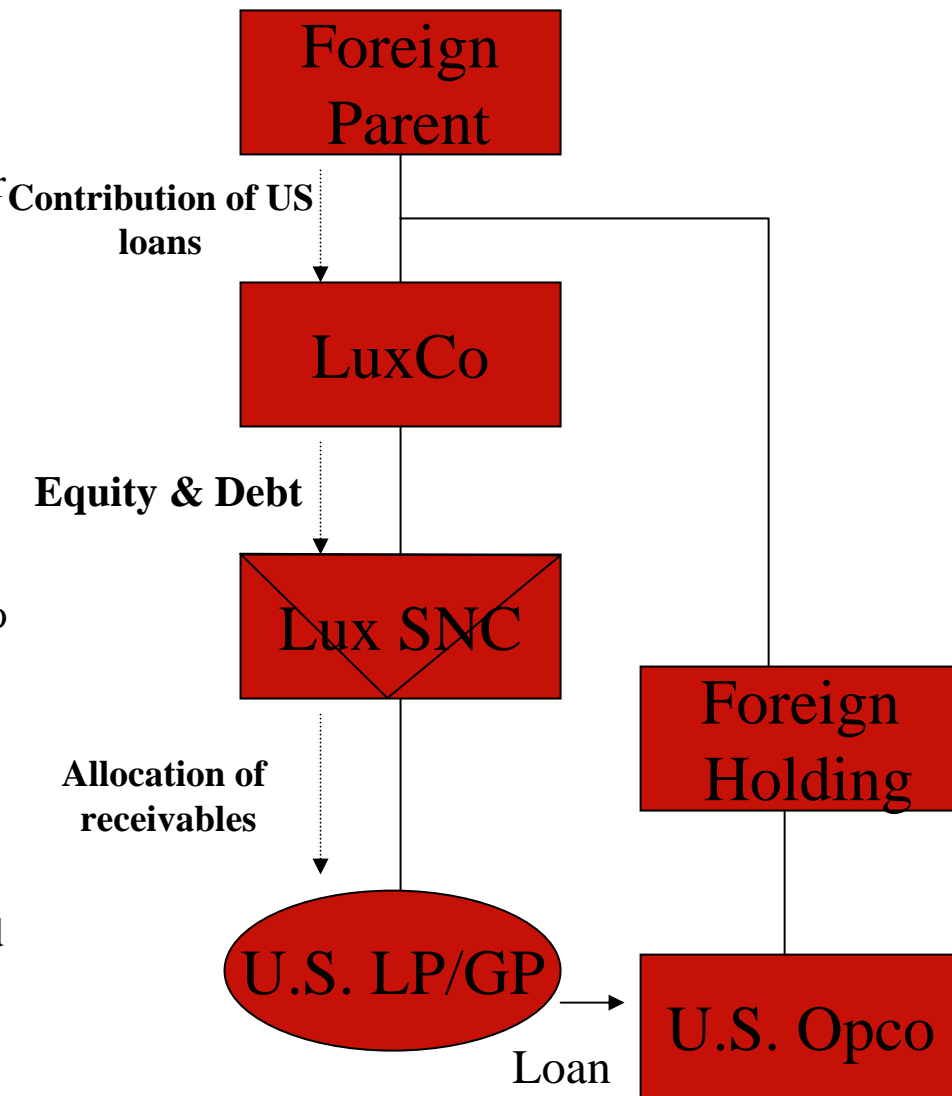
- Interest paid in shares by CanCo to NSULC is deductible against CanCo's business income and is not subject to Canadian withholding tax
- Interest paid by NSULC to US parent is deductible against NSULC's interest income but is subject to 10% Canadian withholding tax

LuxCo with U.S. Finance Branch

Structure Summary

Summary of Steps:

- Foreign parent established Luxembourg company (LuxCo) and contributes cash and/or existing US loans in exchange for ordinary shares
 - Form of contribution may depend on Luxembourg capital tax considerations
- LuxCo establishes Luxembourg partnership (Lux SNC) and transfers cash/existing US loans to Lux SNC for equity and debt (assumed to be 10%/90%); election is made to treat Lux SNC as a corporation for US tax purposes
- Lux SNC establishes US limited or general partnership (US LP/GP), and contributes cash/existing loans in exchange for partnership interest (0.1% partner not pictured in diagram)
- US LP/GP makes loans to U.S. Opco and possibly other US affiliates



LuxCo with U.S. Finance Branch

Intended Tax Treatment

- Intended U.S. tax treatment:
 - Deduction for interest on U.S. loans, subject to applicable limitations
 - No U.S. tax imposed on US LP/GP if no trade or business in the U.S.; withholding tax exemption under US-Luxembourg Treaty
 - If US LP/GP conducts U.S. trade or business, there would be taxable basis in U.S., but reduced by interest paid by LuxSNC to LuxCo
 - Considerations:
 - Level of activity needed to satisfy Luxembourg P/E requirements
 - Effect of inconsistent Treaty positions in the U.S. and Luxembourg
 - U.S. thin capitalization considerations
 - Potential branch profits tax
- Intended Euro Tax Treatment
 - Participation exemption for distributions for LuxCo
 - Foreign controlled foreign corporation rules not applicable to LuxCo, LuxSNC or US LP/GP

LuxCo with U.S. Finance Branch

Intended Tax Treatment (cont.)

- Intended Luxembourg Tax Treatment:
 - Binding ruling should be obtained from Lux authorities that US LP/GP constitutes a P/E for Lux tax purposes
 - Interest payments from U.S. not subject to Luxembourg tax because they are received by a U.S. P/E
 - Only small tax base in Luxembourg
 - No withholding tax on distributions to Foreign parent
 - Considerations:
 - Luxembourg capital tax (possible use of merger structure)
 - Established sufficient U.S. activity/presence for Lux P/E without creating a U.S P/E under U.S. tax rules
 - US LP/GP must be transparent from a Luxembourg point of view
 - Lux functional currency advance tax agreement available

Treasury Centers

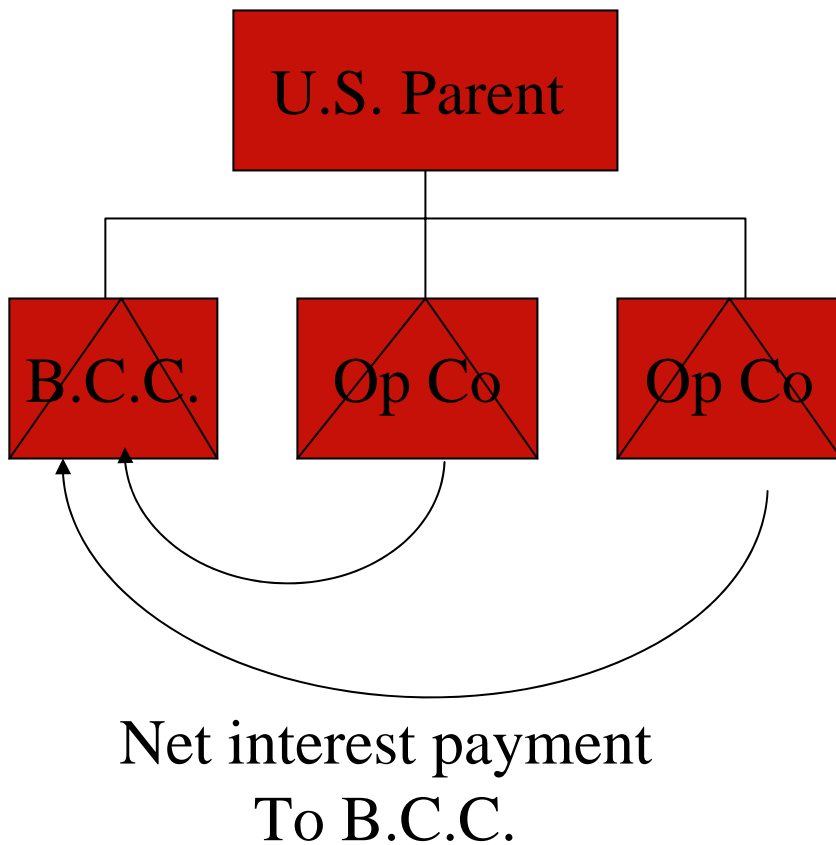
- Business Objectives
 - Efficient use of funds
 - Efficient use of personnel
 - Effective controls
- Tax Considerations
 - Reduce tax
 - Income tax on Treasury Center
 - Withholding taxes
 - Limits on debt/equity ratios
 - Defer parent tax on Treasury Center income

Belgian Coordination Centers

(under pending legislation)

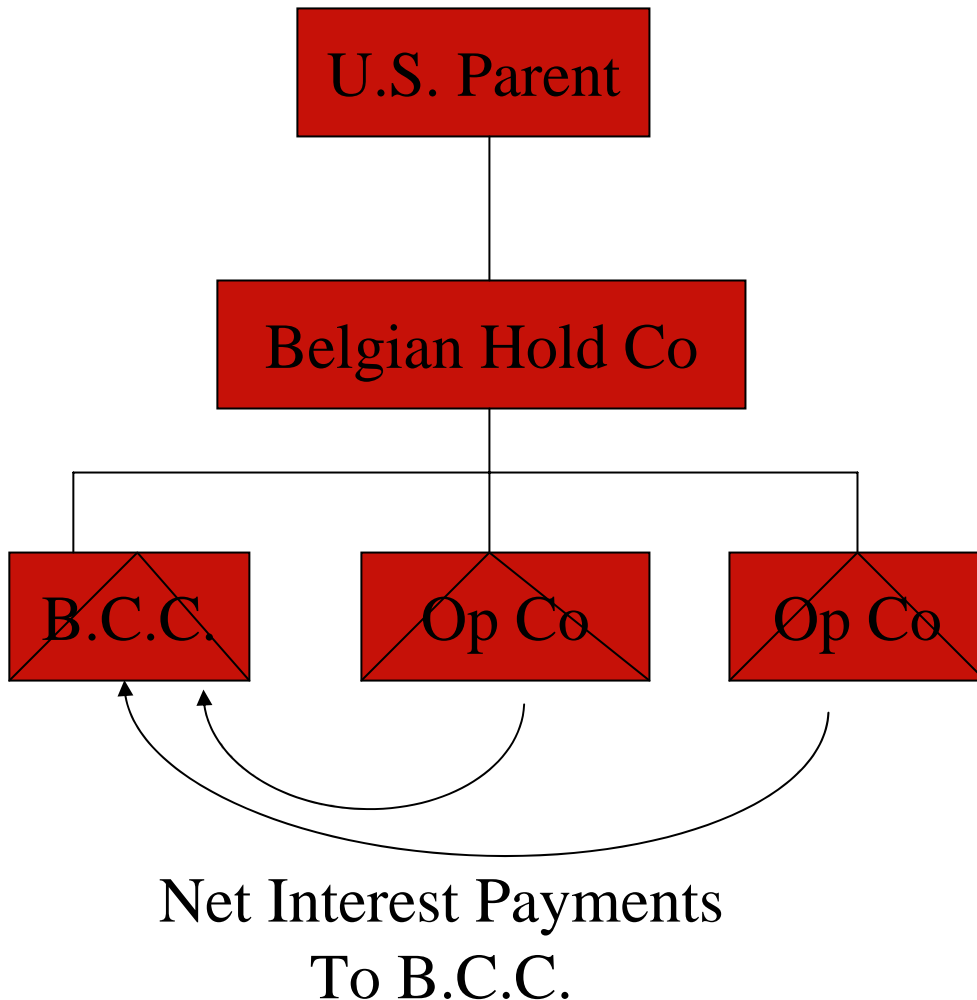
- Interest deduction would be calculated on the company's equity and retained earnings
- No withholding taxes
- Likely in line with the EU treaty (no State aid issues)

Belgian Coordination Center



- Structure
 - U.S. Parent
 - Belgian Coordination center
 - Operating Companies
 - Operating Companies pay net interest to B.C.C.
- Results
 - Less foreign tax due to net interest deduction in source countries, favorable Belgian taxation
 - But Subpart F results in current U.S. tax on net income of B.C.C.

Belgian Coordination Center With Holding Company



- Structure
 - U.S. Parent
 - Belgian Coordination center
 - Operating Companies
 - Operating Companies pay net interest to B.C.C.
- Results
 - Foreign same as before
 - U.S. – “Interbranch interest” disregarded-No U.S. inclusion

Singapore

- Favorable tax regime (10% rate) for treasury services (Financial and Treasury Centers)
- No debt equity (thin cap) limitations