Hybrid capital – the US tax perspective

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US issuers of hybrid securities continue to tinker with these products as they face their dual goals of obtaining enhanced rating agency equity credit or regulatory capital treatment, while preserving the tax deduction associated with such securities. In 2006, the US hybrid securities market witnessed several product innovations, including, expanded tax calls, enhanced interest cancellation, bifurcation of the security's maturity date into a 'scheduled' maturity and a 'final' maturity, and extension of the final maturity date. Each of these innovations bears on the US federal income tax treatment of the hybrid security. After discussing the US federal income tax effects of these innovations, we will provide a brief outlook for 2007.

Tax calls

Almost every hybrid security issued provides for redemption of the security upon the occurrence of a 'tax event' (a 'tax call'). While the specific terms of each tax call may differ from deal to deal, a 'tax event' is typically defined as the receipt of an opinion of counsel, experienced in tax matters, that – as a result of (1) any amendment to or change in United States federal income tax law or regulations, (2) any official administrative or judicial decision, action, or pronouncement applying those laws or regulations announced after the issuance date, or (3) a threatened challenge asserted in connection with an audit of the issuer, of certain of its affiliates, or of another unrelated issuer who issued similar securities – there is a substantial risk that the interest is not deductible by the issuer. Also, in the case of trust preferred securities, further tax call triggers are either that the interest on the junior subordinated debt held by the trust is taxable income to the trust or the trust is subject to more than a *de minimis* amount of other taxes. The new wrinkle to this definition seen in 2006 is the inclusion of a threatened challenge in connection with an audit of the issuer, of certain of its affiliates or of another unrelated issuer, who issued similar securities as a triggering event. Under this new broader definition of tax event, there is a greater chance that a hybrid security will be redeemed prior to its maturity in the event of US Internal Revenue Service (IRS) audits directed at hybrid securities.

For most hybrid security offerings prior to 2006, when the issuer exercises a tax call, the amount paid to the investors is typically the security's redemption price (or principal value) plus all accrued and unpaid distributions. However, several recent offerings have provided that the redemption price for certain tax calls (usually when the tax call occurs prior to the scheduled maturity) will be the greater of the redemption

price plus accrued and unpaid distributions and a make-whole amount. From the experiences of the last several years, it should be apparent that the IRS has adopted a 'forward leaning' enforcement stance on all sorts of financial products tax matters. This make-whole feature is designed to assure the holder that it will be economically protected if the issuer decides to call the instrument in light of increased risk of tax challenge.

Enhanced interest cancellation

Enhanced interest cancellation features are another recent innovation in the hybrid securities market. In a typical case, the issuer may only cancel its obligation to pay interest if the issuer is bankrupt or insolvent. In this situation, investors generally have no claim for deferred and unpaid interest in excess of an amount equal to two years' of unpaid interest. An enhancement to the typical structure first seen in 2006 provides that part, but not all, of the deferred interest may be permanently cancelled, even if the issuer is not bankrupt or insolvent, if (1) interest is deferred for a period of 10 years, (2) no event of default and acceleration is continuing, and (3) the issuer is unable to raise sufficient proceeds to pay the deferred interest (whether because of caps on the amount of securities that must be sold, or otherwise). The addition of this interest cancellation feature helps certain issuers of hybrid securities gain the enhanced rating agency equity credit they seek. Taken out of context, any feature designed to make the hybrid security look more like equity could be used to argue that the instrument is equity for US federal income tax purposes. On the other hand, various instruments with contingent interest features have historically passed muster as debt for US federal income tax purposes, particularly where the contingency is unlikely to in occur in practice. As a result, these enhanced interest cancellation features usually are acceptable to tax counsel.

Scheduled maturities

Some issuers who have included provisions for interest cancellation are also tinkering with other features of their hybrid securities. For example, while many enhanced trust preferred securities have 60 year maturities, several recent issuers of trust preferred securities have bifurcated their security's maturity into a 'scheduled' maturity and a 'final' maturity. In general, these securities have 30 year 'scheduled' maturities and 60 year 'final' maturities. However, the issuer's obligation to fully repay the instrument after 30 years is generally limited to the extent of proceeds raised from the sale of qualified 'replacement securities' such as (in the case of trust preferred securities) securities (other common stock, rights to acquire common stock, and securities that convert into common stock) that qualify as the issuer's core capital and generally rank either pari passu or junior to the trust preferred securities. This bifurcation changes the debt / equity analysis for US federal tax attorneys who are asked to opine on a hybrid security's debt / equity character in connection with the offering. The relevant question now is whether the issuer will be able to sell enough replacement securities to pay off the hybrid in 30 years. If the answer is yes, the 30 year maturity favourably impacts the debt classification of the instrument from a US federal income tax perspective. US tax advisers generally view this reduction in a hybrid security's maturity date as a trade-off for other more equity-like features.

Longer legal final maturities

Interestingly enough, however, while some issuers are bifurcating their hybrid security's maturity date to shorten the maturity, other issuers are extending their hybrid security's maturity date out further. For example, at least one issuer pushed the 'legal final' maturity date for its offering of trust preferred securities out to 80 years. As mentioned above, the shorter 'scheduled' maturity date makes the hybrid security more debt-like from a US federal income tax perspective. US federal income tax principles generally require that debt has a fixed maturity date that is not unreasonably far in the future. This determination of whether the maturity date is reasonable depends on all of the facts and circumstances; there is no bright-line rule here.

Courts have considered several factors in determining the reasonableness of an instrument's maturity date: the nature of the issuer's business, the financial condition of the issuer,

$$\frac{(\text{imagination} + \text{motivation}) * \text{perspiration}}{\text{regulation}} = \text{innovation}$$

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the length of time the issuer has been in existence, and how likely it is that the issuer will be in existence when the instrument matures. (IRS Tech. Adv. Mem. March 15, 1999). If the life expectancy of a debtor's business is 10 years, it is difficult to argue that a debt instrument with an 80 year maturity (or even a 30-year maturity) is not at the risk of the debtor's business. Thus, the extension of a hybrid security's final maturity date places pressure on both the issuer's treatment of the hybrid security as 'debt' for US federal income purposes, and the issuer's payments on the hybrid security as tax deductible 'interest'. In fact, at a meeting of the taxation section of the DC Bar Association on January 25, 2007, the topic of trust preferred securities was discussed. A senior IRS official at that meeting stated that the government was concerned about the terms of hybrid securities, especially those with extremely long maturities.

The same IRS official also stated that issuers of hybrid securities with long maturity periods should expect to have to defend debt classification of such securities and that the absence of an unreasonably long maturity would not necessarily constitute a safe harbour. (Sam Young, Tax Officials, Practitioners Discuss Trust Preferred Securities, Tax Notes Today, 2007 TNT 18-7 January 26, 2007). These statements effectively reiterated guidance originally set forth in IRS Notice 94-47 where the IRS stated 'even in the case of an instrument having a term of less than 50 years, Monon Railroad generally does not provide support for treating an instrument as debt for federal income tax purposes if the instrument contains significant equity characteristics not present in that case.'

2007 outlook

Developments in the US hybrid security markets will not end anytime soon as US issuers constantly face the inherent challenges of achieving their two goals of enhanced equity credit or regulatory capital treatment and tax deductions. Perhaps the biggest factor for change, however, may come from the government. First of all, it is always possible that the Congressional tax writing committees will push the issue of tax treatment of hybrid securities to the forefront. In addition, senior IRS officials at the January 25 meeting in Washington DC added that taxpayers should not be surprised if the IRS opts to audit their hybrid security deals. As has been the case for many years, the facts and circumstances nature of the debt-equity distinction in the US unfortunately does not make for what most taxpayers want: certainty in the tax consequences of instruments that make up their capital structures.

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