APPENDIX TAX DEDUCTIBLE EQUITY AND OTHER HYBRIDS IN THE US – A BRIEF HISTORY AND CURRENT DEVELOPMENTS

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Anyone looking at the tax treatment of US hybrid securities transactions for the first time would be understandably confused. There is no one simple, completely reliable way to create a tax deductible US hybrid. Instead, US issuers are installing billions of dollars of hybrids in their capital structures that are diverse, complicated and in a few cases, tax risky. No one structure is universally accepted. Each structure has a full menu of tax issues.

To understand why the US hybrid market operates this way the reader must understand the brief history of US hybrid transactions – the first part of this article. Only then will the US system, in all its grand complexity, begin to make sense. The second part of this article then explores current developments in the US hybrid market from a US tax perspective.

Early attempts to create deductible equity

US taxpayers have for many years tried to create tax deductible equity. The most relevant history, however, begins in the 1980s, a time of great turmoil for US financial institutions. The story begins with a published Internal Revenue Service (IRS) ruling sought by desperate bankers to help shore up US bank capital during these turbulent times.

Revenue Ruling 85-119

In the early 1980s US banking regulators adopted their first capital requirements for banks and bank holding companies. Among the instruments that qualified for primary capital treatment were ‘mandatory exchangeable securities’. Revenue Ruling 85-119 dealt with one such security issued by a bank holding company (BHC). The instrument was denominated as debt. It had a 10-year term. If interest was not paid, the debt was not accelerated, the holder could only sue for the defaulted interest. At maturity, the issuer paid the holder with primary capital securities (common or preferred stock) with a value equal to the debt instrument’s face amount. The holder could either take the stock or have the issuer sell it on the holder’s behalf. In the latter case, the sales proceeds would be paid to the holder. A shortfall gave the holder a right to sue for the difference.

The IRS held that the instrument was debt for federal income tax purposes. The holder’s weak remedies did not pose much of an issue according to the ruling. While the ‘payable in equity’ feature gave the government more pause, the ruling reasons that the holder always had an ultimate debt claim and therefore was entitled to principal payment in all events.

The mid-1980s were as bad for the banking business as the late sixties and early seventies were for the securities business. Penn Square Bank went bankrupt in 1982 and, soon after rumours of its impending bankruptcy, Continental Illinois was bailed out by federal regulators in 1984. One suspects it is not a coincidence that the government decided that lowering the cost of capital by granting a tax deduction is a cheap price to pay for shoring up the nation’s bank holding companies[2]. Unfortunately, the markets did not accept mandatorily convertible securities and only a handful of transactions were actually done. Nevertheless, it is apparent today that the debt-equity line moves farther towards debt when a regulated industry is in financial distress.

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2 Rev. Rul. 83-98, 1983-2 C.B. 40, involving adjustable rate convertible notes (ARCNs), shows the IRS’s relatively less favourable treatment of non-regulated taxpayers in the same time frame as Revenue Ruling 85 119, 1985-2 C.B. 60. An ARCN was a 20-year debt issued by a corporation. The debt was subordinated to general creditors. It was issued for US$1,000 or 50 shares of issuer’s publicly traded common stock (which had a US$20 per share price). At maturity, the holder could elect to receive US$600 or 50 shares of stock. It paid interest equal to dividends on the underlying common; the issuer’s comparable yield for non-convertible, non-contingent debt was 12%. Revenue Ruling 83-98 holds that the ARCNs are equity for federal income tax purposes. The ruling is based on the notion that there was no sum certain payable because of the “very high probability” that the ARCN would be converted into stock. This, in turn, was based on the deep-in-the money nature of the conversion feature. The IRS discounted the fixed principal and fixed interest on the ARCNs on the basis that buyers did not given them any value – the ARCNs were sold for a price equal to that of the underlying common stock. According to the IRS, Revenue Ruling 68-54, 1968-1 C.B. 69 was “fundamentally different” because there was an obligation to pay a sum certain on a given date and although interest was dependent to some degree on the issuer’s earnings, it was not tied to dividends and the notes were not convertible.

MIPS, etc.
The first MIPS transaction was done by Texaco Corporation in 1993. Texaco had gone bankrupt in 1987. In the MIPS transaction Texaco set up Texaco Capital LLC, a Turks and Caicos limited life company (The Company). The Company issued US$25 par value 'Cumulative Adjustable Rate Monthly Income Preferred Shares, Series A' to investors. It issued common securities to Texaco. The Company then made a 50 year subordinated loan to Texaco. In a new feature, not previously seen in the debt markets, Texaco had the right to defer interest payments on the subordinated loan for 18 months without a default occurring. If Texaco deferred interest for more than 18 months then a default was declared and the subordinated loan was accelerated. The subordinated loan was extendable by Texaco for another 50 years but only if certain conditions were met. These financial conditions, while objective, were not very stringent.

The net effect of the transaction was that Texaco was able to deduct interest on the subordinated loan. The Company was treated as a partnership for federal income tax purposes. Accordingly, the partnership itself did not pay tax. Instead its income was allocable to the preferred security holders and to Texaco. For GAAP accounting purposes, Texaco consolidated the results of the Company with its own because it controlled the Company through its common securities. The accountants treated the preferred securities as a 'minority interest' on Texaco's balance sheet. Accordingly, they were not shown as debt. The rating agencies apparently gave the MIPS substantial equity credit.

The Texaco transaction was followed in short order by a transaction by Enron Corporation, then a newly emerging oil and gas powerhouse.[3] By the spring of 1994, the MIPS security was gaining acceptance in the market place. It is not coincidental that at this point the IRS issued Notice 94 47.[4] This Notice discusses various debt equity factors and then sets out some markers for taxpayers. It remains the most recent published guidance by the IRS on the factors used to weigh debt versus equity. It has been cited by the courts, although not frequently.[5]

The next development was the issuance of preferred securities by a grantor trust. This solved what had been a nagging problem – the fact that a MIPS-type partnership was required to give investors Schedule K 1s. Investors in the preferred securities associated K 1s with partnership tax shelter investments. In addition the K 1 rules require reporting to the ultimate beneficial owner in a manner that can be quite expensive.[6]

In the prototypical 'trust preferred' transaction, the end-user creates a Delaware statutory trust. The trust issues two classes of beneficial ownership: preferred securities and common securities. The preferred securities are perpetual on their face; however, they must be retired if the underlying subordinated loan is retired. The preferred securities are senior to the common upon the trust's liquidation. The trust invests the proceeds of the trust preferred offering in a subordinated, long-dated (e.g. 49 year) debt issued by the end-user. Interest on the debt instrument can be deferred, usually for up to five years, without default. As in a MIPS, from a federal income tax standpoint, interest on the subordinated loan is deductible. The trust is a grantor trust for federal income tax purposes and its income does not attract a separate tax.[7]

The next milestone in the development of deductible equity was a Federal Reserve Board announcement in October 1996.[8] The Federal Reserve Board held that trust preferred securities could be counted as Tier 1 capital[9] for a BHC so long as certain requirements were met.[10] Since 1996 the BHC market has seen billions of trust preferred issuances. One of the more recent innovations is to pool trust preferreds issued by smaller banks or bank holding companies. These transactions, which are arranged by investment banks, allow smaller issuers to obtain the same benefits of trust preferreds as larger issuers. Importantly, none of the other US bank regulators have been comfortable that trust preferreds should be counted as Tier 1 capital. For example, the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Office of Thrift Supervision (OTC) all treat trust preferreds as Tier 2 capital. Therefore, at the bank level, as opposed to the BHC level, trust preferreds have been of little use.

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[3] LEE A. SHEPPARD, IRS ATTACKS ENRON MIPS, TAX NOTES TODAY, 98 T.N.T. 104-4 (June 1, 1998).
[4] I.R.S. Notice 94-47, 1994-1 C.B. 357.
[5] The most recent citation was in Castle Harbour, TIFD III-E Inc. v. United States, 342 F. Supp. 2d. 94 (2004), where the court used the factors in Notice 94 47 to conclude that an interest held by Dutch banks was in reality equity, rather than debt, a taxpayer-friendly finding on the facts of the case.
[6] See I.R.C. § 6031; see also DEPARTMENT OF THE TREASURY AND INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR FORM 1065 available at http://www.irs.gov/pub/irs-pdf/i1065.pdf.
[7] Treas. Reg. § 301.7701-4(c), Example 2.
[8] Press Release, Federal Reserve Board, Use of Cumulative Preferred Stock in Tier 1 Capital of Bank Holding Companies (October 21, 1996) [hereinafter FRB 1996 Press Release] available at http://www.federalreserve.gov/boarddocs/press/bcreg/1996/19961021/default.htm.
[9] See the discussion at III. C.
[10] FRB 1996 Press Release

Prior to the Federal Reserve Board's press release at least one other approach was taken to develop deductible equity. In the best known transaction, Chase Manhattan Bank formed Chase Preferred Capital Corporation (CPCC) as a subsidiary. CPCC qualified as a real estate investment trust (REIT) for federal income tax purposes. CPCC sold US$550m of preferred stock to the public. It used the proceeds to buy real estate mortgages from Chase. The preferred stock was perpetual and cumulative. This structure achieved the same results as deductible equity because the income stream on the mortgages was paid out by the REIT without a corporate level tax. Chase treated the CPCC preferred stock as a minority interest and as Tier 1 capital of the bank. A handful of similar transactions have been done since the Chase transaction.

Treasury department and legislative responses

The Treasury Department's administrative response to the proliferation of deductible equity has been a measured one.[11] In Notice 94-47[12] the IRS set out familiar factors to distinguish debt from equity and added a few new ones to the mix including treatment by rating agencies and treatment for accounting purposes.[13] It posted an 'off-limits' sign around certain transactions and warned that taxpayer attempts to expand Revenue Ruling 85 119 beyond its current scope was not advisable.

On the legislative front, while there has been plenty of talk about curbing deductible equity, relatively little legislation has actually been enacted. In 1992, Congress did add a consistency rule in subsection 385(c) of the Internal Revenue Code of 1986, as amended ('the Code').[14] This bound the issuer and holders (but not the IRS) to an issuer's characterization of a corporate interest as stock or debt. Holders may take an inconsistent position so long as the inconsistency is disclosed on their tax returns. Congress recognised that there was (and is) no definition in the Code that can be used to determine whether an interest in a corporation is debt or equity for federal tax purposes.[15] However, instead of taking the opportunity to create one, Congress instead opted for this administrative rule.

Next, several Clinton Administration budget proposals included proposed changes that would have limited the tax benefit of hybrid securities. The first budget proposal was the Clinton Administration's proposed plan for a balanced budget which was initially released on 7 December 1995. All of the tax proposals in this budget proposal were reintroduced later in January 1996, March 1996, and February 1997.[16] Since 1997, the Treasury has also re-proposed deferring interest deductions for 'original issue discount' on certain convertible debt instruments.[17]

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[11] This may reflect the government's wariness over divining debt-equity questions since withdrawal of the I.R.C. § 385 regulations.

[12] I.R.S. Notice 94-47, 1994-1 C.B. 357.

[13] The Notice 94-47 factors are:
(i) Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future
(ii) Whether holders of the instruments possess the right to enforce the payment of principal and interest;
(iii) Whether the rights of the holders of the instruments are subordinate to the rights of general creditors;
(iv) Whether the instruments give the holders the right to participate in the management of the issuer;
(v) Whether the issuer is thinly capitalised;
(vi) Whether there is identity between the holders of the instruments and stockholders of the issuer;
(vii) The label placed on the instruments by the parties;
(viii) Whether the instruments are intended to be treated as debt or equity for non-tax purposes.

[14] Energy Policy Act of 1992, Pub. L. No. 102-486, § 1936, 106 Stat. 2776 (1992).

[15] H.R. REP. NO. 102-1018 (1992).

[16] See, e.g., STAFF OF THE JOINT COMMITTEE ON TAXATION, 104th CONG., DESCRIPTION OF THE TAX AND HEALTH INSURANCE REFORM PROVISIONS IN THE PRESIDENT'S SEVEN-YEAR BALANCED BUDGET PROPOSAL RELEASED ON DECEMBER 7, 1995 (JCX-58-95) at 64-65 (1995); H.R. 2903, 104th Cong. (1996); STAFF OF THE JOINT COMMITTEE ON TAXATION, 104th CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL (RELEASED ON MARCH 19, 1996) (JCS-2-96) at 64-65 (1996); STAFF OF THE JOINT COMMITTEE ON TAXATION, 105th CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL (JCX-6-97R) at 53-54 (1997).

[17] See, e.g., Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 1999, at 69, available at http://www.gpoaccess.gov/usbudget/fy99/pdf/spec.pdf; see also, STAFF OF THE JOINT COMMITTEE ON TAXATION, 105th CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1999 BUDGET PROPOSAL (JCS-4-98) at 143-144 (1998).

The first of these proposed tax changes would have disallowed interest and original issue discount deductions for issuers of a debt instrument (i) with a weighted average maturity of more than 40 years, or (ii) which is payable in the stock of an issuer or a related party (within the meaning of sections 267(b) and 707(b) of the Code).[18] A debt instrument that is payable in equity of the issuer or a related party included an instrument that would be (a) mandatorily convertible, (b) convertible at the issuer's option, or (c) convertible at the holder's option if there was a substantial certainty that it would be converted into the issuer's (or a related party's) equity.[19] While this proposal originally only excluded demand loans, the 1997 version of this proposal also excluded redeemable ground rents and certain other specified debt instruments.[20]

The second proposed change would have deferred interest deductions in the case of certain convertible debt instruments until the interest was actually paid.[21] This, in essence, would have been an expansion of the 'applicable high yield discount obligation' limitations of Code sections 163(e)(5) and 163(i).

Third, for purposes of section 385 of the Code, equity treatment would have been given to corporate interests that (i) had a term of more than 20 years and (ii) were not shown as debt on the issuer's balance sheet.[22] This proposal was reintroduced several times and the term was lowered from 20 to 15 years in the Clinton Administration's budget proposal for fiscal year 1998.[23]

Of these legislative tax proposals, only one, the non-deductibility of interest on debt payable in stock, was adopted by the Taxpayer Relief Act of 1997 and became effective as Code section 163(l) on 9 June 1997.[24] That section provides that interest on debt payable in equity is not deductible for federal income tax purposes. The section is so broad that it arguably encompasses the fact pattern in Revenue Ruling 85-119 where, although the debt was payable in the issuer's equity, the holder had a claim if the amount of issuer's stock was insufficient to repay the debt instrument.

The IRS also weighed in on MIPS during an audit of a taxpayer (apparently Enron) in 1998. This resulted in the issuance of Technical Advice Memorandum 199910046 (15 March 1999). The TAM held that the issuer can deduct interest on a MIPS-like security. This TAM joins the ranks of other heavily negotiated technical advice memoranda and bears the earmarks of a TAM where substantial advice was solicited from or provided by market participants.

Congress briefly reawoke after the Enron scandal and again began looking at deductible equity simply because Enron had been one of the early MIPS issuers.[25] However, this effort went nowhere. The only tax remnant of the anti-Enron sentiment were amendments to Section 163(l) to expand its scope to debt payable in stock of unaffiliated parties held by the issuer or a related party.[26]

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[18] See STAFF OF THE JOINT COMMITTEE ON TAXATION, 104th CONG., DESCRIPTION OF THE TAX AND HEALTH INSURANCE REFORM PROVISIONS IN THE PRESIDENT'S SEVEN-YEAR BALANCED BUDGET PROPOSAL RELEASED ON DECEMBER 7, 1995 (JCX-58-95) at 64 (1995).
[19] Ibid. at 64.
[20] STAFF OF THE JOINT COMMITTEE ON TAXATION, 105th CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL (JCX-6-97R) at 54 (1997).
[21] See Staff of the Joint Committee on Taxation, 104th Cong., supra note 18 at 65.
[22] Ibid. at 64.
[23] See, e.g., STAFF OF THE JOINT COMMITTEE ON TAXATION, 105th CONG., DESCRIPTION AND ANALYSIS OF CERTAIN REVENUE-RAISING PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL (JCS-10-97) at 54 (1997). In addition, the Taxpayer Relief Act of 1997 added a rule that certain 'debt-like' preferred stock would be treated as 'boot' for purposes of sections 351 and 356 of the Code, which would result in taxable gain but no loss to the recipient of such stock in transfers to controlled corporations and tax-free reorganisations. This rule applies if (a) the holder of such stock has the right to put the stock to the issuer or a related party, (b) such stock is mandatorily redeemable by the issuer or a related party, (c) the issuer or a related party has the right to call the stock and such right is more likely than not to be exercised, or (d) such stock has a floating dividend rate.
[24] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1005, 111 Stat. 788 (1997).
[25] John D. McKinnon and Greg Hitt, How Treasury Lost In Battle to Quash A Dubious Security — Instrument Issued by Enron and Others Can be Used as Both Debt and Equity — Win for Flotilla of Lobbyists, WALL STREET JOURNAL, February 4, 2002, at A1.
[26] Taxpayer Relief Act of 1997, supra note 24.

Regulatory developments

As noted previously, the FRB decided in 1996 to treat 'trust preferred' securities as Tier 1 capital, subject to a limit equal to 25% of a BHC's Tier 1 capital.[27] The FRB guidance treated such instruments as Tier 1 capital so long as they (i) were subordinated to all subordinated debt, (ii) had the longest feasible maturity, and (iii) provided for a minimum five year deferral period. As "with other preferred stock includable in capital" according to the FRB, FRB approval was required before the instrument could be redeemed. It appears that the most important feature to the FRB was the five year interest deferral, the thought being that a financial institution would either be bankrupt or recovered in five years.

In 1998, the Basel Committee issued its own press release dealing with 'innovative capital instruments'. The press release was apparently a response to developments in the market for bank capital both in the US (such as trust preferreds) and outside the US[28] For example, various European issuers had issued preferred stock out of tax haven subsidiaries in order to avoid withholding taxes in their home country.[29] Apparently concerned that a bank would convert a substantial amount of its capital structure into these 'efficient' instruments, the press release stated that common stock and disclosed reserves or retained earnings should be the predominant form of Tier 1 capital.[30] The press release also reminded banks that transparency in terms of the components of Tier 1 capital was required. Most importantly, the press release focused on instruments such as trust preferreds and stated that such instruments should be included in Tier 1 capital only to the extent they met certain criteria including permanence, deferability of distributions on a non-cumulative basis and ability to absorb losses within the bank on a going concern basis. The press release also dealt with one other feature: rate step-ups. It stated that a Tier 1 instrument could include a rate step-up after 10 years but that instruments with such a feature (or any other that might lead to early call) would be limited to 15% of Tier 1 capital. Outstanding instruments that violated the tenants of the press release were grandfathered.[31]

The Federal Reserve Board then responded the same day by issuing its own press release that affirmed its treatment of trust preferred in light of the Basel Committee's press release.[32]

In 1998, the Basel Committee adopted amendments to Basel I in the so-called Sidney Agreement.[33] The Sydney Agreement stated that internationally active bank holding companies generally would be expected to limit restricted core capital elements to 15% of the sum of core capital elements, net of goodwill. Prior to the Sydney Agreement, the FRB was informally encouraged bank holding companies to comply with this standard even though no formal rule was in place.[34]

In March, 2005 the Federal Reserve Board amended its risk-based capital requirements to reflect the Sidney Agreement. At that time, the FRB explained its approach to tax-deductible Tier 1 instruments. It commented that the original 1996 decision on trust preferred had been based on two key factors: the long life of the underlying debt instrument 'approaching perpetuity' and the 'dividend' deferral rights (allowing deferral for 20 consecutive quarters) approaching economically indefinite deferral.[35] It noted that those features provide substantial capital support. The FRB also noted the change in GAAP accounting treatment for trust preferreds,[36] but said that "A change in the GAAP accounting for a capital instrument does not necessarily change the regulatory capital treatment of that instrument."[37] It went on to state: "Regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organisations, not accounting designations established to ensure the transparency of financial statements."[38]

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27 FRB 1996 Press Release, supra note 8.
28 See Joyce M. Hansen, Ivan J. Hurwitz and Diane L. Virzera, Capital Regulation and Supervision of International Banking Organizations, in Regulation of Foreign Banks (Michael Gruson and Ralph Reisner eds., 2003) [hereinafter 'Capital Regulation'] at 175.
29 Ibid. at 174.
30 Ibid. at 175.
31 Ibid.
32 Ibid.
33 Federal Reserve System, Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, 69 Fed. Reg. 28851 at 28853 (May 19, 2004).
34 Ibid.
35 Preamble to Final Regulation (March 1, 2005) [hereinafter FRB Final Rule] available at http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf.
36 Ibid.
37 FRB Final Rule, supra note 35 at 4.
38 Ibid.

The FRB's final rule allowed the continued limited inclusion of trust preferred in a BHC's Tier 1 capital. The FRB considered "its generally positive supervisory experience with trust preferred securities, domestic and international competitive equity issues, and supervisory concerns with alternative tax-efficient instruments."[39] The FRB made clear that it is aware of competitive pressures noting that:

"Approximately 800 BHCs have outstanding over US$85bn of trust preferred securities, the popularity of which stems in large part from their tax-efficiency. Eliminating the ability to include trust preferred in Tier 1 capital would eliminate BHCs' ability to benefit from this tax-advantaged source of funds, which would put them at a competitive disadvantage to both US and non-US competitors. With respect to the latter, the Board is aware that foreign competitors have issued as much as US$125bn of similar tax-efficient Tier 1 capital instruments."[40]

The final rule permitted trust preferred to be included in Tier 1 capital but limited to 25% of the sum of core capital elements. Internationally active BHCs are subject to a limit that trust preferreds not exceed 15% of the sum of core capital elements. An internationally active BHC is basically defined as one that has significant activity in non-US markets. The final rule permitted qualifying mandatory convertible preferred securities to be included in Tier 1 up to a 25% limit. Finally, the FRB continued to prohibit interest rate step-up provisions in Tier 1 capital instruments and Tier 2 subordinated debt but dropped a requirement that trust preferred securities include call provisions.[41] The changes were effective, with various grandfathers and phase-ins beginning 11April 2005.

Current tax developments

Tax treatment of new (and old) equity-like features

In early 2005, Moody's Investors Service rolled out refinements to its 'tool kit' which sets forth the various criteria for classification of instruments as equity or debt for ratings purposes.[42] In general, those refinements made it easier for hybrid instruments to be classified as equity for rating agency purposes. Since that development, issuers have been developing new hybrid features in order to get the highest possible rating agency equity credit while still maintaining a tax deduction. These new features include mandatory deferral, replacement covenants, longer maturities, scheduled maturities, and interest caps.

Mandatory deferral

One of the features of some current hybrids is mandatory deferral of interest payments. As seen previously, a typical trust preferred provides for five year optional deferral of interest. If the obligor continues to defer interest beyond the five year period then, in most cases, a default occurs. The problem with optional deferral is that the rating agencies believe there may be outside factors that influence whether optional deferral is exercised.[43] Therefore, in effect, there is still an obligation to make ongoing payments on the instrument.

A mandatory deferral feature, on the other hand, must be exercised. A typical mandatory deferral feature provides that if the obligor fails certain financial tests, then distributions on the instrument must be suspended.[44] There are various types of financial covenants, for example, whether the issuer has suffered net losses for a sustained period or if the issuer's leverage ratio increases above a certain threshold. The mandatory triggers are designed to give the issuer some latitude, if they are too tight then they may cause the very problem they are designed to cure.[45] On the other hand, they cannot be so loose that the issuer is on the brink of bankruptcy when the trigger occurs.[46]

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[39] Ibid. at 6.
[40] Ibid. at 7.
[41] Ibid. at 14.
[42] NEW INSTRUMENTS STANDING COMMITTEE, MOODY'S INVESTORS SERVICE, RATING METHODOLOGY – MOODY'S TOOL KIT: A FRAMEWORK FOR ASSESSING HYBRID SECURITIES [hereinafter MOODY'S TOOL KIT] (1999).
[43] See MOODY'S TOOL KIT, supra, note 42 at 5-6.
[44] For example, a recent Burlington Northern Santa Fe Corporation (BNSF) (NYSE:BNI) trust preferred offering, the BNSF Funding Trust I (the Trust) uses the proceeds from the sale of its trust preferred securities to purchase junior subordinated notes (the Notes) issued by BNSF. In addition to a discretionary interest deferral feature, the Notes provide that BNSF will be prohibited from paying interest, except from the net proceeds of certain sales of its common stock and/or qualifying preferred stock, in certain circumstances such as when for the preceding three calendar quarters, the total leverage of BSNF is more than 5:1 or if BSNF's interest coverage is less than 2:1. See BNSF Funding Trust I US$500,000,000 6.613 percent Fixed Rate/Floating Rate Trust Preferred Securities Prospectus Supplement, Registration No. 333-130214, filed pursuant to Rule 424(b)(5) as of Dec. 12, 2005, available at http://www.sec.gov/Archives/edgar/data/934612/000119312505242274/d424b5.htm.
[45] See MOODY'S TOOL KIT, supra, note 42 at 4-5.
[46] See STANDARD & POOR'S COMMENTARY REPORT, EQUITY CREDIT FOR BANK AND INSURANCE HYBRID CAPITAL, A GLOBAL PERSPECTIVE (2006) at 7.

Deferral on debt instruments has been one of those unique features that gives the non-tax audience comfort but does not cause the tax advisor too much pain. There seem to be several reasons. First, at the end of the deferral period the instrument's holders still have creditor's rights.[47] This assists in showing that the 'intent of the parties' is that the holders are creditors rather than equity owners. Second, the deferral feature is analogised to a zero coupon instrument. The tax advisor reasons that if the issuer could have issued a long-term zero coupon debt then deferral of five years interest (or 10 years for that matter) is really no worse.[48] Of course under this analysis, the advisor must be comfortable that the issuer's credit quality is so strong that a 60-year zero coupon bond would still fall on the right side of the debt-equity line.

Mandatory deferral seems in some ways both better and worse than optional deferral. Depending on the triggers, it may be better because it takes discretion on the payment of interest out of the obligor's hands. Unless the trigger is hit, interest must be paid. Of course if the mandatory deferral is coupled with optional deferral, which it may be, this argument cannot be made. Mandatory deferral is worse than optional deferral because its links the instrument more closely to the issuer's business fortunes. In this sense it is much like provisions that provide for interest contingent on earnings of the obligor. While these are not by any means fatal to debt classification they are nevertheless negative factors.[49]

The other feature that may be coupled with mandatory deferral is an obligation on the part of the issuer to sell additional equity in order to pay interest if mandatory deferral occurs. Thus, in a typical provision, interest is mandatorily deferred if the trigger is hit but an issuer must continue to pay interest out of the proceeds of stock sales, if it can sell stock. While this is a little better than flat out mandatory deferral it would seem that selling stock when the issuer's financial fortunes are declining may not be that easy. Again, much depends on the mandatory deferral trigger. If the issuer will still be rated investment grade even though the trigger is hit, it may well be possible to sell stock to pay interest. If the trigger is hit on the brink of bankruptcy, the possibility of selling stock is speculative at best and should be disregarded.

Replacement covenants

Another current rating agency favourite is a replacement covenant. In the base case, 'replacement language' simply says that the issuer will not redeem the instrument unless it does so out of the proceeds of equal or better equity content securities. If the issuer ignores the replacement language, the instrument's holders are not harmed – they are repaid. Instead, the harm is to the issuer's senior creditors; however, they are not in privity of contract with the issuer, at least as far as the replacement language is concerned.

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47 These rights may be to sue for the unpaid interest or may be a default that gives the debt holders the right to accelerate the instrument.

48 See, e.g., Fed. Exp. Corp. v. United States, 645 F. Supp. 1281 (W.D. Tenn. 1986) (Holding that the interest deferral received "no weight" in determining whether the debentures were debt or equity, because the deferral of interest until after payment of superior indebtedness does not affect the accrual of that interest or the obligation to repay). See also William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971), at 603 ("[b]ut if cumulative interest is unconditionally payable at maturity regardless of the sufficiency of earnings, the interim deferability of the payments, whether or not discretionary, should be given no adverse weight at all". Plumb, supra, at 603. A footnote explains: "Since all or part of the obligation to pay interest may be properly deferred until maturity in the case of bonds issued at a discount, it should make no difference that a part of the ultimately fixed amount of interest may be paid sooner, on whatever conditions." Plumb, supra, at n. 1386. Plumb notes that debt equity proposals of the American Law Institute, the American Bar Association and the Advisory Group would have made it sufficient for a debt safe harbor provision if interest were payable no later than maturity. Plumb, supra at n. 1386.

49 See, e.g., John Kelley Co. v. Comm'r, 326 U.S. 521 (1946); Crawford Drug Stores, Inc. v. United States, 220 F.2d 292, 296 (10th Cir. 1955) (a debt holder is usually entitled to interest even though there are no net earnings and the fact that interest is payable absolutely is a factor tending to establish a true debt); Tribune Publ'g Co. v. Comm'r, 17 T.C. 1228, 1234 (1952). See Note, Bonds—Income Bonds—Rights of Bondholders and Deductibility for Federal Income Tax Purposes, 56 Mich. L. Rev. 1334 (1958), cited in Plumb, supra note 46, at n. 348.

Recently, issuers have attempted to strengthen replacement language to address this shortcoming.[50] The issuer enters into a 'Declaration of Covenant'. Under the Declaration of Covenant, the issuer is contractually obligated to redeem the subject instrument only out of a specified security, with equal or better equity content. The Declaration of Covenant identifies specific senior debt that is the beneficiary of the promise made. It is thought, although it has not been proven, that the senior debt holders could sue for damages if the issuer acts in contravention of the Declaration of Covenant. This type of feature gives Moody's comfort and pushes the ranking on an undated hybrid from moderate to strong in terms of the 'no maturity' factor.[51]

From a federal income tax standpoint, neither type of replacement feature should be a negative debt factor. The replacement language only affects the issuer's right to call the security before the maturity date. It does not affect the issuer's unconditional obligation to repay its obligation at maturity. Accordingly, it does not diminish the issuer's unconditional obligation to pay. On the other hand, an instrument that is payable upon maturity only out of the proceeds of the sale of stock has a high risk of being treated as equity for federal income tax purposes.[52]

Longer maturities

The US tax law on maturity dates is fairly well known. A debt instrument must have a maturity date that is not unreasonably far in the future. Courts have tested long-dated debt instruments by inquiring whether the obligor will be around at the time the debt matures.[53] On one level, this test does not make much sense because no-one knows whether any of the obligors in today's world will be around in 10 years, much less 60 years or 100 years. In that sense, the relevant court opinions should be seen as a test of credit quality: what is the assessment that the instrument will be paid?

After Notice 94-47,[54] issuers limited the subordinated debt underlying trust preferreds to 49 years or less. More recently, issuers have been extending maturities to 60 years, mainly because the rating agencies view that as 'perpetual'. However, 60-year or 100-year debt is not unknown and with the right issuer should not tip the scale on debt classification.[55]

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[50] See, e.g., USB Capital VIII $375,000,000, 6.35 percent Trust Preferred Securities Prospectus Supplement, Registration No. 333-124535, filed pursuant to Rule 424B2 as of Dec. 21, 2005, available at http://www.sec.gov/Archives/edgar/data/1325524/000095013405023855/c00888be424b2.htm.

[51] See NEW INSTRUMENTS STANDING COMMITTEE, GLOBAL BANKING TEAM AND INSURANCE TEAM, MOODY'S INVESTORS SERVICE, REFINEMENTS TO MOODY'S TOOL KIT: AN ADDENDUM FOR BANKS AND INSURERS [hereinafter REFINEMENTS II] (2006) at 4.

[52] Dillin v. United States, 433 F.2d 1097, 1101 (5th Cir. , 1970). In Dillin, the demand notes in question were payable only when the issuer issued stock in an initial public offering.

[53] Monon Railroad v. Commissioner of Internal Revenue, 55 T.C. 345 (1970).

[54] Notice 94-47 states: "The [IRS] also is aware of recent offerings of instruments that combine long maturities with substantial equity characteristics. Some taxpayers are treating these instruments as debt for federal income tax purposes, apparently based on [Monon Railroad] which involved an instrument with a 50-year term. The [IRS] cautions taxpayers that, 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. The reasonableness of an instrument's term (including that of any relending obligation or similar arrangement) is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument. A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present." I.R.S. Notice 94-47, 1994-1 C.B. 357.

[55] Arguments have been made that 100-year debt should be treated as debt for federal tax purposes because it more resembles debt than equity particularly where the yield difference between an issuer's 100-year debt and its (or a similar issuer's) 30-year debt is relatively small. See, e.g., KAM C. CHAN & P.V. VISWANATH, CENTURY BONDS: ISSUANCE MOTIVATIONS AND DEBT VERSUS EQUITY CHARACTERISTICS, September 2002, available at http://webpage.pace.edu/pviswanath/research/papers/kamchan_final_version_102303.pdf.

Scheduled 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.

Interest caps

Another feature seen recently is interest caps in bankruptcy. In a typical formulation, the instrument provides that interest on the instrument can be deferred for up to 10 years. The instrument also provides that if interest has been deferred and the issuer goes bankrupt, then the holder will have a bankruptcy claim for interest limited to 25% of the face amount of the debt instrument. Accordingly, the excess interest is not treated as a bankruptcy claim and is forfeited. All principal is still payable.[56]

There is little tax authority on the treatment of such interest limitations. In the first instance, the question is whether interest on the instrument is unconditionally payable. It would seem that the correct analysis is to say that only an amount equal to 25% of the face amount is unconditionally payable. Another way to view the interest cap is a form of subordination. In either event, interest caps of this sort are a negative feature. On the other hand, the issuer may conclude that the circumstances under which interest will be forfeited are remote and that, therefore, the feature is not too damaging to debt treatment.

[56] For example in a 2005 offering by BNSF Funding Trust I, the issuer was obligated to sell stock to pay interest during a mandatory deferral period. There was no obligation to sell stock, however, during a 'market disruption event'. A market disruption event included (i) a trading halt on US exchanges generally or with respect to the issuer's stock, (ii) failure to obtain a regulatory body's consent to issue stock despite reasonable attempts to obtain consent, or (iii) an event occurs that causes an offering document for the issuer's securities to be defective. If the issuer did not pay all accrued and unpaid interest for two consecutive years during a mandatory trigger period, all claims with respect to such interest after the two-year period and to the last day of the mandatory trigger period would be extinguished if the issuer went bankrupt during the period. Conceivably, according to the prospectus, this could result in extinguishment of claims for five years worth of interest. See BNSF Funding Trust I $500,000,000 6.613 percent Fixed Rate/Floating Rate Trust Preferred Securities Prospectus Supplement, supra note 44 at s-15.

Current structures

The new wave of hybrid securities[57] addresses the fundamental contradiction inherent between tax and non-tax precepts. From a non-tax standpoint substantial equity credit is only given for instruments that are perpetual and non-cumulative. From a federal income tax standpoint a perpetual non-cumulative debt instrument would be treated as equity for federal income tax purposes. In 2005 and 2006 a number of different structures emerged to address these competing goals. By mid-2007 two structures appeared to have gained broad market acceptance. The first is the enhanced trust preferred. It works in the classic hybrid fashion – creating an instrument that has characteristics of both debt and equity. The second involves two instruments that are held together with a 'velcro' strip. That is, a perpetual non-cumulative security is issued along with a term cumulative security. The intent is to have the instruments treated as one instrument for non-tax purposes and as two separate instruments for US federal income tax purposes.

Enhanced trust preferred - CENTs, etc.

One winner in the competition for the next generation hybrid is the 'enhanced trust preferred'. An example of this is the Capital Efficient Notes (CENTs) created by JP Morgan.[58] In the typical enhanced trust preferred the underlying debt instrument has a 30-year scheduled maturity with a 60 year legal final maturity. It provides for interest deferral for five years coupled with an additional five year interest deferral for another five years. During that five years, the issuer is under an obligation to sell its securities, including common stock or warrants to buy common stock to repay the deferred interest. The obligation to sell such securities is limited, usually to 2% of market capitalisation at the time the securities are sold. Also, in some transactions part, but not all, of the deferred interest may be permanently cancelled, even if the issuer is not bankrupt or insolvent, if (i) interest is deferred for a period of 10 years, (ii) no event of default and acceleration is continuing, and (iii) 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. From a federal income tax standpoint, the tax advisor may accept them if the possibility actual interest cancellation will occur seems remote.

WITS and HITS

The second winner is the WITS/HITS instrument.[59] In these structures, the issuer issues a non-cumulative security (actually a forward contract to buy a non-cumulative security) along with a long-dated subordinated debt instrument. The forward contract requires the investor to purchase non-cumulative perpetual preferred stock of the issuer in five years. The subordinated note has a much longer term, say 40 years. Sometime before the five year forward settlement date, the interest rate on the subordinated note is reset and the subordinated note is remarketed to unrelated third parties. The investor uses the cash from the sale to deliver the purchase price under the forward. If the subordinated note cannot be remarketed (presumably because the issuer is in bad financial shape) then the subordinated note is transferred to the issuer as the purchase price for the preferred stock.

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57 This new wave includes the following transactions: Lehman Brothers Holdings E-Capital Trust I $300,000,000 [the public document is an Offer to Exchange its Floating Rate Enhanced Capital Advantaged Preferred Securities (ECAPSSM) which have been registered under the Securities Act of 1933 for any all of its outstanding Floating Rate Enhanced Capital Advantaged Preferred Securities, Form S-4, SEC File No. 333-129195, dated Oct. 21, 2005 (subject to completion) available at http://www.sec.gov/Archives/edgar/data/806085/000104746905025084/a2163393zs-4.htm]; BNSF Funding Trust I $500,000,000 6.613 percent Fixed Rate/Floating Rate Trust Preferred Securities, supra note 44; Stanley Works Capital Trust I $450,000,000 5.902% Fixed Rate/Floating Rate Enhanced Trust Preferred (November 22, 2005), see http://www.sec.gov/Archives/edgar/data/93556/000134100405000414/nyc521812.txt;
Wachovia Capital Trust III $2,500,000,000 5.80 percent Fixed-to-Floating Rate Normal Wachovia Income Trust Securities Prospectus, SEC File No. 333-131237 and 333-131237-01, filed pursuant to Rule 424(b)(2), dated January 25, 2006 available at http://www.sec.gov/Archives/edgar/data/36995/000095014406000558/g99243bae424b2.htm; Washington Mutual, Inc. $1,150,000,000 5.38 percent Trust Preferred Income Equity Redeemable Securities Prospectus Supplement, Registration No. 333-63976, filed pursuant to Rule 424(b)(3) as of January 21, 2003, available at http://www.sec.gov/Archives/edgar/data/1143930/000090730303000015/prosupp12103b.htm, see also Washington Mutual, Inc. Annual Report for Fiscal Year Ended Dec. 31, 2005 Filed Pursuant to Section 13 and 15(d) (Form 10-K) as of March 15, 2006 available at http://www.sec.gov/Archives/edgar/data/933136/000110465906016786/a06-2446_110k.htm; USB Capital VIII $375,000,000 6.35% Trust Preferred Securities Prospectus Supplement, File No. 333-124535, Filed Pursuant to Rule 424B2 as of August 3, 2005, available at http://www.sec.gov/Archives/edgar/data/36104/000095013405023741/c00888b2e424b2.htm; USB Capital IX $1,250,000,000 6.189% Fixed-to-Floating Rate Normal Income Trust Securities Prospectus Supplement, File No. 333-132297, filed pursuant to Rule 424(b)(2) as of March 10, 2006, available at http://www.sec.gov/Archives/edgar/data/36104/000095013406005305/c02886b2e424b2.htm.

58 See, for example, JP Morgan's own CENTs; JP Morgan Chase Capital XXII $1,000,000,000 6.450% Fixed Rate Capital Securities Prospectus Supplement, File No. 333-126750, filed pursuant to Rule 424(b)(5) as of January 26, 2007, available at http://www.sec.gov/Archives/edgar/data/19617/000119312507016403/d424b5.htm.

59 See, for example, Bank of America's BAC Capital Trust XIII $700,000,000 Floating Rate Preferred Hybrid Income Term Securities Prospectus Supplement Registration Nos. 333-133852 and 333-133852-08, filed pursuant to Rule 424(b)(5) as of February 12, 2007, available at http://www.sec.gov/Archives/edgar/data/70858/000119312507029674/d424b5.htm

The subordinated note and the forward contract can be separated through some rather complicated mechanics which essentially involve substituting Treasury securities for the subordinated note. The investor can also extract the note and accept the remarketing-set interest rate so long as it deposits cash necessary to exercise the forward contract.

The WITS/HITS structure basically relies on Revenue Ruling 2003-97.[60] That ruling dealt with an investment unit composed of (i) a debt instrument, and (ii) a forward contract to buy stock. Revenue Ruling 2003-97 concludes that the two components of the investment unit are separate for federal income tax purposes so long as (i) they are not legally linked, and (ii) there is no economical compulsion to hold them together.[61] Assuming the note and forward are separate, the other tax conclusions follow. Interest on the debt instrument is deductible and the instrument is not payable in equity and therefore does not run afoul of Code section 163(l).

The WITS/HITS creates Tier 1 capital outside of the 15% basket and instead subject to the 25% limit applicable to 'mandatory convertible' securities.

The FRB on 23 January 2006 issued a letter[62] that considered this structure. The letter concluded that the security would count outside of the 15% basket as Tier 1 capital. The Federal Reserve took this position despite the fact that the market viewed the structure as having a step-up in rate after five years. Thus, the FRB has historically not permitted Tier 1 instruments to contain stepped-up interest rates coupled with a call option. The thinking apparently is that the step-up will induce the issuer to exercise the call, creating a de facto maturity date for what the FRB requires be a perpetual instrument. In the transaction the letter was written for when the perpetual preferred stock is issued, the issuer will be paying a non-deductible coupon as compared to a deductible coupon on the subordinated note. The regulatory issue is whether the issuer will be induced to call the perpetual preferred because its after-tax cost of keeping the security outstanding has increased dramatically. So far, there is no indication the FRB believes that this constitutes a de facto step-up. Moreover, in 2007 the FRB dropped its objection to step-ups in Tier 1 capital instruments.

Hybrids issued by foreign issuers in the US

Another aspect of the current hybrid market involves hybrid securities issued by foreign issuers to US holders. In 2003, Congress reduced the US tax rate on dividends received by individuals to 15%.[63] To qualify, the dividend must be 'qualified dividend income' (QDI). Congress decided that dividends on equity issued by foreign corporations should also qualify for the preferential rate. In general, the foreign corporations are ones that reside in a jurisdiction that shares tax information with the US or foreign corporations whose shares are traded on a public exchange. Also, the foreign corporation cannot be a 'passive foreign investment company' under US tax rules[64] which basically means that the foreign corporation must be in an active business.

What makes this provision attractive is that the US treats perpetual debt as equity for federal income tax purposes. Therefore, a foreign corporation can issue perpetual debt which may qualify for a tax deduction in the home jurisdiction. In the US, however, it is treated as equity and individual US holders are treated as receiving qualified dividend income. A number of foreign issuers have taken advantage of this opportunity.

In March 2007 Representative Richard E. Neal (D.-Mass.) introduced legislation (HR 1671) that would exclude foreign equity from QDI treatment. The bill would deny the special 15% individual US tax rate on dividends to the extent stock is issued by foreign issuer and foreign issuer receives a deduction in home country for the dividend or the instrument is treated as other than stock under the foreign country's tax law. A companion bill (S. 1006) was introduced by Sen. John Kerry (D.-Mass.). The proposed effective date is for dividends received after enactment. The proposed legislation has not yet been enacted and its prospects are uncertain.

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60 Rev. Rul. 2003-97, 2003-2 C.B. 80.
61 The genesis of Revenue Ruling 2003-97 was an instrument known as "Feline PRIDES". This instrument was originally adopted by corporate issuers.
62 Letter from the Federal Reserve Board to Wachovia Corporation dated January 23, 2006 available at http://www.federalreserve.gov/boarddocs/legalint/bhc_changeincontrol/2006/20060123/attachment.pdf.
63 Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L.108-27 (108th Cong. , 1st Sess).
64 Section 1293 et. seq.