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Hybrid Horizons: U.S. Tax Considerations in Hybrid Capital Instruments

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In the financial world, Hybrid Capital instruments occupy the space between traditional debt and equity. Common examples include preferred equity with a variety of debt-like features and “Holdco” notes. While Hybrid Capital can be a highly effective tool for crafting creative financing solutions, by its nature, it requires careful U.S. tax analysis. Key to this analysis is that the U.S. federal income tax rules relating to capital structures generally classify all capital instruments as either “debt” (generating interest income) or “equity” (the income from which depends on the U.S. tax classification of the issuer). While the form of a capital instrument is a factor in determining whether it is debt or equity for tax purposes, the U.S. tax laws require evaluating a wide range of factors in making this determination. The U.S. tax consequences of a Hybrid Capital instrument being classified as debt or equity, in turn, are informed by both the U.S. tax classification and status of both the issuer and the investors. Investors and issuers alike should involve U.S. tax advisors who are experienced in structuring Hybrid Capital instruments in order to avoid unexpected tax costs and inefficiencies.

Tax Treatment of Hybrid Capital Classified as Debt

Hybrid Capital that satisfies the requirements to be treated as debt for U.S. tax purposes has relatively predictable U.S. income tax consequences for investors and issuers alike. In general, the income generated by indebtedness is treated as interest for all U.S. tax purposes, and the U.S. tax laws have a sophisticated set of rules requiring that interest income economically accrue over time. Interest generally creates deductions for issuers subject to significant limitations and timing rules. For investors, interest is generally treated as ordinary income that, depending on the terms of the instrument, is taken into account when paid (for coupon interest paid no less than annually) or when accrued (in the case of all other interest, including “paid in kind” (or “PIK”) interest, pursuant to the original issue discount, or “OID” rules). Further complexity arises when the payment of interest is subject to contingencies such as the economic performance of the issuer.

The major considerations for investors in Hybrid Capital treated as debt for tax purposes are:

- The initial issuance of Hybrid Capital treated as debt is generally treated like any other issuance of a debt instrument. Investors who are subject to guidelines that limit their ability to originate debt investments should consult their guidelines carefully before investing.
- For U.S. taxable investors, the OID rules generally will require interest income to be taken into account as it accrues based on a constant yield method, whether or not paid currently in cash. PIK interest is generally included in income as it accrues, even if no cash payment is made. Additionally, all interest income (whether paid in cash or accrued) will be taxed as ordinary income.
- For U.S. tax-exempt investors, interest income from investment is not generally treated as unrelated business taxable income, or UBTI, but there are certain significant exceptions that should be considered.
- For non-U.S. investors, interest income not effectively connected with a U.S. trade or business of the investor can qualify as “portfolio interest” that generally is not subject to U.S. withholding or other U.S. income tax. While the debt of U.S. issuers often satisfies the portfolio interest requirements, care needs to be taken in situations where the investor in the debt might beneficially own (even indirectly or constructively) 10 percent or more of the equity or the return on the debt is contingent on the issuer’s results.
- Special considerations may apply to investors that rely on a tax treaty with the U.S. to avoid U.S. taxation, sovereign wealth funds, and non-U.S. banks and other investors subject to special tax rules (such as certain types of registered funds, including BDCs).

Interest expense is generally deductible to the issuer of an instrument treated as debt for U.S. tax purposes, subject to various limitations under the U.S. tax rules. Certain limitations, such as those for “applicable high yield debt instruments,” or “AHYDOs,” can often be mitigated through careful planning.

Tax Treatment of Hybrid Capital Classified as Equity

The tax treatment of a Hybrid Capital instrument that is equity for U.S. tax purposes principally depends on whether the issuer is a corporation or a partnership for U.S. tax purposes.

A Hybrid Capital instrument issued by an entity treated as a corporation for U.S. tax purposes generally will be treated as a class of stock (equity). As a result, payments made in respect of such an instrument prior to redemption generally will be treated as a dividend for U.S. tax purposes to the extent of the issuer's "earnings and profits" (normally closely correlated with net earnings). A properly structured complete redemption generally will result in capital gain treatment. In some circumstances, a corporation will be deemed to have made a phantom distribution in respect of its stock even if no cash is distributed. U.S. tax counsel should be consulted as to how to minimize leakage of this type, which is especially problematic for non-U.S. investors.

For non-U.S. investors, a key issue is that the portfolio interest exemption described above does not apply to distributions treated as dividends, and while income tax treaties often allow a reduced rate of withholding on dividends, there are only limited circumstances in which a non-U.S. treaty investor is eligible for a zero rate of withholding on dividends. Additionally, phantom dividends attract this withholding tax in a complex (and generally negative) way. By contrast, non-U.S. investors are often able to avoid U.S. withholding tax on capital gains (there are a number of important exceptions, especially related to companies with substantial real estate holdings). As a result, careful consideration needs to be given at the time of the initial investment as to whether and to what extent the issuer and investor expect cash to be actually distributed in respect of a Hybrid Capital instrument treated as equity.

Dividends paid are generally non-deductible by U.S. issuers. However, U.S. corporate investors in such instruments may be eligible for a dividends-received deduction. And, as with debt, there are special considerations that are applicable to certain classes of investors, particularly sovereign wealth funds, as well as registered investment funds and BDCs.

The U.S. tax treatment of Hybrid Capital instruments issued by flow-through issuers such as partnerships and limited liability companies that are not “checked closed” as corporations is fundamentally different. An investor in such an instrument generally will be required to take into account their allocable share of the income and gains, as well as losses, deductions and credits, of the issuer on an annual basis, whether or not any cash is distributed. Although preferred return on an instrument treated for U.S. tax purposes as equity in a partnership is not deductible to the issuer, income allocated to an investor with respect to its preferred return generally reduces the income allocable to other owners of the issuer and so can have an economic effect similar to a deduction.

In many cases, this can create adverse consequences for investors through the flow-through of income and gain that is treated by rule as either effectively connected income, or “ECI,” for non-U.S. investors, or as unrelated business taxable income, or UBTI, for many U.S. tax-exempt investors. Many non-U.S. investors or investment vehicles with foreign partners seek to avoid ECI, which subjects them or their foreign partners to U.S. income tax filing obligations and potential branch profits tax exposure, as well as complex withholding tax consequences. Similarly, many U.S. tax-exempt investors or investors with tax exempt partners are sensitive to UBTI, which undermines the tax efficiency of their investment. These risks can be mitigated by investors using so-called “blocker” entities through which they invest, but the use of blockers adds tax costs (because the blocker is taxed as a U.S. corporation and is generally subject to U.S. corporate income tax on its net income) and administrative burden.

There are also complex rules that govern whether and how an investor in a “preferred” equity position in a flow-through takes into account income, gain, loss and deduction, which can result in non-economic net taxable income. This, and other types of phantom income, are often addressed through tax distributions.

These risks and costs often cause investors and issuers to structure a hybrid instrument in a partnership or other flow-through vehicle as debt for tax purposes rather than equity. Careful U.S. tax planning around all of the economic and other material terms of the instrument is necessary to reach the appropriate debt-equity conclusion. In certain circumstances, it may be advisable to seek an opinion of counsel to the issuer as to this conclusion.

Conclusion

Hybrid Capital instruments offer flexibility and commercial advantages, but their tax treatment is rarely straightforward and contains significant traps for the unwary, many of which can be triggered by otherwise seemingly minor changes to the economic and other material terms. Tax analysis at the earliest stages of structuring such an instrument is essential to ensuring that Hybrid Capital achieves its intended economic objectives while minimizing unintended and potentially significant negative tax consequences.

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