

# Cross-Border Corporate Finance

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*Despite challenges posed by accounting and tax issues,  
income securities continue to be the focus of cross-border finance transactions.*

Last year we wrote about the explosive growth in "specialty business" income fund offerings in Canada and the initial application of the income fund structure to cross-border offerings of U.S.-based assets and businesses. In that article, we identified the initial evolution of three key U.S. tax issues (withholding tax, earnings-stripping rules and equity recharacterization of inter-company subordinated debt) that needed to be addressed before an income fund security could be successfully developed in the United States. Since the time of that article, there have been significant developments in income funds and similar offerings (generally referred to in this article as "income security offerings") that are based on cash flows from U.S.-based businesses and assets and are offered, in whole or in part, to Canadian investors. In this article, we take a closer look at the key issues that have arisen with respect to the current generation of cross-border income security offerings.

## BACKGROUND

What is an income security offering? Among those of us who spend most of our professional time working on these offerings, it seems as though the inner mechanics of an income security offering are common knowledge. On the basis that this is not a sound assumption, we have included a brief summary of the income security offering structure.

Simply put, an income security offering is based on a restructuring of a business, either through the use of flow-through vehicles such as limited partnerships and trusts, or through a recapitalization, primarily with inter-company subordinated debt (often referred to in this article as the "subordinated notes"). As a result, the taxable income of the business is reduced or eliminated, and the cash generated by the business is paid out to investors through flow-through vehicles or used to pay interest and dividends on the subordinated notes and equity that are held by the public income security issuer. These payments are made to investors on a regular basis, usually monthly. While there are variations on this structure, they all share the fundamental objective of delivering to investors the stable portion of cash flow generated by a particular business or asset.

The income security offering structure is suitable for businesses, or assets, with the following characteristics:

- stable historical and forecast operating net cash flows;
- no anticipated major corporate events or industry changes;
- predictable maintenance capital expenditure requirements;
- strong market position in chosen business segment; and
- strong sponsorship.

The attention garnered by income security offerings has been generated by their ability to reduce a business's tax liabilities and pay out a steady stream of cash to investors. This focus on tax-effective cash flows has tended to obscure other key attributes of the income security structure. Most importantly, this structure brings with it a powerful change in management style and corporate governance. A business that must pay out most of its available cash on a regular basis is a business that must be conducted with great transparency. It is also a business whose management must be focused on maintaining predictable cash flow that cannot be used for investments or new projects that do not produce immediate returns for unitholders. Simply put, the returns generated by the business must be paid to unitholders, and management must maintain a strict focus on achieving this outcome.

## RISE OF CROSS-BORDER OFFERINGS

The attractive valuations realized by the early rush of Canadian income security offerings was not lost on some owners of U.S.-based businesses, and in early 2002, efforts began to develop a structure that would permit a Canadian offering of income fund units based on a U.S. operating business. The challenge to develop an effective structure did not, at first glance, seem to be too great. After all, Canadian companies with U.S. operations have for many years found ways to repatriate cash generated in the U.S. without suffering harsh tax consequences. However, as efforts were made to develop these offerings, a number of significant challenges had to be overcome.

From a Canadian tax perspective, there are a number of points that are important to focus on. In order to make an

income security offering more attractive to certain tax-registered plans (such as registered retirement savings plans, or "RRSPs"), it is important that the securities not be "foreign property" for the purposes of the *Income Tax Act* (Canada). This categorization is avoided if the investment is made in a Canadian corporation with a "substantial Canadian presence" and care is taken to ensure that these requirements are met in a cross-border income security offering.

It is also key to ensure that the downstream investment in the U.S. assets or business does not fall into the "foreign investment entity" rules. Offerings are usually structured to gain the benefit of an exemption from these rules by ensuring that the Canadian offering entity controls the U.S. business.

Lastly, careful attention is paid to the application of the rules relating to the taxation in Canada of income derived from the U.S. earnings, particularly the rules governing "foreign accrual property income." The solution to this challenge is to perform sufficient diligence to become satisfied that the U.S. business is earning income from an active business (and not passive income).

From a U.S. tax perspective, three key issues had to be addressed. First, the Canadian income fund would receive most of the cash flow generated by the U.S. business in the form of interest paid on the subordinated notes of the U.S.-operating company. If those interest payments were to become subject to U.S.-withholding tax, the amount of distributable cash would be reduced and the number of income fund units that could be issued to the public would be reduced commensurately. To avoid this unwanted tax leakage, it was necessary to develop a structure that would obtain the benefit of the "portfolio interest" exemption from withholding tax.

Second, unless an exemption could be found, the application of U.S. "earnings-stripping rules" (which apply where the Canadian lender/shareholder owns more than 50% of the U.S. operating entity) would impose significant constraints on the amount of interest deductions that could be taken by the operating business to reduce its U.S. taxable income. The financial impact of this tax leakage would also operate to reduce significantly the number of income fund units that could be issued to investors.

Lastly, the subordinated notes to be issued by the U.S. operating entity had to be structured in such a way as to support legal and accounting conclusions that such debt should be respected as debt, and not be re-characterized as equity, for U.S. tax purposes. Otherwise, interest paid on the subordinated notes would be at risk of being re-characterized as dividends, and accordingly, not being deductible for U.S. tax purposes.

The first two of these challenges was addressed by including in the declaration of trust for the Canadian income fund terms and conditions that would constitute the income fund as a "fixed investment trust" for U.S. tax purposes. The result of achieving this status is that the income fund trust would be ignored for U.S. tax purposes and the public would be regarded as owning the subordinated notes and equity of the U.S. operating entity. The portfolio interest exemption would therefore generally be available to all investors (other than one that held more than 10% of the underlying U.S. entity) and the earnings-stripping rules would not apply (on the basis that no single investor would own more than 50% of the underlying U.S. entity).

The debt-versus-equity characterization issue was addressed by limiting the amount of subordinated notes being

issued, including market terms and conditions in the subordinated note indenture, and preparing financial models that established the issuer's ability to carry the subordinated notes, such that issuers and their advisers would be comfortable treating the interest payments as deductible for U.S. tax purposes. This approach was successfully adopted by a six-pack of cross-border income security offerings that were brought to the Canadian market between the spring of 2002 and the summer of 2003 (Heating Oil Partners Income Fund, KCP Income Fund, Specialty Foods Group Income Fund, ACS Media Income Fund, Custom Direct Income Fund and Great Lakes Carbon Income Fund).

## ACCOUNTING ISSUES RAISED

In the wake of these transactions, four of which closed between March and August of 2003, it was with some surprise that Specialty Foods Group Income Fund ("Specialty") announced on September 15, 2003, that PricewaterhouseCoopers LLP ("PWC") had informed it that PWC would not serve as Specialty's auditors in respect of the 2003 fiscal year. The press release disclosed that PWC had not provided Specialty with a reason for its decision, but, based on its discussions with PWC, Specialty believed that PWC's decision was based upon its uncertainty over accounting for the deductibility of interest paid on the subordinated notes of the U.S. operating company that were held by Specialty. The press release also noted that outside tax counsel for Specialty, and for the underwriters of the initial public offering, provided tax opinions included in Specialty's IPO prospectus that addressed PWC's stated concerns, including that the interest paid on the subordinated notes should be deductible for U.S. tax purposes.

This action by PWC set off a chain reaction that affected all of the other cross-border income funds. Custom Direct Income Fund soon after announced that, at the request of its audit committee, senior management had met with the fund's auditors (BDO Dunwoody LLP) to discuss the issues surrounding the deductibility of interest on the subordinated notes held by the fund and that, based on those discussions, the auditor advised that it would continue as auditor for the fund. Heating Oil Partners Income Fund announced that it had been advised by its auditor, PWC, that as part of an ongoing process, it was beginning a general review of the fund's structure. Subsequently, Heating Oil Partners announced that PWC had completed its review of the tax structure of the fund and had agreed to continue to act as auditor of the fund. However, the fund also announced that its wholly-owned subsidiary had decided to take the conservative financial reporting position of excluding the interest paid on the subordinated notes held by the fund from its tax provision calculations in its financial statements. Great Lakes Carbon Income Fund announced that it was reviewing the deductibility for U.S. income tax purposes of interest expense on the subordinated notes of certain of its indirect subsidiaries. Predictably, the market reacted negatively to these disclosures.

## U.S. DOMESTIC OFFERINGS

Throughout this period, work was progressing on U.S. domestic offerings of income securities that, in the U.S. market, are referred to as "income deposit securities" or "IDSs." The first of these offerings was Centerplate, Inc. (formerly Volume Services America Holdings, Inc.) and, like all that followed it, there are certain structural differences between it and a Canadian income fund.

The most apparent difference between a Canadian income fund and a U.S. IDS is that the U.S. structure does not use a trust as the public offering vehicle. From the outset, U.S. tax counsel was concerned that the effective "stapling" together of the underlying debt and equity securities that are held by the income fund trust was a negative factor in the U.S. debt-versus-equity characterization analysis. Instead, the U.S. approach would be to have the U.S. operating company issue the debt and equity securities directly to investors in the form of a receipt that, like a coat check ticket, could be turned in at any time in return for the underlying debt and equity securities that it represents.

While this is the most obvious structural difference between the Canadian and U.S. approaches, there are a number of other factors in U.S. case law that are relevant to an assessment of whether subordinated debt should be treated as debt for U.S. tax purposes or whether it should be re-characterized as equity. Some of the most relevant factors are as follows:

- Are the term, interest rate and other features of the subordinated notes commercially reasonable?
- Is the issuer of the subordinated notes too thinly capitalized (maximum debt-to-equity leverage of approximately 3 to 1)?
- Do the terms of the subordinated debt have "equity-like" features such as voting or participation rights, flexible interest payment dates or subordination to all creditors and claimants other than equityholders?
- Are there rights to convert into equity of the issuer?
- Are there normal creditor remedies on default?

The U.S. IDS structures also became embroiled in the cross-border income security review that started with PWC and spread to the other major accounting firms (PWC, KPMG LLP, Deloitte & Touche LLP and Ernst & Young LLP). The big four accounting firms progressively developed requirements to ensure debt characterization treatment that now seem to have crystallized largely as follows:

- The issuer's counsel and underwriter's tax counsel must issue opinions that the subordinated notes should be respected as debt for U.S. federal income tax purposes, and the auditor's tax department must concur with these opinions.
- The subordinated notes must rank *pari passu* with a significant amount of other debt of the issuer. If the issuer of the subordinated notes is a holding company, one or more of its operating subsidiaries must guarantee the subordinated notes so that holders of those notes will have a debt claim against the operating subsidiary in the event of a bankruptcy of the issuer. This requirement is aimed at insuring that the subordinated notes are not "structurally subordinated" in a bankruptcy proceeding to the claims of trade creditors of the operating subsidiaries of the holding company.
- The subordinated notes and the equity component of the income security must be legally separable. This requirement is more easily met in an IDS structure, which does not use an income fund trust and instead issues the debt and equity securities to the public separately (even though they are both represented by the IDS receipt). The subordinated notes and the equity do not need to be separately listed on an exchange. In practice, the IDS is listed and posted for trading on a stock exchange and, for securities

that are sold into Canada, the underlying equity component is separately listed in order to ensure that the IDS will be a qualified investment for RRSPs and similar deferred income plans.

- An independent appraisal firm must opine on the terms of the subordinated notes and the validity of the price allocation between the subordinated notes and the equity.
- There must be a sufficient level of "spinster equity"; that is, at least 10% of the common equity must be stock that is not exchangeable for IDS securities for at least two years.
- There must be a sufficient level of "bachelor bonds"; that is, 10% of the subordinated notes must be issued to parties who are not stockholders, and such debt must have identical terms to the debt embedded in the IDS. There must be no plan or intention to sell the bachelor bonds to a shareholder, the underwriting investment bank or a party related to a shareholder or the investment bank (i.e., so as not to be combined with equity to form an IDS).
- The investment bankers must agree to use their best efforts to facilitate the making of a market for the bachelor bonds.
- Dividends on the equity component cannot be paid if interest on the subordinated debt is delinquent.
- Counsel to the issuer must deliver a legal memorandum analyzing the treatment of the subordinated notes and related subsidiary guarantees as debt in a bankruptcy context.

## THE ROAD AHEAD

Now that the tax lawyers and accountants appear to have settled on common ground, what is the future for cross-border income security offerings? In the United States, there have been (at the time of this article) two completed IDS offerings (Centerplate, Inc. and B&G Foods Holdings Corp.), and there are many others (well over a dozen) waiting in the wings. These offerings, while primarily U.S. domestic offerings, often include a portion that is offered cross-border into Canada. This can be done on a private placement basis (like B&G Foods) but can also be publicly offered (like Centerplate).

If a Canadian public offering of an IDS offering is planned, it is readily achieved by preparing a disclosure wrapper that deals with Canadian securities law requirements. The Canadian wrapper is attached to the U.S. offering document, and both are filed and cleared with Canadian securities regulatory authorities within the time limits applicable to the U.S. side of the offering. Continuous disclosure requirements in Canada are satisfied by filing materials prepared and filed in the United States.

The other development in cross-border income security offerings is the introduction of a Canadian version of an IDS called an "income participating security." This structure was used by Medical Facilities Corp. in its offering in March 2004. An IPS offering is essentially a marriage of the early-stage cross-border income funds discussed above and the U.S. IDS offering structure. With an IPS offering in the Canadian market by a U.S. operating company (Medical Facilities was a U.S. partnership, or LLC vehicle, which is a much less common form of issuing entity), it is necessary to create a Canadian corporate structure on top of the U.S. company that mirrors the structures used in the early cross-border income funds mentioned above. A Canadian corporation becomes the parent entity of the U.S. company, and a Nova Scotia unlimited liability company is created as an indirect subsidiary. These entities issue a combination of equity and subordinated notes, respectively, to public

investors that is "clipped" together and represented by an IPS. The current expectation is that IPS offerings will replace the original cross-border income fund structure as the structure of choice for U.S. businesses looking to raise proceeds in Canada.

### **GROWTH IN CROSS-BORDER INCOME FUND M&A**

There have been many examples of Canadian income funds successfully completing domestic acquisitions of complementary assets and businesses. Canadian equity markets have been receptive to these transactions, and established income funds have had little difficulty raising substantial proceeds in the secondary market to fund these acquisitions.

This has also proven to be true with respect to cross-border acquisitions. In February of 2004, Connors Bros. Income Fund announced that it was merging with Bumble Bee Seafoods, LLC in a combination valued at approximately \$800 million. This transaction was significant in that it showed the market's acceptance of a relatively small income fund issuer acquiring a much larger complementary business that was based largely in the United States. The transaction was

financed through a public offering of \$262 million, a senior debt refinancing of US\$125 million and a retained interest of approximately 33%.

There are some lessons to be learned from the Connors Bros./Bumble Bee Seafoods experience. First, Bumble Bee Seafoods could have chosen to launch its own income fund/IPS or IDS transaction as a way of accessing the public markets in Canada or the United States. Had it followed this course of action, it would have subjected itself to the initial public offering process, and it is widely accepted that the execution risks of completing an IPO financing are considerably greater than the risk of an established capital market issuer successfully completing a secondary offering. In addition, from the perspective of an established Canadian income fund issuer, the transaction shows that acquisition opportunities do not need to be limited to businesses that are available in the Canadian market or businesses that are of a smaller size than the acquiring party. The ability to complete acquisitions of substantial size with lower overall execution risk should serve to provide a greater volume of these transactions in the future. ■

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