

Private Equity Tax Alert

—Distressed Debt Restructuring

Business Environment

Capital and credit markets continue to be volatile, and business fundamentals for many Canadian companies have deteriorated. Private equity funds should be considering how they can protect the value of their fund's investee companies, and opportunities for their funds to acquire interests in good businesses that are expected to perform well and increase in value when conditions improve.

This may include acquiring the debt of a company or income trust that may be available at a discount to its principal amount. As loans have been more readily syndicated over the past few years, there may be opportunities to acquire debts from certain creditors.

Funds might also consider acquiring the shares of public companies or units of income trusts that have declined in value. This could include purchasing a small equity position before making a decision about whether to pursue a greater equity or debt interest.

The Debt Forgiveness and Debt-Parking Rules

The Canadian debt forgiveness rules were greatly expanded at the close of the last Canadian recession in the early 1990s, and include complex "debt parking" rules that can result in debt forgiveness¹ for income tax purposes if debt owing to arm's length lenders is acquired at a discount by certain shareholders of the debtor company.

Debt forgiveness, or debt parking resulting in debt forgiveness, can significantly impair the value of an investee company or of a target company's income tax attributes, and in some circumstances can result in taxable income within the particular company.

If a shareholder holds a "significant interest"² in a company's shares, and the shareholder acquires debt of the company at a cost of less than 80% of its principal amount from an arm's length party, the debt-parking rules apply. This will result in debt forgiveness for income tax purposes equal to the difference between the cost of the debt and its principal amount.

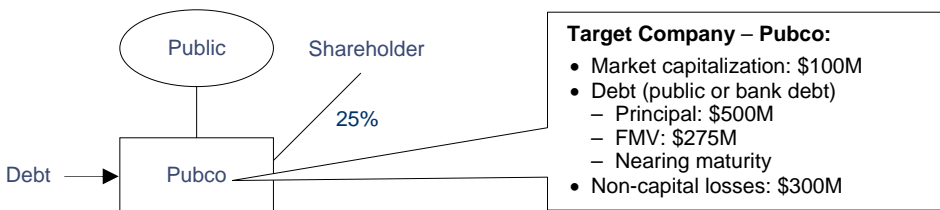
In the case of a debtor other than a corporation (for example, an income trust), the debt parking rules can apply if the debt is acquired by someone who does not deal at arm's length with the debtor.

1. Generally, the "forgiven amount" of any debts that are considered to be settled at a discount to their principal amount reduces the value of the debtors tax attributes in the following order: non-capital loss carry forwards, capital loss carry forwards, depreciable property, cumulative eligible property (based upon 4/3 of the available balance), certain non-depreciable capital property, with 50% of the remainder is included in taxable income.

2. A significant interest refers to shares of a corporate debtor that represent 25% or more of the votes or value of its shares. A shareholder is considered to hold a significant interest if its shareholding, together with those of related parties, reach the 25% threshold.

These income tax consequences are demonstrated in the following examples:

Example 1 – Acquisition of debt by a 25 % shareholder



If Shareholder acquires Pubco debt at an amount less than 80% of its principal amount, the debt-parking rules will result in the deemed application of debt forgiveness. If the cost of the \$500M purchased debt were \$275M, Pubco's non-capital losses would be reduced by \$225M (i.e., \$500M principal less the \$275M acquisition price), leaving only \$75M.

The key issue is that the company can be subject to adverse tax consequences associated with the purchase of its debt when a shareholder acquiring the debt does not control the company. These events could occur inadvertently, without the direct knowledge of the company.

These income tax consequences could also occur as a shareholder increases its interest in the company's shares to the level of a significant interest. For example, if a purchaser:

- owns a minority interest in the company's shares (i.e., less than the 10% level not requiring disclosure under relevant securities laws);
- increases its ownership to the level of a significant interest (i.e., 25% or greater); and
- holds debt that has been previously acquired at a discount.

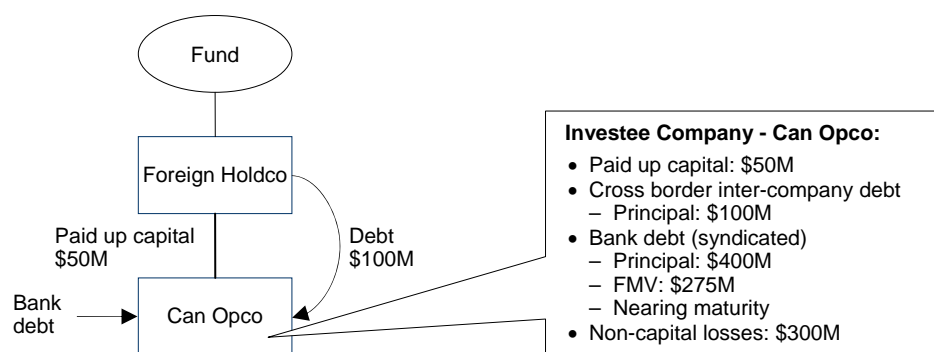
The effect of the debt parking rules on a company's income tax attributes in these circumstances would not normally be a direct concern for a creditor, except for the fact that these rules apply when a creditor is also a shareholder. The reduction of loss carryforwards or depreciable basis in capital assets resulting from these rules can affect a company's cash flow, and therefore the value of either the purchased debts or the existing shareholder's shares.

When shares are acquired that represent control of a company, "acquisition of control" tax rules can also affect the tax attributes of a company.³ The interaction of these rules, together with the debt forgiveness and debt-parking rules, further complicates the tax position of a target company.

It is important to consider these issues when planning for an acquisition that involves a debt forgiveness or debt parking event, including opportunities that may mitigate adverse tax results.

3. When control of a company is acquired, the company is deemed to have a taxation year end within which any unrealized losses on capital or inventory assets are realized for income tax purposes. There are also restrictions on the use of non-capital losses and capital losses that occur within or before the acquisition of control year end. The availability of these tax attributes must be carefully considered in order to optimize the tax position of the company when the debt forgiveness and debt parking rules also apply.

Example 2 – Acquisition of debt by its Private Equity Fund (Fund) controlled shareholder



In Example 2, Foreign Holdco owns all of the shares of Can Opco, and Fund is interested in protecting its investment from adverse creditor actions. If Fund has surplus cash, it may be prepared to make a loan to Can Opco, or it could acquire Can Opco's debt if sources of lending are not readily available to Can Opco.

Foreign Holdco or Fund may also consider acquiring Can Opco debt to support its equity investment or to secure additional future value for the Fund for when Can Opco's value improves.

If Foreign Holdco acquired Can Opco debt at an amount less than 80% of its principal amount, the debt-parking rules will result in the deemed application of debt forgiveness. If the cost of the \$400M purchased debt were \$275M, Can Opco's non-capital losses would be reduced by \$125M. In this situation, the Canadian "thin capitalization" rules would limit future interest deductions on the purchased debt for income tax purposes.⁴

As indicated, the debt-parking rules would apply if the purchased debt is acquired for less than 80% of the principal amount of the debt. It may be possible to restructure Can Opco's debt such that the cost of a particular portion of the debt does not fall below the minimum cost amount in order for debt parking not to apply (i.e. 80%). This could minimize a portion of the income tax consequences associated with debt forgiveness resulting from debt parking.

Finally, a future repayment of the acquired debt could have several beneficial tax results. Using the figures above, a full repayment of the \$400M debt (which had been acquired for \$275M) would give rise to a \$62.5M deduction.⁵ Furthermore, the repayment would not be a dividend, and so would not be subject to Canadian withholding tax.

In summary, the debt forgiveness and debt-parking rules are important for private equity funds to consider when purchasing the debt or equity of distressed companies.

4. The Canadian thin capitalization rules limit the deduction of interest on loans provided by "specified non-resident shareholders" or parties that are related to such shareholders. In general, a specified non-resident shareholder for these purposes is a shareholder that owns shares that represent 25% or more of the company's votes or value. The limitation on the level of such debts is two parts of such debt to one part of "equity" as further defined under the Canadian *Income Tax Act*.

5. The deduction in Can Opco is limited to 50% of the \$125M forgiven amount. The Foreign Holdco would realize a \$125M gain and would have to consider any tax consequences in its country of residence.

Contacts

For more information:

Calgary	Leanne Sereda	403 509 7586	<i>leanne.a.sereda@ca.pwc.com</i>
	Johnson Tai	403 509 7544	<i>johnson.tai@ca.pwc.com</i>
Greater Toronto Area	Mike Bondy	416 365 2724	<i>michael.s.bondy@ca.pwc.com</i>
	Peter Dale	416 869 2437	<i>peter.j.dale@ca.pwc.com</i>
	Doug Frost	416 365 8852	<i>doug.l.frost@ca.pwc.com</i>
	Betty-Ann Jarrett	905 949 7314	<i>betty.ann.jarrett@ca.pwc.com</i>
	Elizabeth Johnson ^{1,2}	416 869 2414	<i>elizabeth.j.johnson@ca.pwc.com</i>
	Ewald Kacnik ²	416 869 8720	<i>ewald.r.kacnik@ca.pwc.com</i>
	David Klassen	416 218 1405	<i>david.klassen@ca.pwc.com</i>
	Chris Kong	416 869 8739	<i>christopher.p.kong@ca.pwc.com</i>
	Debbie Meloche	416 218 1544	<i>debbie.d.meloche@ca.pwc.com</i>
	Janice Russell ²	416 365 8810	<i>janice.russell@ca.pwc.com</i>
Montreal	Denis Langelier	514 205 5270	<i>denis.langelier@ca.pwc.com</i>
	Pierre Lessard	514 205 5034	<i>pierre.lessard@ca.pwc.com</i>
Southwest Ontario	Mark Walters	519 570 5755	<i>mark.g.walters@ca.pwc.com</i>
Vancouver	John Robinson	604 806 7099	<i>john.robinson@ca.pwc.com</i>
	Brad Sakich	604 806 7730	<i>brad.a.sakich@ca.pwc.com</i>
	Lincoln Schreiner	604 806 7713	<i>lincoln.schreiner@ca.pwc.com</i>

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