New US proposed regulations would impact US subsidiaries of Canadian parent companies

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On April 4, 2016, the United States Treasury Department and Internal Revenue Service (IRS) released proposed regulations (the proposed regulations) that, if finalized in their current form, would potentially limit the ability of Canadian corporations to debt finance their US operations.

Canadian corporations often have sought to introduce leverage into a US subsidiary to finance US acquisitions and expansion. Canadian parents have leveraged US subsidiaries through different means—direct loans to a US subsidiary or indirect loans through third country finance companies. The tax benefit to debt financing US operations is to minimize US tax by introducing interest deductions which can offset operating profits. There are numerous Canadian and US tax rules to consider when introducing related debt into a US corporation.

The proposed regulations were issued on the same day as rules intended to deter so-called inversion transactions. Please refer to our tax release for a discussion on tax inversion transactions. The proposed regulations apply to non-US entities that have not undergone an inversion and apply to all non-US entities that seek to debt finance their US subsidiaries.

The proposed regulations would

- treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes,
- authorize the Commissioner of the IRS to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and
- establish extensive documentation requirements in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes.

As described below, the proposed regulations would have far-reaching consequences for non-US corporations that issue debt instruments to related US corporations and US partnerships.

Under these proposed regulations, a purported debt instrument issued by a US corporation would be treated as equity for all US federal tax purposes if the debt is not issued for cash or property, but is instead (i) issued in a distribution to a related corporate shareholder, (ii) issued in exchange for stock of a member of the same affiliated group or (iii) issued in an asset reorganization between members of the same affiliated group.

Thus, a note distributed from a US subsidiary to its foreign parent to add additional leverage in the subsidiary's capital structure would no longer be respected as debt for US tax purposes—even where the US subsidiary has a capital structure that meets arm's length principles. This rule, if finalized, would prevent many typical refinancings of US subsidiaries of Canadian parents.

There are three exceptions to this "deemed equity" rule:

(1) distributions and acquisitions described above in a given year that do not exceed the corporation's current-year earnings and profits;

(2) where the aggregate issue price of all related-party debt instruments issued by a corporation that otherwise would be treated as stock under these proposed regulations does not exceed $50 million; and

(3) acquisitions of affiliate stock where debt was issued in a separate transaction, if the acquisition results from a transfer of property in exchange for stock and, for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the vote and value of the issuer of the debt.

For a Canadian parent of a debt financed US subsidiary, the effect of the "deemed equity" rules would be to deny any deduction for US tax purposes for interest paid on related-party debt treated as equity under these rules, as well as the imposition of dividend withholding tax on purported interest paid.

This "principal purpose" test is subject to a broad, non-rebuttable presumption of a principal purpose to fund a transaction described above, if the debt instrument is issued during the period beginning 36 months before a distribution or acquisition described above, and ending 36 months after such a distribution or acquisition. Because of the broad scope of the presumption rules, corporations issuing debt to affiliated group members on or after April 4, 2016 will generally not be able to rely solely on the fact that the proceeds from a related-party loan are actually used to invest in the corporation's operations or to acquire assets from third parties. Such corporations will have to track whether or not they have engaged in any of above-described distributions or acquisitions since April 4, 2016 or after the issuance of such related-party loan in order to assess if any of the loan proceeds is tainted.

Required documentation and support for debt characterization

The proposed regulations are also prescribing rules to address the documentation and information that needs to be maintained by a taxpayer on whether an instrument is either stock or indebtedness. It reiterates and codifies the industry's best practices about having proper legal documentation and financial analysis evidencing the tax treatment of cross-border instruments. The proposed regulations require a degree of discipline in the creation of necessary documentation support, and in the conduct of reasonable financial diligence indicative of a true debtor-creditor relationship especially in a related-party context. Failure to provide this support to the IRS when requested will result in the IRS treating the purported related-party debt instrument as equity for US federal tax purposes.

In general, the documentation must be prepared no later than 30 calendar days after the date of the issuance or deemed issuance of the purported debt instrument, or no later than 120 calendar days in the case of evidence of an ongoing debtor-creditor relationship.

These documentation requirements are intended to apply only to "large taxpayers" and only if either (i) the stock of any member of the group is publicly traded, (ii) the group's financial statements show total assets exceeding $100 million or (iii) the group's financial statements show annual total revenue that exceeds $50 million.

Impact of the proposed regulations

Canadian companies will still be able to finance their US subsidiaries with related-party debt if the proposed regulations are finalized in the same or substantially same form as proposed. However, Canadian corporations will have new rules to consider when doing so and certain typical transactions previously undertaken may not achieve the intended US tax consequences.

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