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TaxNewsFlash Canada

New U.S. Tax Rules Propose Sweeping Changes to Related-Party Financing

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Many Canadian companies with U.S. operations may be affected by new U.S. tax regulations that may deny debt treatment to financing transactions for U.S. purposes. Inbound and outbound financing arrangements may be adversely affected by these complex rules, which were released by the U.S. Treasury Department on April 4, 2016. As a result, both Canadian multinationals with U.S. subsidiaries and U.S. multinationals with Canadian subsidiaries should consider taking steps to mitigate the unexpected application of these proposed regulations, which are expected to be finalized by the end of 2016.

These rules also impose significant documentation and recordkeeping requirements on intercompany loans and, in some cases, automatically treat intercompany loans as equity for U.S. federal income tax purposes. If a loan is treated as equity, the borrower will not be entitled to an interest deduction with respect to the instrument and any payments on the instrument will be treated as dividends for U.S. tax purposes.

Background

The U.S. tax treatment of a debt instrument between related parties has long been the subject of disputes between the IRS and taxpayers. Court rulings provide much of the guidance in this area.

The IRS and the U.S. courts have traditionally considered all the facts and circumstances and applied the "substance over form" doctrine to determine whether an instrument should be treated as debt for U.S. tax purposes. The underlying principle is that the terms of the instrument should be similar to those that would apply if the borrower were to borrow from a third-party lender.

The U.S. tax authorities believe that debt treatment of an instrument is inappropriate in certain circumstances, such as where no new capital is introduced to the issuer and there is a lack of substantial non-tax business purpose. The proposed regulations prescribe circumstances under which a debt instrument between related parties would be deemed equity (and not debt) for U.S. tax purposes without considering whether the instrument "looks like" third-party debt.

For KPMG's initial impressions of these regulations, see *TaxNewsFlash-Canada* 2016-18, "New U.S. Tax Rules to Broadly Affect Cross-Border Financing".

Re-characterization rules

The most sweeping of these new regulations proposes re-characterization rules that target certain related-party transactions that are intended to create debt instruments. These re-characterization rules are intended to apply to the following types of transactions:

- Debt instruments issued in respect of stock
- Debt instruments issued in exchange for stock of a related party
- Debt instruments issued in exchange for stock in certain asset reorganizations
- Debt instruments issued by a member of an affiliated group who, within 36 months before or after the issuance, engages in transactions economically equivalent to one of the transactions described above (referred to as the "72-month rule").

These rules will apply to affiliated corporate groups (using an 80% direct or indirect ownership threshold) with more than $50 million in cumulative intercompany debt (i.e., the $50 million safe harbour threshold). Once finalized, the rules are proposed to be effective for all debt instruments issued on or after April 4, 2016.

These re-characterization rules do not apply to loans between corporate members of a U.S. consolidated filing group (and such loans do not count towards the $50 million safe harbour threshold).

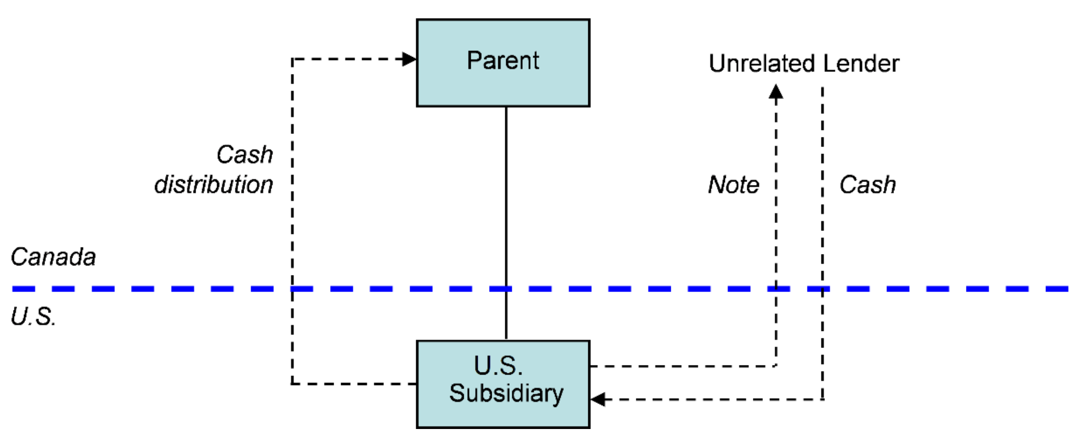
Example 1: Recapitalization

The regulations contain specific examples that illustrate how the re-characterization rules operate, including their application to the recapitalization of a U.S. subsidiary with a non-U.S. parent. In this example, a U.S. subsidiary is not be able to borrow in its earlier years, but has debt capacity once its business operations mature and it becomes profitable. A common way to introduce debt into a structure in this situation is to have this U.S. subsidiary distribute a note payable to its shareholder as either a dividend or a return of capital.

The proposed re-characterization rules change the treatment of this kind of transaction. Although the current rules treat this note as debt, under the proposed regulations, the note will automatically be treated as equity; usually as preferred shares, depending upon the terms of the instrument. Further, the payments on the intended debt instrument would not be treated as interest or principal repayments on the note, but as dividends for all U.S. tax purposes. The payments would therefore be subject to the appropriate U.S. withholding tax for the amount treated as dividends. This result will occur regardless of any other facts or circumstances otherwise supporting a *bona fide* debt instrument. It is assumed, in this example, that the $50 million safe harbour threshold has been exceeded.

This treatment will be different from a similar recapitalization situation where a third party makes a loan, such as where a U.S. subsidiary borrows from an unrelated bank and distributes the proceeds as a dividend or return of capital to its shareholder. In this case, because the loan is not between related parties, it would be respected as debt for U.S. tax purposes under the proposed rules.

Third-Party Recapitalization



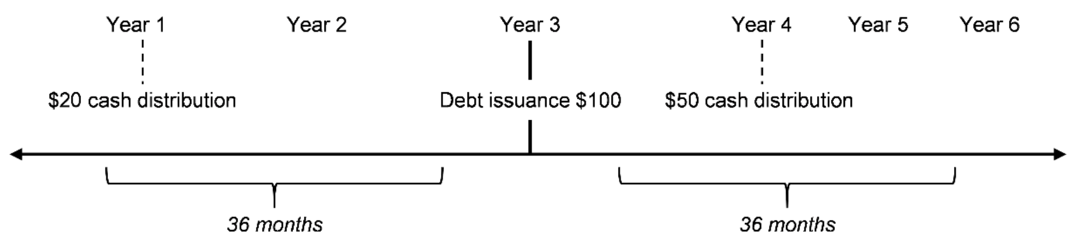
KPMG observations
In this example, if the related party recapitalization occurs first and the debt is subsequently sold to a third party, then the characterization of the instrument would revert to debt for U.S. tax purposes.

Example 2: Distributions and the 72-month rule

A second example illustrates how the re-characterization rules also apply to another common business scenario in which a subsidiary obtains debt financing from a Canadian parent.

Consider a situation where, in Year 3, Canadian Parent loans U.S. Subsidiary $100 cash in exchange for a debt instrument which it uses to acquire new assets. In Year 4, U.S. Subsidiary makes a $50 cash distribution to Canadian Parent. Assuming US Subsidiary has no current earnings and profits in Year 4, $50 of the note issued by U.S. Subsidiary would be re-characterized as equity as of the distribution date. The 72-month rule applies to distributions in excess of current earnings and profits made within 36 months before and after the debt instrument is issued. It is assumed, in this example, that the $50 million safe harbour threshold has been exceeded.

Where U.S. subsidiary made a $20 cash distribution in Year 1 when it had no current earnings and profits, the $20 of the debt instrument would be treated as equity on issuance in Year 3. The remaining $80 of the Year 3 debt instrument would be subject to possible re-characterization for another 36 months (e.g., when the distribution occurs in Year 4).



KPMG observations
As currently proposed, the re-characterization rules could have harsh consequences for taxpayers. The rules' broad wording, in conjunction with the non-rebuttable 72-month rule, may re-characterize common business-motivated transactions. Furthermore, the $50 million safe harbour is a low threshold. Once the threshold is exceeded, all intercompany debt would be subject to the re-characterization rules.

As a result, taxpayers should carefully consider all issuances of new intercompany debt by both U.S. and foreign issuers (including partnerships and disregarded entities) for possible application of the re-characterization rule. This will involve an understanding and monitoring not only the U.S. group's activities, but the worldwide group's activities over a 72-month window.

Due diligence and documentation requirements

The proposed regulations also introduce due diligence and contemporaneous documentation requirements which are necessary conditions to have certain related-party debt instruments be respected as debt for U.S. federal income tax purposes. If a taxpayer fails to collect proper documentation, the proposed regulations will automatically treat the related-party debt as equity in its entirety, without further consideration of the instrument's characteristics. Having the proper documentation, however, does not guarantee debt treatment—the existing facts and circumstances test or the new re-characterization rule discussed above may still re-characterize the documented debt, or a portion of it, as equity.

The regulations require taxpayers to produce documentation to support characterization of a particular instrument as debt both at the time the debt is issued as well as during its life. Similar to the U.S. transfer pricing rules, taxpayers must have contemporaneous documentation (i.e. within 30 days of issuance or other event) that describes:

- The debtor's unconditional obligation to pay a sum certain
- The creditor's rights
- The basis for a reasonable expectation that the debtor will be able to repay the debt (e.g. cash flow projections, credit ratings, asset appraisals).

In addition, on a continuous basis over the life of the debt, taxpayers must have evidence of a genuine creditor-debtor relationship, including evidence of timely interest and principal payments and, in the event of a default, evidence of the creditor's diligence for any action taken in response.

These new requirements will apply to publicly traded companies (and affiliates) or companies with either worldwide group assets in excess of $100 million or worldwide annual gross income in excess of $50 million. This provision is generally effective for debt instruments issued on or after the date the final regulations are published.

KPMG observations
The due diligence and documentation requirements do not alter the traditional principles or guidance for a debt versus equity analysis. However, the new requirements impose new minimum standards that must be satisfied in order for the traditional guidance and process of analysis to be relevant. An undocumented intercompany loan would not be treated as debt for U.S. tax purposes regardless of whether it has the other attributes of debt. Thus, it is imperative that taxpayers that meet the criteria to have these rules apply

and be extremely diligent to ensure they satisfy the documentation standards on a timely basis.

Bifurcated approach of one instrument

In debt versus equity analyses, U.S. courts have traditionally taken an "all or nothing" approach. In a marketplace where financial instruments are becoming increasingly complex, the U.S. tax authorities believe this approach fails to reflect the economic substance of the related party interests where the instruments contain both debt and equity characteristics. The proposed regulations give the IRS the authority to treat an instrument as part debt and part equity.

This provision applies to instruments between parties with at least a 50% common ownership threshold. This provision is generally effective for debt instruments issued on or after the date the final regulations are published.

KPMG observations
The bifurcated approach to debt versus equity analysis works in tandem with the proposed rules' due diligence and documentation requirements. For example, if an issuer cannot be reasonably expected to repay more than $3 million of the total $5 million in principal amount of a related party loan, then the IRS would only treat $3 million of the instrument as debt for U.S. tax purposes. The bifurcated approach will make it much easier for the IRS to raise the debt versus equity treatment of a related party debt on a tax return audit. Taxpayers should be prepared to see increased audit activity in this area.

We can help

For more details, see the KPMG U.S. article, "KPMG reports: Initial analyses of regulations on inversions and on debt-equity". Your KPMG adviser can help you determine the effects of these proposed U.S. regulations on your corporate group's financing transactions.