U.S. FEDERAL TAX RULES APPLICABLE TO LOANS FROM A CANADIAN PARENT TO A U.S. SUBSIDIARY

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Financing a U.S. subsidiary

When a Canadian company creates a U.S.-based subsidiary, one of the first issues to be addressed is how to fund those operations. Generally, funds may be advanced in the form of equity, debt or a combination of both.

Where funds are contributed by way of equity, they may be returned to the Canadian parent by way of a distribution from the U.S. subsidiary. For U.S. tax purposes, that distribution is treated as a dividend to the extent of the U.S. subsidiary's current or accumulated earnings and profits. A dividend is subject to U.S. withholding tax of five per cent in the case of a Canadian corporation owning at least 10 per cent of the voting stock of the U.S. subsidiary under the Canada-U.S. Tax Convention. The U.S. subsidiary does not receive an income tax deduction for this dividend payment.

Alternatively, where funds are loaned to the U.S. subsidiary, the subsidiary is entitled to an income tax deduction for interest paid on the loan, subject to various limitations discussed below. The interest payment is not subject to U.S. withholding tax under the Canada-U.S. Tax Convention. Repayments of loan principal are not deductible by the borrower. Because of the potential tax rate differential on funds flowing through to the ultimate Canadian shareholders of the Canadian parent by way of interest rather than dividends, debt financing of Canadian-owned U.S. subsidiaries can be an attractive option.

What constitutes a debt?

For U.S. federal tax purposes, indebtedness exists only if the parties to the obligation intended to create a debt. The debt must be legally enforceable, provable and unconditional. The Internal Revenue Code (IRC) does not define "debt," leaving taxpayers to look to judicial history on the subject. In classifying a security as debt or equity, the courts have looked to many factors, including:

1. the intent of the parties;
2. the existence of a written document evidencing the indebtedness;
3. the presence or absence of a fixed maturity date;
4. the presence or absence of a stated interest rate;
5. the right to enforce payment of principal and interest;
6. adequacy of the borrower's capitalization, typically interpreted as not more than a 3:1 debt to equity ratio; and
7. the expected ability of the borrower to satisfy the loan in accordance with terms at the inception of the loan.

No single factor is dispositive. The challenge in making a debt-equity determination in the case of non-arm's length parties is even greater as there is often an existing equity relationship. This is an area of Internal Revenue Service (IRS) scrutiny, so particular care must be taken to ensure the economic realities of the transaction match the stated form. The determination of debt-equity status is made at the time the security is issued. That initial characterization is binding on both the issuer and the holder – but unfortunately not on the IRS.

If a taxpayer fails to satisfy these requirements for debt characterization upon examination by the IRS, payments from the U.S. subsidiary to its Canadian parent that were thought to be deductible interest payments and subject to 0 per cent withholding could be recharacterized as non-deductible dividend

payments, subject to five per cent withholding tax. Additionally, the payment that is recharacterized as a non-deductible dividend for U.S. tax purposes may still be characterized as interest and subject to tax for Canadian tax purposes. Care is required to ensure that the U.S. debt characterization requirements are satisfied whenever there is U.S. indebtedness.

General deductibility requirements

Assuming the debt classification requirements discussed above are satisfied, further analysis is required to determine the deductibility of interest for U.S. federal income tax purposes. In computing a taxpayer's income, a deduction shall be allowed for interest paid or accrued within the taxable year on indebtedness. Despite the general allowance for interest deductibility, there are numerous provisions within the IRC that could defer or deny the deduction.

Capitalization provisions

Several IRC provisions can defer deductibility of interest by requiring that it be capitalized into the tax basis of an asset. For instance, IRC §263 requires that certain expenses (including interest) be included in the cost of inventory. IRC §279 can require the capitalization of interest on indebtedness incurred by a corporation to acquire the stock or assets of another corporation.

Related party interest

A common trap for the unwary is found in IRC §267, dealing with transactions between related parties. Generally, an accrual basis taxpayer may deduct interest when accrued. However, in the case of interest to a foreign related person, the interest must actually be paid for it to be deductible by the taxpayer. The term "related person" is defined broadly and includes a person with a greater than 50 per cent ownership interest in the corporation. Furthermore, constructive ownership rules apply. For example, assume a Canadian parent loans funds to its wholly owned U.S. subsidiary and interest is accrued but unpaid by the end of the taxable year. IRC §267 would deny the U.S. subsidiary a deduction for the accrued interest. However, under Canadian tax principles the accrued interest may be taxable to the Canadian parent, creating a current income inclusion in Canada without a corresponding current deduction in the U.S. The U.S. subsidiary should be allowed a deduction in future periods if the interest is actually paid, subject to other limitations.

Although one might assume that what constitutes a payment should be straightforward, there are many situations in which it may, in fact, be unclear. A payment is considered made when the amount would be includible in the income of the beneficial owner under U.S. tax principles governing the cash basis method of accounting. Under this method, amounts not in the taxpayer's possession are constructively received only when they are credited to the taxpayer's account, set apart for him/her, or otherwise made available so that they may be drawn upon at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Earnings stripping rules

The IRS uses several tactics to prevent the diminution of the U.S. tax base by a foreign corporation's excessive leveraging of its U.S. subsidiaries. The first tactic is the thin-capitalization factor of the debt-equity analysis discussed above. Where the amount of a shareholder debt far exceeds that shareholder's capital in the subsidiary, the IRS can question whether the shareholder/lender would treat the debtor in the same manner as an unrelated lender would. It is widely assumed that a debt to equity ratio that does not exceed 3:1 generally will be respected by the IRS. In calculating this ratio, the fair market value of assets and liabilities rather than their historical or book values should be used.

IRC §163(j) targets earnings stripping by disallowing current deductions for interest paid to foreign related parties under certain circumstances. The provision applies only to taxpayers with a debt to equity ratio in excess of 1.5:1. The calculation is complex, but as a general rule, interest paid to a related party (or to a third party on debt guaranteed by a related party) may be disallowed to the extent it exceeds 50 per cent of the payer's earnings before interest, depreciation, amortization and taxes. Disqualified interest amounts may be carried forward to future years but may not be carried back. When considering the amount of foreign related party debt to put into the U.S., careful modeling is required to ensure full U.S. interest deductibility.

Transfer pricing

The U.S. has extensive transfer pricing rules that seek to ensure related party transactions are conducted on an arm's-length basis (i.e., in the same manner as unrelated parties would act). Under these rules, the IRS has the authority to make adjustments to a taxpayer's income to prevent the evasion of taxation or to reflect the taxpayer's income more clearly. Related party interest is subject to these rules that might potentially deny the interest deduction, in whole or in part, if the arm's-length standards are not satisfied. Furthermore, the U.S. transfer pricing rules require that contemporaneous documentation be prepared to substantiate that the related party interest is at arm's length.

Conclusion

Although loans from a Canadian parent to its U.S. subsidiary might appear straightforward at first glance, there are numerous traps that must be avoided to ensure debt treatment and full deductibility of interest payments for U.S. income tax purposes. Careful tax planning is required. Contact your Collins Barrow advisor for help.

U.S. CITIZENS AND CANADIAN TRUSTS

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Trusts are important tools in Canadian tax and estate planning. Discretionary family trusts, in particular, have become common and are continually evolving. Some of the most powerful benefits of these tools include:

- **Flexibility** – the ability to maintain control of assets while directing income and value as the trustees see fit.
- **Income splitting** – directing income of the trust to lower-income beneficiaries (usually family members) to minimize the overall family tax burden.
- **Capital splitting** – allocating capital gains to beneficiaries, enabling the use of multiple capital gains exemptions.

Trust use is even more common in U.S. tax and estate planning, but for different reasons. In fact, many of the typical planning strategies deployed in Canada are not effective – and may in fact be punitive – under U.S. tax law.

When a U.S. person (a U.S. citizen or resident alien) is connected with a Canadian trust, we must consider the U.S. tax implications of the trust arrangement. Two important distinctions under U.S. tax law are whether a trust is domestic or foreign, and whether the trust is a grantor or non-grantor trust.

Domestic or foreign?

Prior to 1996, whether a trust was foreign or domestic was a fact-based determination. In 1996, a two-part objective test was introduced. The test requires that a trust be considered foreign unless it satisfies two tests: the U.S. Court Test and the Control Test.

The U.S. Court Test is satisfied where a U.S. court is able to exercise primary jurisdiction over the trust. This, of course, is a question of fact and a matter of law in the relevant jurisdictions, but in general a U.S. court must have the ability and jurisdiction to determine all issues regarding the administration of the trust. The regulations do contain guidance in terms of certain facts that would, in the U.S. Treasury's eyes, meet the Court Test. In the case of an *inter vivos* trust, the trust will meet the Court Test if the trustees or beneficiaries take steps with a U.S. court that cause the trust to be subject to that court (e.g. registering the trust document with the court).

The Control Test is met if one or more U.S. persons have the authority to control all substantial decisions of the trust. Again, an examination of the trust indenture is required and factors such as the presence of a "primary trustee" must be considered.

If a trust meets both of these tests, it is considered a domestic trust and is taxable in the U.S. on its

worldwide income. If the trust fails either test, it is a foreign trust. Most Canadian discretionary family trust arrangements would not meet the Court Test and, therefore, would be considered foreign trusts under U.S. tax law.

Grantor or non-grantor?

U.S. taxation of a foreign trust varies greatly depending on whether the trust is a grantor or non-grantor trust.

Foreign grantor trusts

Generally, where a U.S. person gratuitously transfers property to a foreign trust directly or indirectly, and that trust has a U.S. beneficiary, the grantor is treated as the owner of that trust property. As the owner of the property, the grantor is taxable on any income or gain relating to the property. In this regard, the grantor trust rules are similar to the Canadian reversionary trust rules. There are exceptions for testamentary transfers and for transfers at fair market value. However, the fair market value exception is limited in what consideration is considered fair market value in transfers from related persons.

The income of a Canadian discretionary family trust considered a grantor trust would attribute to the U.S. owner for U.S. tax purposes. This situation has the potential to create significant exposure to double taxation since, for Canadian tax purposes, the income of the trust often is taxed in the hands of other beneficiaries, or not taxed at all in the case of dividends allocated to a connected corporation.

While the settlement of a typical Canadian discretionary family trust would not generally involve a *direct* transfer from an interested party, the use of the term "directly or indirectly transfers" suggests a broad interpretation of the word "transfer." In fact, legislative history suggests the term "indirectly transfers" includes such situations as share reorganizations initiated by a controlling shareholder and transfers through foreign intermediaries. For example, if a controlling shareholder of a company caused that company to be reorganized to "freeze" the shareholder's value in fixed-value preferred shares and subsequently to issue low-value common shares to a trust, such an arrangement generally would be considered an indirect transfer by the controlling shareholder to the trust. There are also anti-avoidance provisions in the regulations for transfers through intermediaries where the principal purpose was to avoid U.S. tax.

The requirement that the trust have a U.S. beneficiary is far from straightforward. In addition to contemplating the expected scenarios, these rules were bolstered in 2010 to contemplate many "back door" provisions that would allow the addition of a U.S. beneficiary at a later time (i.e. power of appointment), and even to include contingent beneficiaries. Furthermore, the determination is made annually so it is possible for existing trusts to acquire U.S. beneficiaries and thereby become grantor trusts. This can be particularly punitive to the U.S. owner since the throwback rules would apply to any undistributed net income of the trust until the time it acquires a U.S. beneficiary. Thankfully, if a beneficiary becomes a U.S. person at a time that is more than five years after the transfer, they will not be considered a U.S. beneficiary for the purposes of the grantor trust determination.

Given today's global economy and the general mobility of talent between Canada and the U.S., the possibility of a beneficiary becoming a U.S. person is very real. Contemplating this possibility in the drafting of the trust indenture is feasible, but doing so might impact the planning flexibility and could be contrary to the settlor's intent. Mobility of the grantor can also be an issue. If a non-resident alien becomes a U.S. person within five years of the original property transfer, the trust can become a grantor trust upon the individual's residency start date.

Foreign non-grantor trusts

A foreign trust may be a non-grantor trust. Given the risks and pitfalls of the grantor trust rules, one might think this is a good thing. But it is not necessarily so if the trust has U.S. beneficiaries. Foreign non-grantor trusts generally are taxed as non-resident alien individuals. That is to say they are taxed only on their U.S. source income. Such trusts receive a deduction for the proportion of their distributable net income distributed to beneficiaries, and U.S. beneficiaries must include the distributed amounts in their income. To the extent that foreign (i.e. Canadian) tax has been paid on non-U.S. income, a foreign tax credit should be available for U.S. tax purposes.

Because foreign non-grantor trusts are taxed similarly to non-resident aliens, they have the ability to accumulate income without current U.S. tax to the extent that they do not distribute the income to U.S. beneficiaries. To discourage this type of tax deferral, the throwback rules apply to distributions of undistributed net income. The throwback rules are punitive, complex and for the most part, beyond the scope of this article. In general terms, however, they apply a tax rate and interest charge to “throw back” the income into the respective accumulation years. In addition, the accumulated income loses its character and is taxed as ordinary income to the U.S. beneficiary, possibly losing preferential tax treatment. Fortunately most, but not all, Canadian discretionary family trusts distribute their income currently and would not typically accumulate income.

U.S. reporting requirements for foreign trusts can be complex and the penalties for non-filing can be severe.

In addition to the U.S. tax implications of the trusts themselves, there are numerous U.S. income and transfer tax traps affecting much of the Canadian planning strategies for trusts. The most obvious example is a basic Canadian estate freeze transaction, which can result in a realization transaction for U.S. income tax purposes and can potentially trigger U.S. gift tax.

The bottom line is cross-border tax and estate planning is extremely specialized and requires the delicate touch of a tax specialist familiar with these issues. Achieving many of the above-noted benefits Canadians have come to enjoy is still possible but must be done in full contemplation of the tax laws in both countries. Your Collins Barrow advisor can help to ensure your U.S./Canadian trust matters are managed properly.

Collins Barrow publishes a regular *US Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada with respect to US issues. While *US Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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