Final US related-party debt regulations will impact US subsidiaries of Canadian parent companies

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On October 13, the US Treasury Department and the IRS released new final and temporary Section 385 regulations (TD 9790) addressing the treatment of related-party debt. The regulations, initially proposed in April, were seen in some quarters as controversial in the way they limit previously commonplace business transactions that involve related parties—for example, cash pooling—as well as common treasury management techniques.[1]

The intention was, indeed, to deter certain "earnings stripping transactions" and inversion transactions that are often part of corporations' international, domestic, state and local tax planning strategies. In response to taxpayer and stakeholder concerns, however, the new regulations significantly narrow parts of those initial proposals, providing relief from some, but not all, recommendations. The final and temporary regulations include numerous modifications intended to minimize the compliance burdens and also reduce "collateral consequences" resulting from non-compliance.

In other areas, however, the government did not modify or narrow the regulations as many stakeholders and commentators requested. Although this is strictly US legislation, significant impacts on transactions both domestic and cross-border—such as those involving Canadian companies and their US subsidiaries—will be seen.

Key changes to the final and temporary regulations

The final and temporary regulations amend the proposed regulations to address a number of key concerns. Although there are many notable changes, some of the most significant are briefly highlighted below.

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[1] For more information on the initial proposed regulations, please see: http://www.grantthornton.ca/resources/insights/articles/US_Tax_New_proposed_regulations_for_US_subsidiaries_of_Canadian_parent_companies_April12.pdf.

Key changes to the scope of the regulations

The final and temporary regulations significantly amend the scope of the proposed regulations in three key areas.

First, the final regulations do not apply to debt issued by foreign corporations. This change will impact loans issued by non-US subsidiaries of US parent multinational companies. It is important to note that the regulations "reserve" on this issue, so this is likely not a closed matter.

It is critical to note that these rules clearly apply to debt issued by US subsidiaries to Canadian parent companies or other non-US related corporations. Canadian parent companies will have to carefully reconsider how they structure intercompany transactions with their US subsidiaries in light of these regulations.

Second, certain entities were exempted from these rules, including subchapter S corporations, non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs). However, RICs and REITs continue to be subject to the regulations if they are controlled by members of an otherwise existing expanded group.

Third, the final regulations eliminate the bifurcation rule, which authorized the IRS to bifurcate certain related-party debt into part debt and part stock. However, the preamble notes that the Treasury and the IRS will continue to study the issue.

Key changes to the documentation requirements

The new regulations amend the timing requirements for preparation and maintenance of documentation. The final regulations treat documentation and financial analysis as prepared in timely fashion if such documentation is prepared by the time the issuer's federal income tax return is filed (including extensions) for the taxable year in which the debt is issued.

Under the proposed regulations, a documentation failure with respect to a debt instrument resulted in *per se* equity treatment. The final regulations, however, provide limited relief such that if an expanded group is otherwise "highly compliant" with the documentation rules, then taxpayers may be able to rebut, in some cases, the presumption that the documentation failure results in automatic equity characterization.

Finally, the new regulations provide for delayed implementation of the documentation requirements. The documentation requirements will apply only to debt instruments issued on or after January 1, 2018.

Key changes to the recast rules

The final regulations provide much needed relief from many aspects of the recast rules.

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

For a Canadian parent of a debt-financed US subsidiary, the effect of the recast rules would have been 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.

The proposed regulations also provided for 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.

Both of those rules stayed the same in their general application but changed in the final regulations for the following circumstances:

- Under the proposed regulations, the Recast and Funding rules in Prop. Reg. § 1.385-3 were not to apply to the extent of corporations' current-year earning and profits (E&P) or to the extent of the first US$50M of debt that may be recharacterized. The final regulations retain and expand the current E&P exception, as well as the US$50-million exception.

- The final regulations provide a new exception that permits all E&P that accumulate in years ending after the initial proposal to be included in the "buffer" that prevents recharacterization of debt instruments under the recast rules. This change is implemented through the new concept of a member's "expanded group earnings account," which includes earnings accumulated by the member in taxable years ending after April 4, 2016.

- Finally, the US$50 million exception was changed so that it no longer has a cliff effect. Under the final regulations, taxpayers can exclude the first US$50 million of indebtedness that would otherwise be recharacterized as equity and not have the whole amount revert outside of the exception once it exceeds that threshold.

Foreign issuer exception

A recurring comment made to the IRS during the summer was that certain provisions of the proposed regulations were "unmanageable" for non-US multinational groups. For example, a Canadian multinational, in computing the current E&P or the US$50 million exception, had to consider intercompany transactions that had nothing to do with its US subsidiary but were made relevant by the proposed regulations.

The final regulations broadly exempt all debt issued by foreign corporations, including both controlled foreign corporations (CFCs) and non-US controlled foreign corporations. The change is implemented by limiting the current application of the rules to debt issued by a domestic (i.e., US) corporation. For both US and non-US multinational groups, this carve-out is likely the most important change from the proposed to the final regulations.

Areas where issues may remain

Despite the taxpayer-favourable amendments provided by the final regulations, some remaining areas of potential concern for taxpayers and other stakeholders were not addressed. Following are a few notable examples:

- The recast rules apply retroactively to April 4, 2016.

- Cash pooling arrangements and regulated entities are not exempt from the documentation rules.

- Debt issued by a partnership is subject to the recast rules under the "aggregate model" if the partnership has partners that are members of an expanded group.

- Most important, the final regulations provide no exception to the *per se* funding rule. Consequently, any debt issued within 36 months before or 36 months after a "tainted transaction" is automatically recast as equity to the extent of the amount of the tainted transaction.

State tax implications

These rules result in some interesting state implications:

- Will the states conform to the final and temporary regulations?

- Will the states have the ability to independently apply these rules or will they have to follow the IRS characterization?

- Can the state recharacterize a related-party debt instrument as equity even if the IRS does not do so?

Effective date considerations

Technically, the rules came into effect October 21, 2016, with a 90-day delay. The recharacterization rules will apply to taxable years ending on or after January 19, 2017. The rules are not applicable to instruments issued on or before April 4, 2016. There is a transition rule that allows the taxpayer the option to apply proposed regulations for instruments issued after April 4, 2016 and before October 13, 2016.

The documentation rule generally applies to debt instruments issued on or after January 1, 2018.

Preliminary observations

Despite the significant revisions made to the proposed regulations, the final regulations retain significant consequences for non-compliance and continue to impact many related-party funding, reorganization and other ordinary course transactions. The basic impact of the proposed regulations remains: any new US related-party financing that does not result in a net new investment in the US is subject to equity treatment.

Canadian parent companies with US subsidiaries should understand the impact of the final regulations on their related-party debt structures and on future debt capitalization of US subsidiaries.

Canadian parent companies should be aware that even if they are exempt under the final regulations, any related-party debt structure involving a US subsidiary should satisfy the common law debt-equity standards. In other words, US debt structure that is exempt under the final regulations could still be challenged by the IRS under traditional notions of thin capitalization, lack of a written debt instrument, market conditions, etc. And taxpayers who do not have contemporaneous documentation under the transfer pricing rules are still subject to certain penalties in the event that the IRS successfully challenges a related-party debt structure.

The final regulations make related-party debt financing of a US subsidiary more complex and increase the steps necessary to deal with an IRS challenge. A Canadian parent company looking to introduce new debt financing into the US should ask the following questions:

1. Should the new related-party debt be respected as debt for US federal income tax purposes under the jurisprudence developed by the US courts?

2. Do the final regulations apply to the new related-party debt and, if so, what are the additional requirements necessary for such debt to be respected for US tax purposes?

3. What are the documentation requirements under the final regulations and the transfer pricing documentation rules?

4. Do any of the code sections that potentially disallow or defer interest deductibility, such as Code Section 163(j), apply?

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