

Loans to U.S. Subsidiaries Should Be Carefully Structured and Documented to Obtain U.S. Tax Benefits

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by John D. Hollinrake, Jr.

Canadian companies should carefully structure and document loans and advances to their U.S. subsidiaries. If loans to U.S. subsidiaries are not properly structured and documented, such loans may be recharacterized as equity investments for U.S. federal income tax purposes, and important U.S. tax benefits will be lost.

Properly structured loans are treated as debt for U.S. federal income tax purposes with favorable tax treatment. The U.S. subsidiary may deduct interest paid in computing taxable income. Such interest payments to its Canadian parent corporation are generally not subject to U.S. withholding tax under the Canada – U.S. income tax treaty. Repayment of the principal amount is generally not subject to U.S. tax for both the U.S. subsidiary and Canadian parent corporation.

Loans which are recharacterized as an equity investment do not qualify for favorable tax treatment. The U.S. subsidiary cannot deduct interest paid in computing taxable income. Interest and principal payments will be treated as dividends to the extent of current or accumulated earnings and profits of the U.S. subsidiary. Dividends are subject to U.S. withholding tax of 5% or 15% under the Canada – U.S. income tax treaty.

Loans should be properly documented with promissory notes and, in some cases, loan agreements. This documentation should include, at a minimum:

- an unconditional obligation to pay a sum certain by the U.S. subsidiary,
- a stated interest rate,
- the applicable currency (Canadian or U.S. dollars),
- payment terms (demand or one or more fixed dates),
- a maturity date, and
- creditors' rights provisions.

Evidence showing that the U.S. subsidiary has a reasonable expectation of repaying the loan is very important. At a minimum, internal projections should be prepared showing the U.S. subsidiary has the capacity to repay the loan. For larger loans, consideration

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should be given to obtaining a debt capacity report from a financial advisory or accounting firm.

Beginning in 2018, new regulations under Code Section 385 will require that certain loans meet detailed documentation rules to avoid automatic recharacterization as equity.

U.S. and Canadian transfer pricing rules will require certain documentation supporting the interest rate charged on the loan. A discussion of the transfer pricing rules is beyond the scope of this summary.