



TaxNewsFlash Canada

New U.S. Tax Rules to Broadly Affect Cross-Border Financing

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Many Canadian companies with U.S. operations will be affected by new U.S. tax regulations just issued. These regulations affect not only “inversions”, as reported in the media, but also common financing transactions between Canadian and U.S. companies in the same corporate group. In particular, the regulations will affect whether debt instruments are considered debt or equity for U.S. tax purposes.

The U.S. Treasury Department and the IRS released proposed regulations on April 4, 2016 concerning the tax treatment of certain U.S. corporations and U.S. partnerships with assets that are directly or indirectly acquired by a non-U.S. corporation and certain persons related to the U.S. corporations and U.S. partnerships (i.e., inversions).

In proposed regulations issued concurrently with the inversions guidance, the U.S. Treasury has introduced new U.S. thin capitalization rules significantly expanding the number of financing instruments which will be denied treatment as debt for U.S. tax purposes.

Actions to address certain financing transactions and inversions

New U.S. thin capitalization rules

The proposed regulations introduce two new rules that an instrument must satisfy to be considered debt. The broader of these rules targets transactions that generate large interest deductions by increasing related-party debt without financing new investment in the United States.

This rule requires an analysis of the transactions, not only of the entities that are party to the debt, but also those of related entities for a six-year period centered around the date the

debt instrument is issued. These new measures will apply to debt issued by members of groups with collective levels of intercompany debt above threshold amounts.

Though the proposed regulations are not yet final, these rules are proposed to be effective for debt instruments issued on or after April 4, 2016.

KPMG observation

Corporate groups must consider these new rules when carrying out any financing transactions between Canada and the U.S. Because the regulations are very broad, companies will need to consider how they will affect the characterization of most related-party debt.

The second new rule will require improved due diligence and compliance by requiring corporations that are members of corporate groups that collectively have assets or revenue above threshold amounts to do up-front due diligence and documentation supporting the characterization of related-party financial instruments as debt. Corporate groups must also maintain documentation over the life of the debt supporting the characterization. If these requirements are not met, instruments will be treated as equity for tax purposes.

In addition, the regulations will allow the IRS on audit to divide debt instruments into part debt and part equity, rather than the current system that generally treats these instruments as wholly one or the other.

KPMG observation

The rule allowing bifurcation of putative debt instruments applies to all debt instruments issued after the effective date, with no safe harbour for small issuers.

The measures requiring documentation and allowing the bifurcation of debt on audit will be effective when the proposed regulations become final, which the IRS expects to happen quickly.

Inversions

Treasury's release states that the regulations will limit inversions by disregarding non-U.S. parent stock attributable to recent inversions or acquisitions of U.S. companies—to prevent a non-U.S. company (including a recent inverter) that acquires multiple U.S. companies in stock-based transactions from using the resulting increase in size to avoid the current inversion thresholds for a subsequent U.S. acquisition.

The regulations also formalize two previous actions in this area taken by U.S. Treasury in September 2014 and November 2015. These actions will be effective as of those dates.

U.S. Treasury states that it will continue to explore additional ways to address inversions.

Details available

For details, see the article from KPMG in the U.S. dated April 4, 2016, "[Regulations: "Inversions" and earnings stripping: new business tax reform framework](#)".

We can help

Your KPMG adviser can help you determine the effects of these proposed U.S. regulations on your corporate group's financing transactions. For details, contact your KPMG adviser.

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