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How to avoid unintended consequences from intercompany cross-border loans

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When funds are moved through a corporate group, whether to fund an acquisition or the working capital needs of an affiliate, the transfers may be recorded as book-entry advances and not documented — or documented at a later date.

That approach may not be advisable for credit and tax reasons, particularly in the case of funds that have been moved cross-border. It may result in the unintended and potentially serious consequences of an intercompany loan being treated as equity or any collateral for that loan not being legally effective.

U.S. tax principles

Practitioners should be aware of some basic U.S. tax law principles that may affect the parties' characterization of the funds advanced as an intercompany loan for U.S. tax purposes. First, the intent of the parties to treat funds advanced as a loan is a relevant factor for tax purposes, but not the only one. For the parties' intent to be respected, the loan should be documented, and the terms set forth must be truly indicative of an arms-length transaction.

The documents should provide for a return based not on earnings of the borrower, but reflecting a commercially reasonable interest rate, with fixed payment dates for principal and interest, and other terms typically found in a loan.

Second, under the U.S. "thin cap" rules, even a well-documented loan owing by the U.S. subsidiary can be treated as equity if the U.S. subsidiary is too thinly capitalized (i.e., too highly leveraged). There is no mathematical formula under U.S. tax law for establishing when a company is too thinly capitalized, although most practitioners suggest a debt-equity ratio of 3:1 or less is likely to be respected. It will depend on the circumstances, such as industry norms and what a third- party lender would require.

If debt is re-characterized as equity, any interest paid on the debt will be treated as a non-deductible distribution in contrast to deductible interest and subject to U.S. withholding tax, to the extent of earnings and profits. Withholding tax on dividends by a U.S. subsidiary to its Canadian parent is not scheduled to be eliminated under the fifth protocol to the 1980 Canada-U.S. Tax Treaty, and is generally at a five percent rate (in contrast to withholding tax on interest payments, which is scheduled to be eliminated in 2010).

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However, the earnings stripping rules under s. 163(j) of the *Internal Revenue Code* should also be considered. These rules may operate to limit the deductibility of interest paid by the U.S. subsidiary to a related party.

Credit concerns

A parent may have the additional objective of wanting certain funds downstreamed as a loan rather than as equity for the purpose of protecting itself if the U.S. borrower is having or later encounters financial difficulty. However, intercompany advances that are not properly documented and structured as loans on commercially reasonable terms not only run an increased risk of being re-characterized as equity for tax purposes, but also may be re-characterized as equity in a bankruptcy proceeding under principles of equitable subordination under s. 510(c) of the U.S. *Bankruptcy Code* or by a bankruptcy court exercising its very broad general equity powers.

Unfortunately, establishing commercially reasonable terms for a loan may be easier said than done when the borrower is troubled or incapable of obtaining a loan from a third party, which may result in an unavoidable risk of the loan being re-characterized as equity for both tax and bankruptcy purposes.

Securing an intercompany loan

Another way of improving the parent's position in the event of insolvency of the U.S. subsidiary is to secure any intercompany loan with collateral. Under s. 547 of the U.S. *Bankruptcy Code*, if the collateral to be granted by the U.S. subsidiary is not documented contemporaneously with the advancing of the funds by the parent or all perfection steps (filing of financing statements, recording of mortgages and the like) are not completed at the same time (or within 30 days thereafter), the grant of collateral by the U.S. subsidiary may be subject to being avoided (that is, nullified) as a preference in a bankruptcy of the U.S. subsidiary.

For an insider, like the parent, this preference risk will continue to exist for a one-year period following the date that both the collateral documents have been signed and proper perfection steps have been taken (the "preference period"). For non-insiders the preference period is only 90 days. Therefore, when it comes to securing an intercompany loan, waiting until there is a problem is unwise.

Best practices

Deferring decisions on how to move funds through a corporate group or delaying documenting intercompany loans may affect the desired outcome for tax or credit purposes. Best practices therefore require the parties to:

- make a decision upfront as to what extent funds will be advanced as a loan, and whether the repayment obligation will be secured by collateral;
- evidence any intercompany loan by a promissory note or a loan agreement;
- provide in the promissory note or loan agreement for interest at a reasonable, arms-length commercial rate (in no event below the so called "applicable federal rate: see www.irs.gov/app/pick list/list/federalRates.html), and for the periodic payment of interest;
- establish a fixed maturity date, if feasible, rather than having the loan be payable on demand;
- enter into any collateral documents at the same time as the loan is advanced;
- make sure all necessary perfection steps under U.S. law are taken at the time the collateral is documented and the loan is advanced;
- cause the borrower to actually make the principal and interest payment on the schedule set out in the promissory note.

Following these best practices will not guarantee any outcome, but should offer material benefit if the characterization of an intercompany loan or the collateral for the loan is challenged. ■

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