FEATURED PERSPECTIVES

U.S. Tax Effects of Canadian Prescribed Rate Loan Strategy

by Roy A. Berg and Kim G.C. Moody


Roy A. Berg


Kim G.C. Moody

Roy A. Berg is a U.S. tax lawyer and Kim G.C. Moody is a Canadian chartered accountant with Moodys Gartner Tax Law LLP in Calgary, Canada.

On October 1, 2013, the prescribed rate in Canada (applicable for some deemed taxable benefits and as a measure of a fair return of capital) increased from 1 percent to 2 percent, and taxpayers and advisers feverishly worked to execute prescribed rate loans between related parties to take advantage of this popular income-splitting strategy before the prescribed rate doubled. Unfortunately, in the fury to beat the deadline, many people ignored the U.S. tax consequences of this strategy when one or more family members (including a spouse or child) are U.S. citizens, U.S. residents, or U.S. green card holders.

Prescribed rate loans are an elegant and common strategy to income split among Canadian family members, and an abundance of ink has been spilled over the years on this strategy. However, until this article, nary a drop of ink has been spilled on analyzing the tax consequences of a prescribed rate loan strategy when one of the participants is a U.S. person.

Few would argue that both Canadian and U.S. tax law are complex and nuanced, and different outcomes are dependent on a taxpayer's particular facts. This article, therefore, focuses on the identification of salient issues and the legal framework for individual analysis. Full legal analysis of all factual permutations would require us to spill more ink than many tax minds would find useful.

I. Background

In Canada, unlike the U.S., married or common law partners do not have the ability to file joint tax returns. If the two individuals have widely disparate income levels, the result is that in Canada the couple will pay more tax in aggregate than if individuals were combined. This result encourages families to explore strategies to split income among lower-income family members to achieve a lower overall tax rate.

The uninformed may attempt to achieve this result by simply making a gift of capital or other property transfer from the high-income earner to the low-income earner. Unfortunately, this simple strategy does not work for Canadian income tax purposes because Canada has a robust body of attribution rules (obvious examples being subsections 56(2), 56(4.1), 74.4(2), 75(2), and sections 74.1, 74.2, and 74.3 of the Income Tax Act). When the attribution rules apply, the usual result is that income from the gifted property will be attributed back to the transferor and taxed to him personally. Obviously, this result defeats the tax purpose of the initial transfer.

Fortunately, however, section 74.5 of the ITA provides a tool to avoid the application of the attribution rules. In general, this section exempts from the attribution rules (and resulting income and gains) loans to family members under specific circumstances, notably when interest on the obligation is at the prescribed rate set forth in the ITA and regulations. As long as the accrued interest is no less than the prescribed rate and is paid by the borrower to the lender no later than

January 30 of the following calendar year for each year, then the attribution rules under sections 74.1, 74.2, and 74.3 of the ITA will not apply.

The prescribed rate is set quarterly by the government of Canada and is determined with reference to the short-term government of Canada T-bill rates. The prescribed rate has been at a historic low of 1 percent since the second quarter of 2009.

The simple example below illustrates how a prescribed rate loan works in practice. Let us assume the following facts:

- Mr. and Mrs. Maple Leaf are Canadian residents and not U.S. citizens or residents.
- Mr. Maple Leaf is in the highest tax bracket and Mrs. Maple Leaf is in the lowest tax bracket.
- Mr. and Mrs. Maple Leaf have two minor children who are also Canadian residents and not U.S. citizens or residents.
- Mr. Maple Leaf would like to split some of the investment income generated from his investment portfolio with Mrs. Maple Leaf and his children.
- Mr. Maple Leaf's historical investment return and expected future return is 5 percent (for simplicity, let us assume that such return is in the form of interest).

Given these facts, the taxpayers execute the following transactions.

On January 1, 2012, a friend of Mr. Maple Leaf created a Canadian resident trust — the Maple Leaf Family Trust — for the benefit of the Maple Leaf family. Mr. Maple Leaf is the trustee of the trust and the income and capital beneficiaries of the trust are all of the members of the Maple Leaf family.

On January 2, 2012, Mr. Maple Leaf loaned $1 million in the form of cash to the Maple Leaf Family Trust. The interest rate on the loan was the prescribed rate at that time, 1 percent.

The Maple Leaf Family Trust invested the funds in a portfolio account of publicly traded bonds and realized approximately $50,000 of investment return on its portfolio for the year ending December 31, 2012.

The Maple Leaf Family Trust paid $10,000 of interest to Mr. Maple Leaf no later than January 30, 2013. The trustees of the Maple Leaf Family Trust decided to allocate the net investment return of $40,000 to Mrs. Maple Leaf and their two children beneficiaries equally ($13,333 each).

Those poor minds indoctrinated in Canadian tax law will note that the ''kiddie tax'' under section 120.4 of the ITA will not apply for the amounts allocated to the child beneficiaries, since the trust income was generated from publicly traded portfolio assets and the kiddie tax does not apply to such income received by minors.

The same result could be achieved by having Mr. Maple Leaf loan monies directly to Mrs. Maple Leaf without the use of a trust if it was thought that there was no benefit to income splitting with the children.

II. U.S. Tax Issues

When a U.S. person (either a U.S. citizen, U.S. resident, or U.S. green card holder) participates in a prescribed rate loan strategy, the analysis gets very interesting (trust us on this). U.S. tax law has a multitude of different rules regarding the estate tax, taxability of interest, below-market loans, above-market loans, the deductibility of interest, trusts, trust distributions, and its own attribution rules, the confluence of which can cause the prescribed rate loan strategy to backfire.

The U.S. tax issues will vary depending on whether the lender or the borrower is the U.S. person, and whether the loan is made to an individual or to a trust. In order to discuss these variables without resorting to color-coded diagrams, let us assume the following:

- ''Mr. (Maple Leaf or Bald Eagle)'' and ''Mrs. (Maple Leaf or Bald Eagle)'' are married.
- Both spouses are Canadian residents.
- One spouse, ''Bald Eagle'' is a U.S. citizen.
- The other spouse, ''Maple Leaf'' is not a U.S. citizen or U.S. resident.
- ''Mr. (Maple Leaf or Bald Eagle)'' is the individual who lends capital at the prescribed rate.
- ''Mrs. (Maple Leaf or Bald Eagle)'' is the individual who borrows capital at the prescribed rate.
- Therefore, ''Mr. Maple Leaf'' is a Canadian resident and not a U.S. citizen or resident who loans capital at the prescribed rate to his spouse, ''Mrs. Bald Eagle,'' who is a Canadian resident and U.S. citizen.
- Conversely, ''Mr. Bald Eagle'' is a Canadian resident and U.S. citizen who loans capital at the prescribed rate to his spouse, ''Mrs. Maple Leaf,'' who is a Canadian resident and not a U.S. citizen or U.S. resident.

We will use these facts to explore the U.S. tax consequences to the parties in the following circumstances:

- Canadian husband (Mr. Maple Leaf) makes loan to U.S. wife (Mrs. Bald Eagle).
- U.S. husband (Mr. Bald Eagle) makes loan to Canadian wife (Mrs. Maple Leaf).
- Canadian husband (Mr. Maple Leaf) makes loan to a trust.
- U.S. husband (Mr. Bald Eagle) makes loan to a trust.

A. Example 1

Mr. Maple Leaf loans capital at the prescribed rate to Mrs. Bald Eagle.

1. U.S. Tax Consequences to Mr. Maple Leaf

a. Promissory note is ''U.S. situs'' asset and subject to U.S. estate tax. Canadian residents who are not U.S. citizens or residents are subject to the U.S. estate tax only to the extent they possess assets within the U.S. (U.S. situs property) at the date of death. Section 2104(c)(1) of the Internal Revenue Code deems debt obligations of U.S. persons to be U.S. situs property subject to the estate tax. Therefore, Mr. Maple Leaf will be subject to the U.S. estate tax on the value of the promissory note if he dies before it has been repaid. Further, if Mr. Maple Leaf's will cancels the obligation, or if the cancellation feature is found in the note itself, or (in some cases) is transferred within three years of the date of death, IRC section 2104(b) will nonetheless include the value of the note in Mr. Maple Leaf's U.S. estate for estate tax purposes.

b. Promissory note is not U.S. situs asset for gifting and therefore generally not subject to gift tax upon transfer, according to IRC section 2501(a)(2). Generally, the U.S. estate tax and gift tax act as two sides of the same coin. Namely, property given away during life is subject to the gift tax and property held at death is subject to the estate tax. The ''credit equivalent'' (currently $5.25 million) is available either during life (for the gift tax) or at death (for the estate tax), but not both. As with the U.S. estate tax, the gift tax applies to the transfer of property that is within the U.S. (U.S. situs property). However, the definition of U.S. situs property for gift tax purposes excepts intangible assets located within the U.S. under IRC section 2501(a)(2).

Therefore, Mr. Maple Leaf would be able to transfer the promissory note by gift and incur no U.S. gift tax or estate tax. Note, as mentioned above, that transfers within three years of death risk being brought back into the estate under some circumstances.

c. If Mrs. Bald Eagle is ''resident'' in the U.S. at any time payment is made, the interest is U.S.-source income, according to IRC section 871(a)(1). If the interest payments Mrs. Bald Eagle makes to Mr. Maple Leaf are U.S. source, IRC section 871 may cause them to be taxable in the U.S., unless such payments qualify for the portfolio interest exception of IRC section 871(h). Interest payments are U.S. source if they are made by a U.S. resident, according to IRC section 861(a)(1). Reg. section 301.7701(b)-1(a) provides that, for purposes of determining whether a U.S. citizen is a U.S. resident for purposes of section 861, one should apply the principles found in section 301.7701(b)-1(c), including the substantial presence test.

In order to qualify for the portfolio interest exception, IRC section 871(h)(2)(B)(ii)(I) obligates Mrs. Bald Eagle to obtain an executed Form W-8BEN from Mr. Maple Leaf in order to be relieved of her withholding obligations. See the analysis in Section II.A.2.b below for more of Mrs. Bald Eagle's obligations in this regard.

Even if the interest paid to Mr. Maple Leaf is U.S. source and not eligible for the portfolio interest exception, Article XI(1) of the Canada-U.S. treaty provides that interest ''arising in the U.S.'' but paid in Canada will be taxable only in Canada. Article XI(2) of the treaty provides that interest ''arises in the U.S.'' if it is paid by a resident of the U.S.

Thus, in most cases, regardless of whether Mrs. Bald Eagle is a resident when interest payments are made, Mr. Maple Leaf will not be subject to U.S. tax on the interest payments he receives.

2. U.S. Tax Consequences to Mrs. Bald Eagle

a. Mrs. Bald Eagle can deduct the debt from her estate only if it is bona fide, according to Estate of Derksen v. United States, *110 AFTR 2d 2012-6620 (E.D. Pa. 2012).* In determining the taxable estate of a U.S. citizen, IRC section 2053 allows a deduction for claims against an estate. If the claim is based on a promise to pay, the estate must show that there was a bona fide contract, promise, or agreement made for adequate financial consideration and that the claim was an enforceable obligation that existed on the date of the individual's death. If the estate is unable to satisfy its burden, the deduction will be disallowed.

In *Derksen*, the decedent's estate was denied a deduction for a promissory note between the decedent and her spouse because, according to the court's analysis, the obligation was not bona fide. The court set forth a five-factor test to establish whether the obligation was bona fide.

b. Mrs. Bald Eagle must obtain Form W-8BEN if she is resident in the U.S. when interest payments are made in order to be relieved of withholding, and only if interest payments are ''portfolio'' interest, according to IRC section 871(h). As discussed in Section II.A.1.c above, in order to qualify for the portfolio interest exception, Mrs. Bald Eagle must obtain from Mr. Maple Leaf Form W-8BEN, which is not filed with the IRS, but must be retained by Mrs. Bald Eagle. Ordinarily, Mrs. Bald Eagle must also prepare and submit Form 1042-S in order to notify the IRS of source withholdings; however, if the interest qualifies as portfolio interest, this form need not be filed with the IRS. The failure to obtain Form W-8BEN can be subject to penalties and interest if it is later found that the treaty exemption does not apply and withholding is required.

c. Mrs. Bald Eagle can deduct interest only if it qualifies as ''investment interest,'' according to IRC section 163(d)(3), and is subject to limitation as a miscellaneous deduction. Mrs. Bald Eagle's ability to deduct the interest paid to Mr. Maple Leaf is limited by the rules set forth in IRC section 163. The general rule is that ''personal interest'' is not deductible but other forms of interest, notably ''investment interest,'' are deductible. Section 163(d) of the IRC defines investment interest to mean interest that is paid or accrued on indebtedness properly allocable to property held for investment, which would usually include interest paid on a loan at the prescribed rate.

Even if the interest payment qualifies as investment interest, the deduction allowed is limited to the ''net investment income'' that can be traced to the loan proceeds. IRC section 163(d)(4) provides that net investment income is investment income in excess of investment expenses. Thus, if Mrs. Bald Eagle pays $10,000 in interest to Mr. Maple Leaf and her net investment income is only $8,000, she will be permitted to deduct $8,000 and the difference ($2,000) may be carried forward for use in subsequent years.

It is important to note that the interest deduction allowed, according to IRC section 163, may not be fully available to Mrs. Bald Eagle because interest is a miscellaneous deduction. Generally, Mrs. Bald Eagle will take the greater of the standard deduction or the sum total of allowable miscellaneous deductions. The standard deduction in 2013 for a married individual filing separately is $5,950 ($11,900 if married filing jointly). Thus, if Mrs. Bald Eagle is filing a separate return and pays less than $5,950 in interest she will, effectively, obtain no U.S. tax benefit for the interest she pays to Mr. Maple Leaf.

d. Mrs. Bald Eagle can deduct interest payment only on the later of payment or Mr. Maple Leaf's inclusion in income, according to IRC section 267(a)(2) and (3). IRC section 267 provides rules for the timing of deductions that result from payments between related parties, including husband and wife. IRC section 267(a)(2) and (3) provide that Mrs. Bald Eagle will not be able to deduct the interest paid until the later of the year:

- the payment is actually made; and
- of Mr. Maple Leaf's inclusion of this amount in his income.

These rules will delay Mrs. Bald Eagle's interest deduction for U.S. purposes if she makes payment after December 31 of the tax year, which would be the case if, as permitted by Canadian law, the payment is made after December 31 and before January 30 of the following year.

e. If interest is less than the applicable federal rate (AFR), the interest paid by Mrs. Bald Eagle will be part gift and part loan, according to IRC section 7872. IRC section 7872 provides that when the interest rate on a debt obligation is less than the AFR, the interest paid is recast as part interest and part gift. The below-market amount is deemed paid by Mrs. Bald Eagle (and subject to the limitations on interest deductibility set forth above) and received as a gift to her by Mr. Maple Leaf.

IRC section 7872(f)(2)(B) provides that the AFR for demand obligations is the federal short-term rate compounded annually. As of September 1, 2013, this rate is 0.23 percent per annum. Thus, until the applicable federal rate increases to a level above the Canadian prescribed rate, the part-gift and part-interest results of section 7872 will not apply.

If the provisions of section 7872 do apply, however, Mrs. Bald Eagle may have reporting obligations resulting from the ''gift interest'' she receives from Mr. Maple Leaf. Generally, Mrs. Bald Eagle will be obligated to report this gift interest on Form 3520 when it, combined with all other gifts and bequests, exceeds $100,000 per year in aggregate, according to IRC section 6039F.

f. Above-market loan would have gift tax consequences and result in denial of interest deduction. If the interest paid on the loan is above market, as it is when the prescribed rate is greater than the AFR, Mrs. Bald Eagle is deemed to have made a gift to Mr. Maple Leaf of the excess, according to IRC section 2512. As such, the gift could trigger gift tax if it is in excess of the annual exclusion provided in IRC section 2523(i)(2), which is $139,000 per annum for 2012. Further, section 163 of the IRC would deem the gift interest to be personal interest and deny a deduction for payment thereon.

B. Example 2

Mr. Bald Eagle loans capital at the prescribed rate to Mrs. Maple Leaf.

1. U.S. Tax Consequences to Mr. Bald Eagle

a. If interest is less than the AFR, the interest paid will be part gift and part loan, according to IRC section 7872. As discussed above, if the interest on the loan is less than the AFR, IRC section 7872 will reclassify the payment as part interest and part gift. The extent to which the interest is below market will be deemed paid by Mrs. Maple Leaf to Mr. Bald Eagle and included in his income for U.S. tax purposes. Mr. Bald Eagle is then deemed to make a gift of that amount back to Mrs. Maple Leaf. If this gifted interest is in excess of the annual exclusion provided in IRC section 2523(i)(2), Mr. Bald Eagle may incur a gift tax liability and will be obligated to report the amount on Form 709.

b. Mr. Bald Eagle may have to report the loan on Form 8938. For tax years beginning 2011, IRC section 6038D obligates U.S. persons to report certain ''specified foreign assets'' on Form 8938. IRC section 6038D(b)(2)(B) would include a promissory note from Mrs. Maple Leaf to be a specified foreign asset. The failure to file Form 8938 when required can trigger a penalty of $10,000 and reduction of some other tax attributes.

c. Mr. Bald Eagle may be subject to 3.8 percent tax, according to IRC section 1411, on the interest received. In 2010 the U.S. Congress passed the Patient Protection and Affordable Care Act, which included new section 1411. The purpose for new section 1411 was to raise revenue to fund the U.S.'s version of socialized healthcare. To that end, and beginning January 1, 2013, IRC section 1411 imposes on U.S. citizens and U.S. residents a 3.8 percent tax on the lesser of:

- the taxpayer's net investment income; or
- the ''modified adjusted gross income'' less the ''applicable threshold.''

The applicable threshold is $125,000 for married taxpayers filing separately. Thus, if Mr. Bald Eagle's net investment income and modified adjusted gross income is high enough, he will incur this additional 3.8 percent tax on the interest payments he receives from

Mrs. Maple Leaf. While this 3.8 percent additional tax can come as a nasty surprise, the news gets worse.

The U.S. foreign tax credit is granted under IRC section 27 but is available only against those taxes found in chapter 1 (sections 1 through 1400U). The 3.8 percent tax is found in section 1411 (chapter 2a to be precise) and therefore is not eligible for the foreign tax credit. The result could be double taxation to Mr. Bald Eagle on this incremental amount.

2. U.S. Tax Consequences to Mrs. Maple Leaf

Mrs. Maple Leaf is the fortunate one in the foregoing scenarios because there are only indirect U.S. and tax filing obligations (that is, those of her husband, Mr. Bald Eagle) resulting from the loan from her U.S. citizen husband.

C. Example 3

Mr. Maple Leaf makes a loan to a Canadian trust at the prescribed rate. Mr. Maple Leaf is the trustee and a discretionary beneficiary, and Mrs. Bald Eagle is a discretionary beneficiary.

1. U.S. Tax Consequences to Mr. Maple Leaf

a. If the trust is a U.S. domestic trust, Mr. Maple Leaf will own a U.S. situs asset for U.S. estate tax purposes and may have U.S.-source income. Just as discussed in sections II.A.1.a and II.A.1.c, above, if the maker of the promissory note, the trust, is considered a U.S. trust, the obligation will have U.S. situs for U.S. estate tax purposes, and the interest Mr. Maple Leaf receives may be U.S. source.

The trust will be considered a U.S. trust only if it satisfies both the ''courts test'' and ''control test'' set forth in reg. section 301.7701-7. Generally, the courts test is satisfied if a U.S. court can exercise primary supervision over the administration of the trust. Similarly, the control test is satisfied if U.S. persons control all substantial trust decisions. Since Mr. Maple Leaf is a Canadian resident and not a U.S. citizen or resident, it is unlikely that the trust will be considered a U.S. trust, and therefore the interest paid by the trust will not likely be considered U.S. source.

2. U.S. Tax Consequences to Mrs. Bald Eagle

a. Distributions to Mrs. Bald Eagle may be subject to ''throwback tax,'' according to IRC section 665. Assuming the trust is not a U.S. trust, distributions to Mrs. Bald Eagle may be subject to the throwback tax imposed by IRC section 665(a), which seeks to treat a U.S. beneficiary as having received income of the trust in the year in which it was earned. The result is that undistributed net income of the trust later distributed to Mrs. Bald Eagle is taxed at the highest marginal rates for the year in which it was earned by the trust (and not the year of distribution). Also, IRC section 865 adds an interest charge, which accrues from the date the income was earned and ends on the date of distribution. The result can be little or no net-tax benefit to the U.S. beneficiary.

b. Mrs. Bald Eagle may have reporting obligations on Form 3520, according to IRC section 6048(c). Assuming Mrs. Bald Eagle is not considered an owner of the trust because she has no power as a trustee or otherwise, IRC section 6048(c) requires her to report any distributions to her on Form 3520. IRC section 6677 imposes a penalty of 35 percent of the distribution for failure to timely file Form 3520 to report a distribution.

D. Example 4

Mr. Bald Eagle makes a loan at the prescribed rate to a Canadian discretionary trust. Mr. Bald Eagle is the trustee and a discretionary beneficiary, and Mrs. Maple Leaf is also a discretionary beneficiary.

1. U.S. Tax Consequences to Mr. Bald Eagle

a. Loan to the discretionary trust triggers Mr. Bald Eagle's obligation to file forms 3520 and 3520-A, according to IRC section 6048. IRC section 6048 provides that when Mr. Bald Eagle makes a loan to the discretionary trust, he will be obligated to give notice to the IRS by filing Form 3520. IRC section 6677 provides that the penalty for failure to file Form 3520 when due is 35 percent of the gross value of the property transferred to the trust.

Since Mr. Bald Eagle is the trustee of the trust, the grantor trust rules found in IRC sections 672-679 will deem him to the be the owner of the trust. As the owner of the discretionary trust, he will be obligated to file Form 3520-A annually for the trust, according to IRC section 6048(b). According to IRC section 6677, the penalty for failure to file Form 3520-A when due is 5 percent of the gross value of the assets considered owned by Mr. Bald Eagle, which in this case is all of them.

b. As a grantor trust, Mr. Bald Eagle will be currently taxed on all income generated by the discretionary trust regardless of distribution, accumulation, or allocation to another beneficiary, which can result in double taxation to Mr. Bald Eagle. Since the discretionary trust is a grantor trust, according to IRC sections 672-679, the trust itself will be disregarded for U.S. income tax purposes and, instead, Mr. Bald Eagle will be taxable on the income generated by the discretionary trust. This is the case regardless of whether the income is accumulated, distributed, or allocated to another beneficiary.

Further, since the discretionary trust is disregarded for U.S. purposes, the interest the trust pays to Mr. Bald Eagle is ignored, as is the income, if any, he receives from the discretionary trust. As a result, for U.S. tax purposes (aside from the reporting obligations mentioned above), the discretionary trust is treated as if it did not exist but, rather, that Mr. Bald Eagle owned the trust's assets directly.

At first blush, this result may seem rather banal: Nothing was gained but nothing was lost. Upon closer examination, however, it is clear that exactly the opposite is true and that we've actually conjured the demon that haunts all tax practitioners: double taxation.

Double taxation will occur when, for Canadian purposes, anyone other than Mr. Bald Eagle recognizes the income generated by the discretionary trust, such as when the income is allocated to Mrs. Maple Leaf.

In that case, Mrs. Maple Leaf recognizes the income for Canadian purposes but, as noted earlier, Mr. Bald Eagle recognizes the income for U.S. purposes. Since Mr. Bald Eagle pays no Canadian tax on the income, he will not be eligible for the foreign tax credit under IRC section 901. The result is double tax to the combined marital unit.

2. U.S. Tax Consequences to Trust and Mrs. Maple Leaf

As noted earlier, since the discretionary trust is disregarded for U.S. purposes, neither it nor Mrs. Maple Leaf will incur U.S. tax consequences. The only U.S. tax consequences that will flow from the structure will be to Mr. Bald Eagle directly.

III. Concluding Comments

While prescribed rate loans are certainly effective Canadian income-splitting vehicles when used properly, the addition of a U.S. person into such planning can add significant and dramatic complexity. Such complications can come in the form of U.S. income tax, gift tax, estate tax, and additional reportings (with nasty penalties for failure to timely file such forms).

A good fiction author will ensure that all of the characters in his story are fully identified and developed. The same principle applies when engaging in prescribed rate loan planning: Make sure you understand if the ''characters'' are U.S. citizens, residents, or green card holders so the story does not end in tragedy. ◆