MNP U.S. Federal Tax Update - 2017

ACCOUNTING › CONSULTING › TAX

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With the approval of the U.S. tax reform act a done deal just before Christmas, we now have a good idea of its impact on U.S. shareholders of foreign corporations.

The law is formally known as An Act To Provide For Reconciliation Pursuant To Titles Ii And V of the Concurrent Resolution On The Budget For Fiscal Year 2018. It is informally known as the Tax Cuts and Jobs Act.

Foreign Income: Deferral to Exemption

Under the old law, when a U.S.-owned foreign corporation earns active business income, as long as the assets resulting from that income remain offshore, the income is not subject to U.S. tax. When those funds are distributed to the U.S. corporate parent, the parent pays U.S. tax and is eligible for a foreign tax credit in respect of the foreign tax paid by the subsidiary. This is called a "deferral system."

The U.S. is moving to an "exemption system." Active business income earned offshore will never be subject to tax by the U.S. in this scenario (well, sort of).

Transitional tax

The question is: what happens to the retained earnings that represent deferred profits. Technically, this amount is called accumulated earnings and profits, or "E&P." It is the tax version of retained earnings.

This will be included in the U.S. shareholders' incomes in 2017. The inclusion is ordinary income, not qualified dividends. While unimportant for corporate parents, this is very important for individuals.

The amount to be included is the greater of the November 9, 2017 and December 31, 2017 amounts.

Foreign Corporations Included

This inclusion only applies to "deferred foreign income corporations." To be one, it must:

- Have at least a 10 percent U.S. shareholder;
- Have post-1986 E&P, other than from income effectively connected with a U.S. trade or business, or that has already borne U.S. tax;
- Be a controlled foreign corporation, or have at least one U.S. domestic corporation that is a U.S. shareholder, and
- Not be a passive foreign investment company.

Rates

There are special corporate rates of tax that apply: 15.5 percent of E&P represented by cash and near cash (including the net of accounts receivable and payable, if positive), and 8 percent of the remainder.

But the way the rates are arrived at is, to say the least, awkward. Instead of simply applying the above rates to the income, taxpayers are allowed a deduction from income which effectively yields these rates. For a corporation, the normal top rate of tax is 35 percent. To get to a 15.5 percent rate, they deduct from income 55.7 percent (15.5 % = 35 % * (1-55.7 %)). Similarly, to get to an 8 percent rate, they deduct 77.1 percent.

Interestingly, these percentages are the same for individuals. But an individual is subject to graduated rates. That means the net tax rate can be higher, or lower than the 8/15.5 percent corporate rates. An individual who is at the top bracket will pay 9.1 percent or 17.5 percent. An individual whose top rate is 28 percent will pay 6.4 percent or 12.4 percent.

Foreign Tax Credit

A foreign tax credit (or deduction from income) is allowed, but the foreign taxes are reduced by the same proportions (55.7 / 77.1 percent). It will be challenging to see how this "grind" to foreign tax is applied in the case of an individual living abroad who pays foreign personal tax. Will there be a tracing required of individual tax to dividends coming out of the foreign corporation?

There are no comments about cross-crediting, including carry forward or back of foreign taxes.

This means that it may be possible for a U.S. shareholder, resident in Canada, to avoid double taxation by having the corporation pay a taxable dividend. That would create Canadian tax. This will work if the effective Canadian tax rate is higher than the effective U.S. rate (prior to considering the grind). It's not as easy as under the current deferral system, where dividends are typically qualified, and subject to a maximum rate of 20 percent.

Deferral of payment

Payment of this transitional tax can be made over a period of eight years: 8 percent in each of the first five years, 15 percent for year six, 20 percent for year seven, and 25 percent for year eight. It is payable on the due date (without extensions) of each tax return. Estimated tax is not required.

If the taxpayer is late in making an instalment, or he substantially liquidates the company, the remainder of the tax becomes due on the upcoming due date.

Gotcha

This is a "gotcha" tax. For Americans living abroad and owning corporations in the country where they reside, this is tantamount to retroactive taxation. It means that a person who has followed the rules and accumulated assets inside a corporation, now is faced with a real prospect of double taxation.

In Canada, for instance, the only way to avoid it is to pay out a substantial dividend in 2017, accelerating Canadian tax. There will be a very short window of time for taxpayers to plan.

It appears that Canadian tax paid in 2018 will be eligible for carry-back to 2017, but paying a dividend in 2018 to utilize this strategy would create a cash-flow issue. The individual would have to pay the first instalment of tax based without considering the foreign tax credit created with the carry-back.

Everything Counts

When it comes to tax, it's all about the details. Knowing the rules and regulations, what qualifies, what doesn't and how to structure your business and claims most effectively. Our specialized teams are focussed on every facet of tax – in Canada and abroad. We have the in-depth knowledge and experience that will allow you to capitalize on all the opportunities available. We know what to look for, right down to the smallest details. And it's the small details that can add up to make a big difference.

About MNP

MNP is a leading national accounting, tax and business consulting firm in Canada. We proudly serve and respond to the needs of our clients in the public, private and not-for-profit sectors. Through partner-led engagements, we provide a collaborative, cost-effective approach to doing business and personalized strategies to help organizations succeed across the country and around the world.

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