The US "Transition Tax" for 2017: More Sad News for Many US Citizens Residing Abroad

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Transitions come in all different types, some good, some bad, and some just strange. For example, when Canada changed the official English lyrics to "O Canada" to be more gender inclusive, many thought this was generally a good transition. After all, changing the words to the national anthem to be more inclusive is a good thing, right? Well, like most things in life, it depends on your point of view.

However, not all transitions are positive. When Prime Minister Trudeau recently belittled an attendee at a town hall meeting for using the term "mankind" instead of "personkind," that's the kind of transition that most would view as strange. Some transitions are unequivocally negative; the transition tax on deferred foreign income imposed by the US's Tax Cuts and Jobs Act of 2017 is one of those unequivocal negative transitions. As US citizens residing outside of the United States and a shareholder of a Canadian professional corporation, many of my colleagues and I are unfortunate members of this sad club.

The term "transition" implies a journey from Point A to Point B. In the case of a US corporation that holds at least 10% of the shares of a foreign corporation, there are important changes to the US international tax laws worthy of the expression "transition." The old US system was based on general deferral of the earnings of foreign subsidiaries or investee corporations with at least 10% share ownership. There were certain anti-deferral regimes like subpart F and the passive foreign investment company or ("**PFIC**") rules. These anti-deferral regimes, which depend on share ownership and the presence of certain forms of "tainted" income or assets, may require a US shareholder to accrue the earnings of a controlled foreign corporation or pay tax on an excess distribution of a PFIC at the highest rate with a punitive interest charge. Both these regimes remain intact. However, US taxation of foreign earnings from business activities in the foreign company could generally be deferred until an actual dividend was paid to the US shareholder.

Since US corporate tax rates were high at 35%, many US-based multinational enterprises engaged in tax planning to maximize the deferral of foreign earnings in low-tax jurisdictions. Any dividend that was paid was income for US purposes and the US tax on that dividend could be fully or partially absorbed by foreign tax credits. For a US corporate shareholder, an indirect credit was also available for underlying foreign taxes incurred or paid by the foreign company. If, however, there was little or no foreign tax on those earnings, thanks perhaps to the kind of aggressive tax planning castigated by the OECD in its BEPS (base erosion and profit shifting) initiative, then a dividend from a foreign subsidiary could result in significant US corporate tax payable. Add to that a financial accounting rule that allowed public companies not to accrue US tax on deferred foreign earnings if management expressed its intention to reinvest those foreign earnings off-shore on a permanent basis and it is easy to understand why there was a pronounced tendency among US-based multinationals not to repatriate foreign earnings. That was the old regime.

The new US international tax regime has been dubbed a "participation exemption" or a "territorial system." However, to the extent that subpart F remains in place and there are some new provisions like the tax on global intangible low-taxed income, otherwise known as GILTI, it would be more accurate to refer to the new regime as a partial or quasi-territorial regime. Henceforth, US 10% shareholders of foreign corporations that are **US domestic corporations** will be eligible for a 100% dividends received deduction for dividends from specified 10%-owned foreign corporations. Please note that this new dividends received deduction applies only in the case of US domestic corporations that are US shareholders. That means that US shareholders who are individuals are not eligible for the new regime. For US individual shareholders, there really is no new regime, only the same old one. Yet those same US individual shareholders will be called on to pay a tax for a transition to a new regime from which they are excluded. It's like being forced to pay club dues to a club that will not have you as a member.

So, what is this transition tax all about? Like nearly every aspect of the Internal Revenue Code, it is complex and cumbersome and will require regulations, administrative pronouncement, and, quite likely, litigation before its shadowy contours become clearer. The general idea is this: take those earnings of the foreign corporation that have not yet been subjected to US taxation because of subpart F or carrying on business in the United States and tax them at reduced rates before US **corporate** shareholders may repatriate those earnings without any further US tax. Once again, if you happen to be a US individual shareholder who won't be able to benefit from a subsequent tax-free dividend from the foreign corporation, it's tough luck for you. However, since misery loves company, you are welcome to cry in your beer with my colleagues and me!

Here are a few of the complex operating rules for the transition tax. You start with the balance of earnings and profits ("**E&P**"), which is similar but not identical to retained earnings of the foreign corporation, which is the higher of the balance as of December 31, 2017 or November 2, 2017, the date that the tax reform bill was introduced in the House of Representatives. There may be adjustments for current subpart F inclusion, dividends between specified foreign corporations and rules for netting E&P deficits of one or more foreign corporations against deferred foreign earnings of other foreign corporations. The amount of E&P that remains after those adjustments, the "accumulated post-1986 deferred foreign income," is includible in income at full rates, which for corporations was 35% and for individuals was 39.6% for 2017. However, there are deductions allowed for what is referred to as the 8% rate equivalent amount for aggregate foreign non-cash position and 15.5% rate equivalent amount for the aggregate foreign cash position. The idea is to provide deductions such that the result of applying ordinary corporate and individual tax rates to the deferred income net of the deduction will result in effectively taxing the cash assets of the foreign corporation at 15.5% and the non-cash assets at 8%. Now the aggregate foreign cash position includes much more than mere cash. It includes net accounts receivable, securities, commercial paper, certain debt instruments, etc. The deferred foreign income less the aggregate foreign cash position yields the aggregate foreign non-cash position eligible for the 8% rate equivalent percentage.

Here are a couple of further complexities. So far, we have assumed that the foreign corporation is on the calendar year. If it has a fiscal year, there are further challenges. Blended individual and corporate rates must be determined according to the number of months in the fiscal year that fell in 2017, with top rates of 35% for corporations and 39.6% for individuals, and the number of months in 2018, with top rates of 21% for corporations and 37% for individuals. Another rub that has a detrimental effect on US individual shareholders is that the law requires that the top corporate rate be used for calculating the 8% and 15.5% deduction amounts. For a calendar year corporation, the US individual shareholder must include the income at a top individual rate of 39.6%, whereas the deduction is based on the top corporate rate of 35%. The upshot of this rate disparity is that for a calendar year corporation, the transition tax rate for a US individual shareholder becomes 9.05% for the E&P related to the aggregate foreign non-cash position and 17.54% for the aggregate foreign cash position. For corporations with a fiscal year-end, the foregoing rates will apply to the number of months in 2017 but for the months that occur in 2018, the transition tax rate climbs to 14.1% for the non-cash portion and 27.31% for the cash portion. The disparity increases because, although the individual tax rate that applies to the income inclusion drops by 2.6% points from 39.6% to 37%, the corporate rate that applies to the deduction nose-dives from 35% to 21%.

For US citizens living in Canada who have controlling interests in Canadian corporations, a further issue is whether the payment of such transition tax can be used as a foreign tax credit to reduce Canadian tax payable on any income sources. The short answer is no for most cases that we can think of. In most cases, the US citizen's income sources will be solely Canadian sourced and therefore Canada will not grant foreign tax credits (as a result of the payment of the US transition tax) on Canadian sourced income. Ouch. This can result in outright double taxation! Some practitioners are contemplating the possibility of generating Canadian tax on amounts withdrawn from the Canadian corporation for 2018 and 2019 and carrying back such Canadian generated foreign tax credits to apply against the 2017 US transition tax. However, it is not yet certain that this "plan" will work given the lack of guidance about foreign tax credit application against the transition tax. Stay tuned.

For those US individual shareholders living abroad this amounts to more insult for being drawn into a party that we certainly didn't wish to attend in the first place. If the numbers are significant enough and the US individual shareholders want to explore their options, consideration should be given to making an election to treat the US individual shareholder as if he or she were a US corporate shareholder. This election is fraught with its own complexities and pitfalls. Therefore, the numbers and consequences will have to be examined closely.

An election to pay the transition tax in installments over an eight-year period is available. The election must be made with the first tax return of the US shareholder that follows the year-end of the specified foreign corporation. For example, for specified foreign corporations with a calendar year-end of December 31, 2017, the US individual or corporate shareholder will have a tax return due date of April 16, 2018. For fiscal year-ends occurring thereafter, the US individual or corporate shareholder will have a tax return due on April 15, 2019. The IRS will need to clarify whether the election can be made on a return filed six months later with a valid extension. The statute makes clear that the payment must be made by the due date without extension. Presumably late payments will be subject to penalties.

These installments are not in equal payments and are actually back-loaded in favour of the taxpayer. For the first five installments, 8% of the transition tax liability is due. For the sixth installment, 15% is due. For the seventh installment, 20% is due. For the final eighth installment, 25% is due. Even with the election to adopt this installment plan, there are acceleration events such as liquidation of a US corporate shareholder, sale of substantially all its business assets, etc. It may be possible for a successor corporation to enter into an agreement with the IRS to continue the installment payments.

The policy behind moving to a quasi-territorial system is intended to encourage US-based multinationals to repatriate foreign earnings through dividends to the US parent corporation, which, it is hoped, will use the funds to expand business in the United States and employ US workers, especially since the US federal tax rate has now fallen to a competitive 15%. A number of major corporations, including Apple and Exxon Mobil have made announcements that go in that direction. Apple is taking a $38 billion charge for transition tax and has announced plans to repatriate approximately $274 billion and add 20,000 US jobs. Exxon Mobil has announced its intention to increase a prior pledge to invest $15 billion in US expansion by another $25 billion in the wake of tax reform. Microsoft has recorded a charge of $13.8 billion, mostly due to transition tax, whereas Goldman Sachs is recording a charge of $5 billion. Be that as it may, this policy has nothing to do with a US citizen residing in Canada or some other foreign country who has incorporated his or her business or professional practice and chooses to reinvest earnings in the business or even invest some portion of earnings in some other enterprise. Even if these measures turn out to benefit the US economy, it will be cold comfort to US individual shareholders residing abroad, who seem to be unwitting members of a club that subjects them to surprise and harsh new tax rules.

In the meantime, US citizens who are residents of Canada and have controlling interests in Canadian corporations should seek immediate advice.