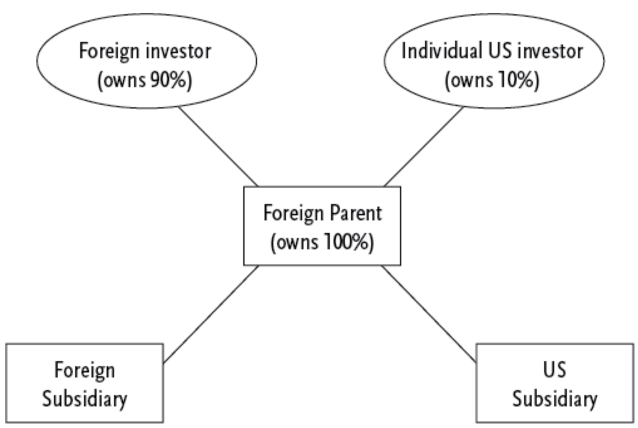
US Shareholder of a Canco After 2017 Tax Reform

Public Law no. 115-97 (2017 tax act)—the Tax Cuts and Jobs Act, signed December 22, 2017—significantly changed the Code and negatively affects a US person in Canada holding shares in a closely held corporation. The changes were intended to target a large corporation, such as Apple, that has large non-US retained earnings, an oversight no doubt attributable to hasty legislative drafting.

A US CFC shareholder is deemed to be a US shareholder if 10 percent of the CFC's votes or value is held by a US individual or US corporation. A CFC is a non-US corporation in which more than 50 percent of the votes or value is owned by US shareholders. Before the 2017 tax act, a US shareholder was a US person who held at least 10 percent of the votes of the non-US corporation.

The 2017 tax act eliminated Code section 958(b)(4), which prevented the attribution of shares owned by a non-US person to a US person. Thus an individual US investor in the accompanying chart is deemed to be a US shareholder of Foreign Subsidiary. The chart is from the **AICPA**'s letter (dated March 13, 2018) to the IRS and the Department of Treasury.



IRS Notice 2018-13 (2018-6 IRB 341) stated an intent to amend **IRS form 5471** to except category 5 filing for a US person deemed to be a US shareholder via the new attribution rules.

A US CFC shareholder is subject to the section 965 transition tax regime (also referred to as the "toll tax," or "repatriation tax"). That tax is levied on all earnings and profits (similar to retained earnings) accumulated post-1986 to the higher of earnings and profits on November 2, 2017 or December 31, 2017, and it is payable on the pro rata share of earnings held by a US shareholder. If the US shareholder is a corporation, the cash repatriated is subject to tax at a flat rate of 15.5 percent; other assets are subject to an 8 percent flat rate. A US individual shareholder does not benefit from the flat rates, but if his or her income level is taxed at the highest rate, he or she is subject in 2017 to a toll tax rate of 17.5 percent (or about 27.3 percent in 2018) for cash and 9 percent (or about 14.1 percent in 2018) for non-cash. (See Amanda Athanasiou, "Toll Charge Is Taking Individuals by Surprise," *Tax Notes International*, February 19, 2018.) The 2018 rate applies to an individual whose tax liability is less than US$1 million and who seeks to use the eight-year payment plan in section 965(h)(1).

Income accumulated in a non-US corporation that was not subject to the toll tax (because it was earned after the tax was introduced) may be subject to the tax under section 951A's global intangible low-tax income (GILTI). GILTI is taxed in the US individual shareholder's hands at his or her highest tax rate: a US corporate shareholder is taxed at 10.5 percent (there is a 50 percent deduction under section 250).

The favourable tax treatment for a US corporate shareholder has many practitioners considering the section 962 election, which allows to an individual US shareholder the corporate tax rates in section 11 on section 951(a) inclusions. This annual election also entitles the individual to claim an otherwise unavailable deemed-paid foreign tax credit under section 960. Sections 965 and 951A are both part of subpart F; arguably, a section 962 election is available to a US individual shareholder faced with the transition tax and with GILTI thereafter. On September 18, 2018 the US Tax Court released *Barry M. Smith and Rochelle Smith* (151 TC no. 5), which considers the election in a regular subpart F context, not in the context of section 965 or 951A. The court provided a sound overview of the election and explained that it does "not create hypothetical corporations or change real-world facts. [It] simply provide[s] a mechanism that enables an individual U.S. taxpayer to elect what he or she may deem more desirable tax treatment."

In *Smith*, the CFCs in question were based in Hong Kong and in Cyprus. There was no US-Hong Kong tax treaty and the US-Cyprus tax treaty did not apply (the treaty's LOB clause was not met). The taxpayers elected to treat the Hong Kong CFC and Cyprus CFC as corporations under section 962, and the issue was whether current distributions from each CFC—a domestic corporation under the election—received qualified dividend treatment under section 1(h)(11)(B)(i)(I) or ordinary dividend income treatment at a higher tax rate. This case confirms that a distribution of a qualified foreign corporation that has made a section 962 election will be accorded qualified dividend treatment under section 1(h)(11)(B)(i)(I). A US shareholder of a Canco would meet the section 1(h)(11)(B)(i)(I) test, which accords qualified dividend treatment to dividends "from—domestic corporations, and qualified foreign corporations." Section 1(h)(11)(C) defines a "qualified foreign corporation" as a corporation incorporated in the United States or eligible for benefits under a comprehensive US income tax treaty. Notice 2006-101 provides that Canada meets those requirements; the election is therefore worth considering for US persons in Canada who are deemed US shareholders. Note that the election forfeits the benefits of section 959(a), which holds that a deemed distribution taxed in a CFC is not taxed again in the shareholder's hands upon distribution. Section 962(d) states that, upon actual distribution, the shareholder must include in income that portion of the distribution that exceeds the transition tax paid on the election, which could result in a larger tax liability to the individual taxpayer if an election was not made and if the dividend was issued by a corporation in a non-qualified country. Given the qualified status of Canada, the current higher tax rates on dividends in Canada, and the low tax rates accorded to qualified dividends in the United States, a US shareholder of a Canadian corporation is better off if it makes the section 961(d) election today. However, if Canada lowers its general tax rates and dividend rates, a section 961 election may not be such a good thing.

It is the author's view that a section 961 election does not apply to the GILTI deduction under section 250.

The unintended consequences described above are likely to be corrected by the IRS Treasury, but a question remains about the timing of that correction and what it will entail.

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