THE LAWYER'S DAILY

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Tax

Trump's tax changes hit U.S. residents of Canada, dual citizenship holders

By **Veronika Chang**


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(September 10, 2018, 9:16 AM EDT) -- Recent tax changes in the United States can have huge implications for Canadian residents with U.S. or dual U.S.-Canadian citizenship.

The *Tax Cuts and Jobs Act* of 2017 introduced a new Internal Revenue Code Section 965. It levies tax on post-1986 deferred foreign income of deferred foreign income corporations (DFICs) as of Nov. 2, 2017, or as of Dec. 31, 2017, whichever is greater.

One can think of deferred foreign income as retained earnings of a company, with some adjustments. The one-time tax imposed is at an effective tax rate of 15.5 per cent for cash assets and eight per cent for all other assets. While complex math is involved in achieving these rates, the result is clear — additional tax for U.S. persons who have non-U.S. business with retained earnings.

More recently — on Aug. 3, 2018 — more fuel was thrown onto the fire. The IRS proposed regulations implementing Section 965, which put an end to any tax planning that may involve foreign tax credit carryforward. Details of the proposed regulations, a whopping 249 pages no less, are complex, but to make such a plan work those affected would have to receive almost twice as much dividend — and in the process pay twice as much Canadian tax!

Let's look at an example.

Harry — not his real name — lives in Toronto and runs a successful business. He has always sought financial and tax advice. Through shrewd financial and tax planning over the years, or so he thought, he saw his enterprise grow to five Canadian corporations with one corporation in each province where he has significant business interests or where he holds real estate.

For the most part, Harry has taken advantage of the lower Canadian corporate tax rate and kept a good chunk of his income in those companies, thereby deferring personal tax on most of the revenue from his enterprise.

As of Dec. 31, 2017, he had saved about $7 million in retained earnings across his five companies. But this past June Harry had to pay more than US$500,000 to the government — not the Canada Revenue Agency, but the Internal Revenue Service (IRS) in the U.S. Why? Harry is a dual U.S.-Canadian citizen.

He had to report an additional US$2 million on his U.S. income tax return, which resulted in tax liability of over half a million bucks.

According to the IRS, Harry's five Canadian corporations are seen as deferred foreign income corporations and the IRS wants U.S. persons (citizens and residents) who own such DFICs to repatriate the deferred foreign earnings. Simply put, the IRS wants U.S. persons who deferred paying taxes by keeping the money in their foreign (non-U.S.) corporation to pay up.

President Trump's changes to the U.S. tax code hit Harry right between the eyes. The $7 million he saved up in his Canadian companies resulted in a transition tax of over $500,000. Until recently, Harry had hoped that he could have the companies declare large dividends this year and pay Canadian tax later. Why would Harry have wanted to create unnecessary income and pay the tax thereon?

Remember, the transition tax was imposed on retained earnings, not on actual dividend income received by Harry. This means he had to pay U.S. tax on deemed dividends — income he did not receive — which was not the plan. The plan was to pay the Canadian tax in 2018 so he could use it as a foreign tax credit in the U.S. for 2018, and then carryforward the excess foreign tax credit back to his 2017 U.S. tax return.

In hindsight, it would have been simpler if Harry had the companies declare and pay him dividends in 2017, but alas, such was not possible without a crystal ball. The transition tax is levied on retained earnings as of Nov. 2, 2017, or Dec. 31, 2017, whichever is greater. Since the future *Tax Cuts and Jobs Act* was released to the House only on Nov. 2, 2017, Harry had no time to plan.

As a small reprieve, s. 965 gives him an option of paying the transition tax in instalments over eight years, with the percentage of the net tax liability payment being higher in the later years. This is what the new IRS regulations are saying: If you pay the transition tax using the instalment payment method and give up your U.S. citizenship before all the instalments are paid, then you must pay all future instalments when you renounce. So, unless you have the money to pay up when you renounce, U.S. citizens are stuck being U.S. citizens.

Harry played it by the book in that he got good tax and financial advice, but the rules changed during the game. And he, too, is stuck.

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