Wolters Kluwer

GLOBAL TAX WEEKLY
a closer look

ISSUE 286 | MAY 3, 2018

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Due Date Clarified For Transition Tax On Foreign Company Owners

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Introduction

Of all the income tax provisions in Trump's major tax reform legislation,[1] the so-called "transition tax" is perhaps the most unusual in its scope and breadth. For many US persons owning foreign companies[2] that trigger the transition tax, a certain degree of panic set in at the beginning of this year, because the transition tax statute (IRC Section 965), if read strictly, seems to have given a hard deadline of April 15 for paying the first portion of the tax under the statute's payment installment plan.

In terms of the due date, further angst could be felt among US persons living abroad,[3] who have become accustomed to having at least a two-month reprieve (to June 15) to file and pay their US taxes. The extra time can be crucial for gathering information while abroad, especially in the case of company ownership, where financials are not produced for some time after year end.

In this article, we provide a brief overview of the transition tax and its relevant provisions for US expats, and highlight recent IRS guidance addressing the issue of the due date for US persons living abroad.

The Transition Tax – How Does It Work?

As part of the transition to a so-called participation exemption system, new Section 965 of the Internal Revenue Code uses the mechanics under Subpart F to impose on US shareholders owning at least 10 percent of a foreign subsidiary a one-time mandatory "repatriation tax" or "transition tax" on the undistributed, non-previously taxed, post-1986 foreign earnings and profits ("E&P") of a "specified foreign corporation." A specified foreign corporation is defined as (i) any CFC, and (ii) any foreign corporation with respect to which one or more domestic corporations is a 10 percent United States shareholder. The portion of the E&P comprising cash or cash equivalents is taxed at the rate of 15.5 percent, while any remaining E&P is taxed at the rate of 8 percent.

Section 965 does not distinguish US corporate shareholders from other US shareholders, so the transition tax potentially applies to any US person (including an individual) owning at least 10 percent of a foreign subsidiary. The transition tax rates can be slightly higher for US individual shareholders whose effective tax rate was higher than 35 percent for the 2017 tax year.

Section 965 specifies, importantly, that the transition tax applies to the greater of the accumulated post-1986 deferred foreign income (essentially the previously untaxed E&P) of the foreign corporation determined as of November 2, 2017 or as of December 31, 2017. In order to prevent pre-transition tax avoidance planning, the section adds that E&P is determined by essentially ignoring dividends distributed during the 2017 taxable year (other than dividends distributed to another specified foreign corporation).

Easing The Pain Of The Transition Tax

Other aspects of Section 965 that could potentially ease the pain of the transition tax include the following:

- US shareholders can elect to pay the transition tax in installments over a period of up to eight years;
- Deferred earnings of a US shareholder are reduced (but not below zero) by the shareholder's share of deficits from other specified foreign corporations;
- The transition tax does not apply to previously taxed E&P;
- The portion of earnings subject to the transition tax does not include E&P that were accumulated by a foreign company prior to attaining its status as a specified foreign corporation;
- Owners of foreign companies that are fiscal year taxpayers may not have a payment obligation until next year (although the transition tax rate may be higher at that point); and
- An election is available for an individual to be treated as a corporate taxpayer for purposes of the transition tax in order to claim a credit for foreign taxes paid at the corporate level (although we note that such an election has potential drawbacks that require consideration and analysis).

When Is The Transition Tax Due?

When reading new Section 965, the only due date mentioned for the transition tax is in the context of the eight-year installment election. Section 965 caveats that "the first installment shall be paid on the due date (determined without regard to any extension of time for filing the return) for the return of tax for the taxable year." The natural reading of the statute seems to be that the first installment should be due on April 15 even for those living abroad, because June 15 is essentially an extension of the original due date.

In recently published Notice 2018-26,[4] however, the US Treasury and the IRS clarified first that in the case of a taxpayer who otherwise qualifies for the automatic June 15 extension (including US citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States), the date of June 15 (and not April 15) is the general deadline for the transition tax. They further clarified that June 15 (and not April 15) is the deadline for the first payment for those who elect to pay the transition tax in annual installments.

Further Guidance From The IRS

Since the enactment of new Section 965, Treasury and the IRS have issued several rounds of guidance on the transition tax rules, including a FAQs page[5] that gives instructions on reporting and paying the tax, and Publication 5292,[6] which includes worksheets that assist with calculating the tax.

For further guidance, the IRS page dedicated to the transition tax and other provisions of the tax reform can be found at https://www.irs.gov/newsroom/tax-reform

Endnotes

1 https://www.expattaxprofessionals.com/tax-reform-officially-arrived-mean-u-s-expats-2/

2 https://www.expattaxprofessionals.com/expat-tax-information-other-information-foreign-companies/

3 https://www.irs.gov/individuals/international-taxpayers/us-citizens-and-resident-aliens-abroad

4 https://www.irs.gov/pub/irs-drop/n-18-26.pdf

5 https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns

6 https://www.irs.gov/pub/irs-pdf/p5292.pdf