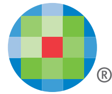
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Owners Of Fiscal Year Foreign Corporations To See Higher Transition Tax Rates

by Joshua Ashman, CPA & Nathan Mintz, Esq., Expat Tax Professionals

Owners of fiscal-year foreign corporations (*i.e.*, corporations that do not have a tax year end of December 31) owing "transition tax" generally have the luxury of waiting until next year's tax season to deal with reporting and paying the one-time tax liability.

Such individuals may be surprised to find out, however, that their transition tax rate will actually be significantly higher than owners of calendar-year foreign corporations who were tasked with filing and paying the tax this year.

In this article, we review the basics of the transition tax and its calculation and demonstrate why the transition tax rate should increase next year.

The Transition Tax – How Does It Work?

As part of the transition to a so-called participation exemption system (which we describe more fully here,[1] new Section 965 of the Internal Revenue Code uses the mechanics under Subpart F to impose on US shareholders owning at least 10% 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" ("SFC").

A SFC 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. It should be noted that a PFIC that is not a CFC is exempted from being treated as a SFC.

Section 965 specifies, importantly, that the transition tax applies to the greater of the accumulated post-1986 deferred foreign income (essentially the previously untaxed earnings and profits)

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).

Does The Transition Tax Apply To Individual Shareholders?

The IRS's recently promulgated proposed Section 965 regulations[2] confirm that 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 Preamble to the regulations notes that "numerous comments were received requesting guidance exempting individuals from the application of Section 965," however, the "statute is clear that Section 965 applies to all United States shareholders." As support, the Preamble also quotes the Conference Report on the bill enacting the transition tax, which states that "In contrast to the participation exemption deduction available only to domestic corporations that are US shareholders under Subpart F, the transition rule applies to all US shareholders."

How Is The Transition Tax Calculated?

The transition tax calculation can be tricky, particularly because it is not set out as a particular rate of tax. Instead, the tax is applied at ordinary rates (as would be the case with other Subpart F income), but only after the undistributed, non-previously taxed post-1986 foreign E&P of the SFC have been reduced by a certain "plug deduction."

For US shareholders of calendar-year SFCs, the plug deduction is 55.7 percent in the case of E&P comprising cash (and certain cash equivalents described in the statute) and 77.1 percent in the case of any remaining E&P. The 55.7 percent plug is determined by applying a ratio that is 15.5 percent over 35 percent, while the 77.1 percent plug is determined by applying a ratio that is 8 percent over 35 percent. The 35 percent denominator represents the maximum corporate tax rate for the 2017 tax year, which is the year of the transition tax inclusion for U.S. shareholders of calendar-year SFCs. After applying the plug deductions, the ultimate transition tax rate for individuals taxed at the highest 2017 ordinary rate of 39.6 percent should therefore be approximately **17.5 percent in the case of E&P comprising cash and cash equivalents** (100 percent – 55.7

percent times 39.6 percent) and approximately **9.1 percent in the case of any remaining E&P** (100 percent – 77.1 percent times 39.6 percent).

For US shareholders of fiscal-year SFCs (*i.e.*, foreign corporations with a tax year end that is not December 31), the year of the transition tax inclusion should be the 2018 tax year and not the 2017 tax year. Because of this, the plug deduction will be significantly lower because the maximum corporate tax rate for the 2018 tax year is 21 percent, a significant reduction from the previous rate of 35 percent. In the case of E&P comprising cash (and cash equivalents), the plug deductions should instead be 26.2 percent, and in the case of any remaining E&P, the plug deduction should instead be 61.9 percent. After applying the plug deductions, the ultimate transition tax rate for individuals taxed at the highest 2018 ordinary rate of 37 percent should therefore be approximately **27.3 percent in the case of E&P comprising cash and cash equivalents** (100 percent – 26.2 percent times 37 percent) and approximately **14.1 percent in the case of any remaining E&P** (100 percent – 61.9 percent times 37 percent).

We are not aware of guidance from the IRS that specifically recognizes the increase in the transition tax rate, but the above analysis is what seems to follow from the current language of the Section 965 statute and the accompanying proposed regulations.

Further Guidance From The IRS

For further guidance, the IRS has a FAQ page dedicated to explaining the nuances of the transition tax and its reporting rules.

The page can be found here: https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns

Endnotes

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

2 https://www.federalregister.gov/documents/2018/08/09/2018-16476/guidance-regarding-the-transition-tax-under-section-965-and-related-provisions