U.S. Tax Reform: How it affects a U.S. owner of a foreign corporation

U.S. Congress has passed new tax legislation which President Trump signed into law in December 2017. As part of this legislation, Congress overhauled the corporate tax system by reducing the corporate tax rate from a maximum 35% to a flat rate of 21%. This means lower taxes for large corporations and higher taxes for small corporations.

In addition to this tax rate change, Congress has attempted to change taxation of corporations from worldwide taxation to a quasi-territorial taxation system. The intent is to force large multinationals to bring back to the U.S. profits that have accumulated in their foreign subsidiaries, often taxed at lower foreign rates. Unfortunately, the new law treats all American shareholders the same – whether the shareholder is a U.S. domestic corporation or an individual U.S. citizen or Green Card holder who has business interests abroad.

Two new taxes have been introduced:

- For the year 2017 tax year – a one-time "Repatriation Tax" on previously untaxed profits of foreign corporations owned by U.S. persons (entities or individuals)
- From 2018 tax year onwards – an annual tax based on specially-calculated income of the foreign corporation called "Global Intangible Low-Taxed Income".

Who must pay the one-time Repatriation Tax?

The one-time Repatriation Tax applies to:

- a "Controlled Foreign Corporation" (CFC) of which a U.S. shareholder owns at least 10%. To determine 10% ownership there are family attributions rules that group together ownership by family members.
    - The foreign corporation is a CFC if it is more than 50%-owned by U.S. shareholders (U.S. citizens, Green Card holders, U.S. domestic corporations) for more than 30 days during the year
- a U.S. domestic corporation which owns 10% or more of a foreign corporation.

Therefore a U.S. individual who owns a foreign corporation (ex. a Swiss GmbH or AG) and meets the above definition will be subject to this one-time tax. The Repatriation Tax is included in the owner's personal 2017 U.S. income tax return. The tax owing must be paid by April 17, 2018, with the possibility of paying, interest-free, over 8 installments.

How is the one-time Repatriation Tax calculated?

The Repatriation Tax is assessed on the profits of the foreign corporation that have not been previously taxed in the U.S. If a taxpayer owns a group of foreign corporations, profit of one corporation can be netted against a deficit of another. The overall net untaxed profits will then be taxed at a rate of either 15.5% or 8%. The tax rate depends on the make-up of the assets on the balance sheet of the corporation, or group of corporations:

- Profits attributable to cash are taxed at 15.5%
- Profits attributable to all other assets are taxed at 8%.

These tax rates apply to U.S. domestic corporate owners and are slightly higher for U.S. individual owners. The U.S. owner will owe Repatriation Tax based on the proportion of the shares he owned on December 31, 2017.

How will profits of a CFC be taxed by the U.S. going forward?

The new tax legislation changes the way a CFC is taxed annually starting with tax year 2018. Previously, the undistributed annual earnings of foreign corporations were not subject to U.S. taxation. As of 2018, the profits of a CFC will be taxed each year based on a new concept of "Global Intangible Low-taxed Income". Calculations of this income differ if the owner is an individual or a U.S. domestic corporation:

- If the U.S. shareholder of the CFC is an individual:
    - The CFC may claim a deduction equal to 10% of its depreciable tangible property
    - The remaining profit is taxed at the individual's tax rate which for 2018 can be as high as 37%.
- If the U.S. shareholder of the CFC is a U.S. domestic corporation:
    - The CFC may claim a deduction equal to 10% of its depreciable tangible property
    - The CFC's profits are further reduced by 50% and a deduction of 37.5 % of deemed intangible income of the U.S. domestic corporation can be taken
    - The resulting adjusted profit is then taxed at a 21 % tax rate. A U.S. domestic corporation can also offset U.S. taxes with a credit for foreign (ex. Swiss) taxes, subject to certain limitations.

As a U.S. individual shareholder, how can I reduce the U.S. tax burden of owning a foreign corporation?

There are some ways to reduce your U.S. tax burden and simplify your U.S. tax reporting obligations:

- Avoid CFC status of the business by limiting total U.S. ownership to 50% or less
- Create a U.S. domestic corporation to be the owner of the CFC, thus benefiting from greater tax relief
- Elect to have your business's profits taxed in the U.S. as a corporation rather than in your own hands, as an individual.

This new tax law will affect each U.S. taxpayer differently depending on facts and circumstances. We would be pleased to meet you to discuss your particular situation, assess the consequences of the tax changes and explore opportunities to limit their impact. Please do not hesitate to get in touch with us.

Your U.S. Tax Services Team
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