

# UNFAVOURABLE GUIDANCE ON SECTION 965 TAX

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On April 13, 2018, the IRS made a surprising and disappointing announcement that overpayments of 2017 estimated taxes by US shareholders will be applied first to future (post-2017) instalments of section 965 tax; such an overpayment is not eligible for refund or for credit against other 2018 US tax liabilities until the entire section 965 tax has been paid. The position is contrary to what most practitioners were expecting and contrary perhaps to the congressional intent of allowing a taxpayer to pay a section 965 tax liability in prescribed instalments over eight years: in the result, this IRS position could force the current payment of taxes not yet due. Barring an IRS change of view, as a practical matter the position imposes an initial instalment payment in excess of the stated 8 percent amount.

The onerous new US rules under section 965 impose a tax on a US shareholder of a foreign (non-us) corporation that is a controlled foreign corporation or specified foreign corporation on its share of post-1986 undistributed earnings. The section has a particularly harsh effect on many US citizens resident in Canada. The new rules not only impose substantial us tax on such earnings payable in instalments over eight years starting in 2017, but also present obstacles to synchronizing the timing of the tax on the income in Canada and the United States: lack of synchronization may lead to double tax.

In addition to this potential cost to a taxpayer who overpays an estimated 2017 US tax liability, there may also be a significant cost to a person who underpays such a liability. If a taxpayer underpays—makes estimated tax payments by the applicable due date (April 15 or June 15, 2018) that turn out to be less than the actual 2017 tax liability—theoretically the person may be ineligible to elect to pay a section 965 tax liability in eight annual instalments. Although the IRS seems unlikely to take that hardline approach and impose such a hardship on a taxpayer who calculates his estimated 2017 tax liability in good faith, concern is nonetheless raised because the result is so draconian.

The April 13, 2018 IRS announcement heightens the stakes for a US shareholder who miscalculates an estimated 2017 US tax liability. Moreover, the IRS has been slow to provide guidance needed to make accurate tax estimates. For example, an

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individual US shareholder who did not elect under section 962 and who incurred 2017 Canadian tax on 2017 dividends received from his CFC may be helped by knowing whether the IRS thinks that the entire, or only some portion of, Canadian tax is creditable against section 965 tax. Similarly, if a shareholder receives a 2018 dividend and incurs 2018 Canadian tax that is carried back to the 2017 US tax return, is the full amount or only some portion creditable? There is also uncertainty for an individual US shareholder who elects under section 962 to access foreign tax credits for Canadian taxes incurred at the CFC level and who also incurs personal 2017 Canadian tax on 2017 dividends from his CFC at a greater than 20 percent rate: Is the excess (above the 20 percent base of the Canadian tax amount that offsets the 20 percent US federal tax on the dividend) creditable against the section 962 inclusion? Many practitioners have their own views and interpretations of how these issues should be resolved, but it would be helpful to know the IRS position so as to help provide informed advice to clients.

Various situations and nuances do not seem to have been considered by Congress when the new US tax rules were rushed through in December 2017; this comment applies also to the new US GILTI (global intangible low-taxed income) tax. At an April 25, 2018 conference, the IRS associate chief counsel (international) clarified that a US shareholder who has GILTI income and elects under section 962 should place the gross-up component of the inclusion (for Canadian taxes imposed on the CFC on the income) in the same foreign tax credit basket as normal GILTI income, despite the fact that the statute does not necessarily yield that result. One hopes that soon further guidance will confirm that an individual shareholder who elects under section 962 is entitled to the 50 percent deduction available to corporate shareholders.

The June 15, 2018 date is fast approaching for many US citizens resident in Canada who must estimate and pay 2017 US tax liabilities. It is hoped that soon the IRS will issue more and pro-taxpayer guidance. However, the special adviser with the Treasury Office of International Tax Counsel recently indicated that, although further guidance under section 965 has not necessarily been ruled out, Treasury's primary focus has now shifted to writing regulations. Also looming later this year is the important decision and calculation of how much of a dividend should be paid by a CFC in 2018 to generate sufficient Canadian tax to minimize double tax on earnings subject to US tax for the next seven years under section 965; that fact pattern will involve prospective foreign tax credit planning through 2024.