

A SECTION 962 ELECTION?

Andrew Oppenheimer
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A US citizen who is resident in Canada and subject to the transition tax under Code section 965 should consider or have considered a section 962 election. There may still be time to make this election.

A US individual shareholder subject to the transition tax must include in income his or her proportionate share of the earnings and profits (E & P) accumulated after 1986 that has not yet been subject to US tax. Such inclusion must be reported on the tax return for the year in which Canco's last taxable year beginning before 2018 ends. Thus, a US individual subject to the transition tax with respect to a Canco that properly has a June 30 fiscal year-end (for US and Canadian tax purposes) must include the income in his or her 2018 tax return.

How does a section 962 election work? In general, a US individual who owns stock of a Canco does not pay US tax on Canco's E & P until it makes a distribution. But if the US individual owns more than 50 percent of Canco, an anti-deferral regime (subpart F) applies. This regime generally requires the US individual shareholder to include in income his or her proportionate share of Canco's subpart F income, if any, in the year earned. Absent a section 962 election, the US individual cannot offset the US tax liability on subpart F income with Canco's taxes paid on that income, but a US corporate shareholder subject to a subpart F inclusion can credit its US tax liability with such taxes. For instance, a US individual who owned 100 percent of a Canco that earned \$100 of subpart F income in year 1 and paid \$25 of Canadian tax thereon (assuming that the US and Canadian dollars are at par) has a US income inclusion of \$75 (the net amount) and pays tax on the \$75 at his or her personal US rates. A US corporation that owned Canco must gross up the subpart F inclusion by the taxes imposed (\$75 plus \$25 tax) and include \$100 in income with a US tax offset of \$35 ($\100×35 percent, the corporate tax rate before 2018); because \$25 of foreign taxes were paid on that income, the net US tax liability is \$10. On actual distribution, in either case no additional US tax is imposed on this previously taxed income. Thus, a US corporate shareholder can use taxes paid by Canco, but a US individual cannot unless he or she makes a section 962 election.

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A section 962 election allows an individual to be taxed as if he or she was a US corporate shareholder and to use Canadian taxes paid by Canco on the E & P as a credit against his or her US tax liability. The downside is on actual distribution: that distribution is again subject to US tax because it is not treated as previously taxed income. Thus, a US individual who makes a section 962 election must include the same income on his or her tax return twice (first, in the year the income is earned and includible under the subpart F rules; and second, when an actual distribution is made). While this double tax appears to be a downside, it may not be after all.

If the amount of taxes paid by Canco that are available as a result of a section 962 election to offset the US individual's US tax liability is sufficient to offset such US tax liability, then no incremental US tax is paid even though the anti-deferral rules required an income inclusion. In such a situation, a section 962 election presents an opportunity to eliminate the US tax imposed under the anti-deferral rules as if they never applied. Thus, notwithstanding the fact that an actual distribution will be taxed again in the US when paid, if the taxes paid by Canco can fully offset the US tax liability under the anti-deferral rules, then a section 965 election keeps the US individual in the same position as if the anti-deferral rules had never required an inclusion.

Similar to the subpart F context, a US individual subject to the transition tax cannot use the taxes paid by Canco to offset the US tax liability unless he or she makes a section 962 election. Plenty of ideas have been considered and proposed, but most involve making a distribution or otherwise triggering Canadian tax at the shareholder level to offset the US transition tax. Thus, these ideas require an acceleration of at least a portion of the Canadian and US tax on the E & P of Canco that the US individual was deferring. In addition, the proposed regulations under Code section 965 potentially diminish the benefits of these ideas because the amount of Canadian taxes paid that are available to offset the US transition tax is limited. In contrast to these ideas, a section 962 election does not require triggering Canadian tax to offset the US transition tax.

While a section 962 election may not completely eliminate the US transition tax, it may still be beneficial and can also be used in conjunction with other ideas.

For those who will pay the transition tax on their 2018 tax return, a section 962 election should certainly be considered and can be reported on the 2018 tax return. For those who paid (or made the first instalment) on their 2017 tax return, it is not entirely clear whether a section 962 election can be made without IRS approval on an amended return; however, because the tax savings may be significant, filing an amended return to make a section 962 election should also be considered.