

A U.S. SHAREHOLDER OF A CANADIAN PROFESSIONAL CORPORATION MAY BE SUBJECT TO U.S. INCOME TAX ON PROFESSIONAL FEES

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Within the last few years, every province and territory in Canada began allowing the formation of professional corporations, and I have encountered many doctors, lawyers, and other service professionals who have taken advantage of this choice of legal entity because of its benefits in Canada. However, if more than 50 percent of the voting power or total value of the stock of the professional corporation is owned, directly or indirectly, by a U.S. citizen or U.S. resident (in which case the corporation meets the definition of a “controlled foreign corporation” or a “CFC” under the Internal Revenue Code), certain U.S. citizen or resident shareholders could be subject to some unexpected U.S. income tax consequences.

Generally, the Internal Revenue Code taxes certain U.S. citizen shareholders of a CFC at ordinary income tax rates on the U.S. shareholder’s allocable share of the corporation’s “Subpart F income,” even if the U.S. shareholder does not receive a distribution from the corporation. Subpart F income generally includes:

- Interest
- Dividends
- Rents
- Royalties
- “Personal service contract income”

Professional fees earned by a professional corporation may be considered personal service contract income and, therefore, Subpart F income subject to U.S. income tax currently at ordinary income tax rates, even if the U.S. shareholder does not receive a distribution from the corporation. Whether professional fees are considered personal service contract income is determined by looking at several factors, including whether the individual who is to perform the services is designated (by name or description) in a contract with the person for whom the corporation is providing services and whether the recipient has the right to designate the performer of the services provided by the corporation.

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A U.S. person should carefully consider the potential U.S. income tax consequences that could result from the ownership of stock in a Canadian professional corporation, which could include the application of the passive foreign investment company (PFIC) rules. I have analyzed existing structures and advised on new structuring options to avoid triggering these unexpected U.S. tax consequences. This potential tax trap comes as a surprise to many but, in certain instances, it can be dealt with.