

Tax issues of interest to the U.S. person in Canada and their advisors

Date: January 16, 2019

STEP: Toronto CONNECTION Branch Newsletter

U.S. persons who are shareholders of Canadian corporations which are deemed controlled foreign corporations under the Internal Revenue Code will be subject to the transition tax as set out in section 965. The section 965 tax was aimed at forcing large companies such as Apple to repatriate large sums of cash (retained earnings) held outside of the U.S. back to the U.S. In Apple's case, the Company would be remitting retained earnings to a U.S. shareholder corporation. A foreign corporation remittance to a U.S. corporation is subject to a toll tax of 15.5% on cash and 8% on all other assets. Problematic for the Canadian shareholder is that there is no U.S. corporation to repatriate its cash and assets to. As such, an individual would be subject to much higher rates. According to Amanda Athanasiou, *Toll Charge is Taking Individuals by Surprise*, Tax Notes International, February 19, 2018, an individual would be subject to a toll rate of 27.3% for cash repatriated in 2018 and 14.1% for non-cash.

The favourable tax treatment to a U.S. corporate shareholder as compared to tax treatment of a U.S. individual shareholder has many practitioners considering the section 962 election under the Code which allows an individual US shareholder to be treated as if he or she was a corporate shareholder. This election, which can be made annually, also entitles the individual to claim a deemed paid foreign tax credit under section 960, which would otherwise be unavailable. Section 965 and IRC §951A are both part of subpart F of the Code and an argument can be made that an IRC §962 election is available to a US individual shareholder faced with the transition tax and with GILTI after the transition tax. On September 18, 2018 the U.S. Tax Court released *Barry M. Smith and Rochelle Smith v. Commissioner of Internal Revenue*, 151 T.C. No. 5 bolstering this thought. In the Smith case, the Court considered the section 962 election but not in a section 965 but in a regular subpart F context. The decision provides a sound review of the section 962 election. The Court explains that the section 962 election "do[es] not create hypothetical corporations or change real world facts. They simply provide a mechanism that enables an individual U.S. shareholder to elect what he or she may deem more desirable tax treatment".

In the Smith case, the CFCs at issue were based in Hong Kong and in Cyprus. The U.S. does not have a tax treaty with Hong Kong but it does have one with Cyprus. However, the Cyprus Treaty was not applicable as the Cyprus entity did not meet the LOB clause of the treaty. The taxpayers in Smith elected to treat their Hong Kong CFC and Cyprus CFC as corporations pursuant to section 962. The issue was whether the distributions from the CFC now being treated as a domestic corporation could receive qualified dividend treatment pursuant to IRC §1(h)(11)(B)(i)(I) instead of being accorded ordinary dividend income treatment at a higher tax rate. A U.S. shareholder of a Canadian corporation would meet the IRC §1(h)(11)(B)(i)(I) test which accords qualified dividend treatment to dividends from domestic corporations or from “qualified foreign corporations”. Section 1(h)(11)(C) defines a “qualified foreign corporation” as a corporation incorporated in the United States or a corporation eligible for benefits of a comprehensive income tax treaty with the United States. Notice 2006-101 provides that Canada meets the requirement of IRC §1(h)(11)(C).

The section 962 election is therefore worth considering for those U.S. persons in Canada deemed to be US Shareholders. For those who have already filed their 2017 tax returns, consideration should be given to filing an amended return with a section 962 election.

[Treasury, IRS Announcement – Making large gifts now won't harm estates after 2025](#)

The 2017 Tax Cuts and Jobs Act temporarily increased the base amount of the lifetime gift and estate tax from US\$5 million to US\$10 million to 2025. After 2025 the base amount of the life time gift and estate tax exemption will drop back to US\$5 million. There was concern amongst advisors that the estate tax after 2025 could apply to gifts exempt from gift tax prior to 2025. On November 20, 2018, [the Treasury and the IRS announced](#) that individuals taking advantage of the increased gift and estate tax exclusion amount would not be adversely affected after 2025 when the exclusion amounts drops to pre-2018 levels. The Treasury and the IRS also announced the proposed regulations implementing the increased exemptions. The proposed regulations also amend the existing regulations to provide that in the case of decedents dying or gifts made after December 31, 2017 and before January 1, 2026, the increased base amount to US \$10 million is adjusted for inflation.

US spouses share an unlimited marital deduction for federal estate tax purposes and do not have to rely on the increased life time estate tax exemption between each other. However, the estate of the last to die will bear the burden of the tax levied on the entire estate. Advisors have to remember that upon the first to die, one must elect on the estate tax return of the first spouse to die that the surviving spouse will be using the unused estate tax exemption upon his or her death. IRS Form 706, *United States Estate and Generation-Skipping Transfer Tax Return* will have to be filed by the surviving spouse declaring that the deceased spouse's available exemption be added to the surviving spouse' exemption. Given that for 2018 the base amount adjusted for inflation of the estate tax exemption is \$11.2 million, care should be taken that the increased estate tax exemption is ported correctly upon the death of one U.S. spouse prior to 2026 to the surviving spouse.

The annual gift exclusion amount for 2019 remains at \$15,000. A U.S. person may gift \$15,000 to as many persons he or she wishes to.

[Excise Tax on premiums on policies issued by non-U.S. insurance companies](#)

Recently, there have been many queries about the 1% excise tax levied by the U.S. under section 4371(2) of the Code on premiums, paid to non-U.S. insurance company, on a policy of life, sickness or accident insurance of a U.S. citizen or a U.S. resident.

This is not a new tax and goes back to the 1970s when it was known as a stamp tax. The section 4371 excise tax is an area often overlooked by advisors who are conditioned to rely on the Treaty which provides an exemption from income taxation where a Canadian corporation carries on business without a permanent establishment in the U.S.

The Canadian Tax Treaty however does not provide relief to a Canadian insurer or its agents or the beneficiaries of the policy where the life insured is a U.S. person and where the Canadian insurer does not carry on business in the U.S. or does not attribute the premiums in Canada to a U.S. office. Section 4371 to 4374, the relevant provisions of the Code, are the successor to the original stamp tax levied on foreign insurance companies. The retention of this stamp tax which is now called an excise tax was necessary in the eyes of Congress in order to reduce the competitive advantage of a foreign insurer's otherwise tax-free operation. See H.R. Rep. No. 2333, 77th Cong., 2d Sess., at 61 (1942); 61 Cong. Rec. 7180-81 (1921).

The Canadian Tax Treaty does not provide relief. Article 2 which addresses what taxes are covered under the Treaty does not exempt the section 4371 excise tax. As such an argument cannot be made pursuant to Article VII of the treaty that a premium paid in Canada to a Canadian or other non-US insurer would be exempt from U.S. taxation as such insurer was not carrying on a business through a U.S. permanent establishment. Section 4374 holds that the excise tax has to be paid by any person who makes, signs, issues or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued or sold. This is a very broad scope of liability.

The IRS has stated in its [Excise Tax – Foreign Insurance Audit Techniques Guide](#) that

“while the Service will generally seek payment of the excise tax from the U.S. person making the premium payment, the Service may, in its discretion, seek payment from any of the following persons:

- The insured, sometimes referred to as the beneficiary,
- The policyholder, if that person is someone other than the insured,
- The insurance company, and
- The broker obtaining the insurance.

Regulation 46.4374-1(d) warns that any person who fails to comply with the requirements of this section with intent to evade the tax shall, in addition to other penalties provided therefor, pay a fine of double the amount of tax.

