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The Tax Cuts and Jobs Act adopted the idea that U.S. shareholders should be immediately taxed on some portions of the purely active business profits of controlled foreign corporations. In this article, the author examines how that rule, as modified by recently proposed regulations, would affect Canadian CFCs.

This article briefly considers how recently proposed regulations (REG–104464-18) on the U.S. global intangible low-taxed income rules might affect U.S.-owned Canadian corporations.

In the course of the enactment of the Tax Cuts and Jobs Act (P.L. 11597), U.S. lawmakers and the Trump administration widely claimed they had finally brought territoriality to the U.S. tax system after years of lobbying by U.S. multinational corporations. However, the new GILTI rules put that claim into question because they reduce or eliminate the benefits of the participation exemption under new IRC section 245A or of a territorial approach in general.[1]

GILTI refers to prescribed portions of the income of controlled foreign corporations from actively conducting business (and therefore not included in attributable subpart F income) that will be attributable to the CFCs' U.S. shareholders because it is derived in specified situations and is not subject to sufficient foreign taxes, according to a definition discussed below.

What types of business situations result in GILTI? From the words that make up the acronym, one would assume the impugned business is the development or other procurement of intellectual property and the licensing or selling thereof. But that (logical) assumption would be wrong. Instead, GILTI is that portion of the income of any business that may be considered to arise from its intangibles, as opposed to income arising from the business's tangible property. Statutorily, that portion is identified and measured by a simple formula. GILTI is the amount of income exceeding 10 percent of the aggregate, adjusted basis of the business's depreciable tangible property.[2]

For U.S. Corporate Shareholders

The GILTI formulas for corporate shareholders, including an inclusion rate of 50 percent (62.5 percent after 2025)[3] and credit for 80 percent of foreign tax,[4] would seem to eliminate net GILTI-related tax when the CFC's effective rate is at least 12.5 percent during the first phase of the rules.

For corporate U.S. shareholders of Canadian operating companies, there should be no net GILTI tax because Canadian corporate tax rates (combined Canadian federal and provincial) for

[1] *See* Nathan Boidman, "The U.S.'s Illusionary Turn to Territoriality," *Tax Notes Int'l*, Feb. 12, 2018, p. 619.

[2] IRC section 951A.

[3] By way of deduction under section 250(a)(i).

[4] Section 960(d).

foreign-owned Canadian subsidiaries are typically around 27 percent.[5] There are, however, numerous factors that may change the base case results and raise GILTI tax for U.S. corporate shareholders of Canadian CFCs. Those include interest and other expense allocation requirements stemming from foreign tax credit computations, multiple CFC GILTI income and loss mismatches, and mismatches arising from the requirement to measure GILTI under the tax accounting rules of both countries.[6]

For U.S. Individual Shareholders

Before the Proposed Regs

For individual owners of Canadian CFCs, the initial GILTI rules have provided mixed results — that is, direct net tax in some cases, but not in others.

A threshold aspect is whether the individual elects the provisions of section 962, which operates as follows for GILTI: The individual's tax is calculated as though a hypothetical U.S. C corporation owned the CFC, and as if corporate tax rates applied to its share of GILTI. However, the hypothetical corporation apparently may not, under current law, take the section 250 deduction noted above for U.S. C corporation shareholders of CFCs.

If the individual is not a resident of Canada (so that the Canadian CFC's domestic tax rate is around 27 percent) and does not elect section 962, the individual will include in income and pay U.S. tax on the CFC's GILTI, net of the 27 percent Canadian tax.

If the individual does elect section 962, there should be no net U.S. tax even though the hypothetical U.S. C corporation is not entitled to the 50 percent reduction. That results from applying the U.S. corporate rate (21 percent) to the pre-Canadian-tax GILTI and deducting 80 percent of the Canadian tax of 27 percent. (After 2025 there would be some slippage, but that should be eliminated by the proposed section 962 regs, discussed below.) That will also be the result if the individual is a Canadian resident and the Canadian CFC pays the 27 percent tax.

However, a Canadian CFC owned by a U.S. individual who resides in Canada can be eligible for a much lower rate of combined federal-provincial tax, a rate that will lead under current law to GILTI tax even when a section 962 election is made.

A special regime applies to Canadian controlled private corporations – a classification that requires that the corporation be governed by Canadian corporate law and not be controlled by nonresidents or publicly traded corporations. In that case, a special reduced tax (ranging up from 9 percent) applies to the first C $500,000 of business profit, subject to reduction in specified circumstances.[7] The federal component of the reduced rate is 9 percent. The provincial component ranges up from 0 percent. The rate in Quebec is reduced to 4 percent, resulting in an overall small business rate of 13 percent, 0.5 percent higher than Ontario's aggregate 12.5 percent rate.

In those cases, the section 962 election without the 50 percent deduction would see insufficient tax credits. For example, if the Ontario small business rate of 12.5 percent applies, the U.S. federal rate applied to 100 percent of GILTI would exceed 80 percent of the Canadian 12.5 percent tax (10 percent), resulting in U.S. tax for the individual equal to 11 percent of the pretax GILTI.

The Proposed Regs

On March 4 the U.S. Treasury Department issued prop. Treas. reg. section 1.962-1(b)(1)(i)(B)(3), which would extend to section 962 electors the 50 percent (37.5 percent after 2025) deduction in section 250. That would reduce the 11 percent net tax to 0.50 percent for years up to 2026, with a bit more slippage after 2025 (the net cost thereafter would be about 3.13 percent of the pretax GILTI).

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[5] *See* Boidman, "The Tax Cuts and Jobs Act: Canada-U.S. Comparative for Multinational Enterprises," *Tax Notes Int'l*, Mar. 19, 2018, p. 1169.

[6] For a discussion of the status of new regs that may address some of these issues, see Andrew Velarde, "GILTI Regs Almost to Finish Line," *Tax Notes*, May 20, 2019, p. 1231.

[7] *See* Boidman and Michael Kandev, "Canada Retreats From Its Controversial Passive Reinvestment Proposals," *Tax Notes Int'l*, Apr. 9, 2018, p. 333. The entitlement is eliminated if the investment income reaches C $150,000 or if the Canadian controlled private corporation's capital exceeds C $10 million.

Concluding Comments

While the radical U.S. GILTI regime (which the OECD and other countries are eyeing as part of additional base erosion and profit-shifting initiatives) generally will not result in any material direct tax for the U.S. shareholders of a CFC, some shareholders will require the benefits of the proposed regulations to reach that result.

U.S. individuals must also consider two other factors, which are beyond the scope of this article. There are U.S. and Canadian tax considerations of subsequent distributions by the Canadian CFC of its post-Canadian-tax GILTI. That may be particularly troublesome for U.S. individuals residing in Canada. There are also several structures for carrying on business in Canada that do not involve CFCs that may be preferable, depending on the circumstances.[8] ■

[8] For further discussion, see Boidman, "The Tax Cuts and Jobs Act: Canada-U.S. Comparative for Private Businesses and Individuals," *Tax Notes Int'l*, May 7, 2018, p. 741.