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GILTI and Canadian CFCs Under Recent Regulations

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I. INTRODUCTION

There was little in the prolonged run-up to, and debate in the business and tax community or in government circles of, the 2017 tax reform (enacted in December of that year as the "Tax Cuts and Jobs Act" (TCJA)[1] to foresee the radical new USA tax (and/or USA tax compliance/reporting burdens) that USA shareholders of controlled foreign corporations (CFCs)[2] would face on or in respect of straightforward active business operations of a CFC conducted in normal ways with third parties.[3]

That radical new tax is, of course, that imposed on a USA shareholder of a CFC in respect of that shareholder's share of the "Global Intangible Low Taxed Income" (GILTI) of the CFC. GILTI is the *excess* of the CFC's net income[4] other than that taxed as (passive) Subpart F income from any type of business income (notwithstanding the inference of the term) *over* 10% of the basis to the CFC in its tangible depreciable property used in the business.[5] And under the base rules for USA C corporate shareholders,[6] the tax is computed by applying the standard corporate tax rate (21%) to the excess of the GILTI over 50% of the GILTI for tax years to 2025 and 37.5% of the GILTI for tax years thereafter[7] and deducting as a foreign tax credit (FTC)[8] 80% of the tax the CFC pays in its country of operations.

The purpose of this article is to examine how the base rules just described operate in respect of a USA corporation carrying on business in Canada through a wholly owned Canadian corporate subsidiary (CFC), how issues they may raise may be ameliorated by the regulations issued in June, how the base rules operate where the USA shareholder (of the Canadian CFC) is an individual, and how issues for that category may be ameliorated by a proposed (GILTI-related) reg under §962 issued on March 4. As well, the latter discussion is extended to the overall Canadian and USA tax effects on distributions of GILTI by Canadian CFCs to shareholders who are individuals.[9] (For a corporate USA shareholder of a CFC, distributions of

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[1] Pub. L. No. 115-97 (Dec. 22, 2017). For relevant background, see Nathan Boidman, *How U.S. Tax Reform Affects Canada — U.S. Tax Factors*, 47 Tax Mgmt. Int'l J. 639 (Oct. 12, 2018).

[2] A "CFC" is a foreign corporation, more than 50% of the shares of which, by votes or value, are owned by USA persons (§957(a)) and a "USA shareholder of a CFC" is a USA person who owns at least 10%, by votes or value, of a CFC (§957(c)).

All section references are to the U.S. Internal Revenue Code, as amended ("the Code"), or the Treasury regulations thereunder, unless otherwise indicated.

[3] Indeed the high anticipation was that the USA would finally move to a full territorial system for CFCs so that their active business income would not be taxed by the USA either when earned or distributed. That was not to be, as discussed herein.

[4] Computed under USA (Code) tax accounting rules.

[5] §951A. For prior discussions of GILTI with a Canadian perspective, see Boidman above n. 1 and Robert E. Ward, *GILTI Until Proven Corporate: The CFC Dilemma of Individual U.S. Shareholders*, 48 Tax Mgmt. Int'l J.135 (Mar. 8, 2019), and *GILTI Until Proven Corporate: The CFC Dilemma of Individual U.S. Shareholders: New Developments*, 48 Tax Mgmt. Int'l J. 446 (Sept. 13, 2019).

[6] All discussions up to IV., below, relate to corporate USA shareholders, and the situation for USA individuals (citizens and alien residents) is dealt with in that section as well.

[7] §250.

[8] §960(d).

[9] For a corporate USA shareholder of a CFC, distributions of GILTI should simply be excluded from USA tax under the new

GILTI should simply be excluded from USA tax under the new "territorial type" rule in §245A.) To maintain focus on the fundamental factors the discussion herein deals only with wholly owned Canadian CFCs that earn active business profits none of which comprise Subpart F income.[10]

II. BASE EFFECTS FOR USA CORPORATE SHAREHOLDERS OF CANADIAN CFCs UNDER GILTI

In principle, a USA C corporation shareholder should pay no net USA tax in respect of the GILTI of a Canadian CFC. That is because the tax paid in Canada by such CFC on its GILTI would generally be in the area of 27%.[11] That rate incorporated in the basic formula for taxing GILTI outlined above would totally eliminate any net GILTI tax for a USA corporate shareholder.[12]

Under those basic rules, there is no need for additional alleviating rules as may have been announced in the June regs. But, as discussed in the next section, issues can arise that could raise net GILTI tax in respect of Canadian CFCs and where additional alleviating rules are required.

III. DO JUNE REGULATIONS RESOLVE ISSUES THAT MAY ARISE UNDER THE BASE RULES?

On June 21, the Treasury released final regulations (further to 2018 proposed regulations) and (new) proposed regulations related to GILTI.[13]

There are three significant changes, only one of which is relevant to the scope of this article (100%-owned Canadian CFCs with no Subpart F income).

First, the final regs would adopt an aggregate approach to determining the level of indirect ownership a USA person must have in a CFC owned through a domestic partnership in order to be subject to GILTI tax. The level is 10% and an aggregate approach would see that test met where, for example, the USA person owns 15% of a partnership that owns 100% of a CFC but *not* met where the person owns, say, only 5%.[14] This new rule is not relevant to this discussion.

Second, the final regs would make the foregoing partnership rule applicable to determining whether Subpart F attribution applies where a CFC that earns Subpart F is owned through a domestic partnership. This new rule also is not relevant to this discussion.

Finally, the proposed regs contain a long-sought-after rule for the GILTI regime — one featured in the Subpart F provisions — that can address issues arising under the basic GILTI rules. GILTI will not include that portion that has been subject (in Canada in our discussion) to a tax rate equal to or higher than 90% of the standard USA rate of 21% — or 18.9%. This rule (herein the "High Tax Kick Out Rule" (HTKOR)) will be available once the proposed regs are made final — that is not retroactive to any prior date.

It is not necessarily obvious why the HTKOR should be relevant in the Canadian context given the basic shield — seen above — from USA tax afforded by the pre-existing basic rules. But the following analysis indicates where it will be helpful and where it will not.

As a threshold matter, HTKOR will not be a notional rule. It will not be sufficient to say the rate for a Canadian corporation owned by a USA corporation or USA individual not resident in Canada is singular: 27% in Ontario, Quebec and many other parts of Canada, and that is higher than 90% of 21% so the USA shareholder should have no exposure to USA tax on Canco's GILTI. Instead one is looking for an actual rate paid in Canada by the CFC.

The following is a situation where the HTKOR will eliminate USA tax that could arise in a Canadian CFC situation. Suppose in a particular year the business income of the CFC is the same under tax accounting rules of both countries and there are no loss carryovers. Assume the GILTI income is $100. Assume Canco pays 27%. That ostensibly should eliminate any USA tax on the GILTI because under the base rules USA corporate shareholder includes $50 in income, at 21% — $10.50 — but has a foreign tax credit equal to 80% of 27.

The problem, however, is the possibility that, under the base rules, the FTC is ground down to zero be-

"territorial type" rule in Code §245A. For a corporate USA shareholder of a CFC, distributions of GILTI should simply be excluded from USA tax under the new "territorial type" rule in §245A.

[10] GILTI does not include Subpart F income unless it is the object of a high tax (kick out) rule discussed below.

[11] This is made up of a net 15% rate paid to the Canadian federal government and a rate which is generally in the 12% area paid to a province in which the business is carried on through a domestically defined permanent establishment. That currently is the rate or near the rate in all provinces except Nova Scotia and Prince Edward Island (16%), New Brunswick (14%), and Newfoundland (15%). The newly elected government of Alberta intends to lower that province's 12% rate to 8% by year 2022.

[12] $100 of GILTI taxed at 27% in Canada would see a foreign tax credit of, say, 80% of 27% or $21.60, which would far exceed the tax of 21% on 50% of the GILTI or even after 2025 on 62.5% of the GILTI.

[13] Final GILTI regulations under §951A (T.D. 9866) and proposed GILTI regulations (REG-101828-19).

[14] An entity approach, rejected in the final regs, would allocate GILTI to any USA partner where the foreign corporation is a CFC *vis-à-vis* the partnership. The final regs also rejected a hybrid (entity/aggregate) approach seen in the 2018 proposed regs.

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cause of expense allocation requirements under the Code. Thus far under the base rules, USA corporation pays USA tax of 21% of $50 with no FTC.

But, here is where the HTKOR will dissolve the issue (once the June regs are finalized). The rule will operate here to totally eliminate the USA tax because the Canadian tax actually paid (which is greater than 18.9%) triggers the kick out of the GILTI inclusion under §951A.

However, the following is a situation where the HTKOR will not solve an issue. CFC earns GILTI of $0 under Canadian tax accounting rules and thus pays no Canadian tax, but earns $100 of GILTI under USA (Code) tax accounting rules. There is no FTC for the basic rules. There is also no effective tax for the high-tax kick out. So USA parent pays USA tax of 21% of $50.

IV. THE SITUATION FOR USA INDIVIDUALS WHO OWN CANADIAN CFCs.

A. Overview

When a USA individual owns a Canadian CFC, the overall results, in comparison to where a USA C Corp I is the owner, are as follows:

• First, notwithstanding that individuals are not entitled to the §245A (participation exemption) exempting deduction, to which C corps are entitled, for dividends received from CFCs, individuals not only are subject to tax on a CFC's GILTI, but are so in potentially much harsher fashion than are C corps.

• Second, absent possible advantageous effects under the §962 election, discussed in IV.B., below, an individual does not benefit from the §250 (50%/37.5%) deduction or the §960(d) 80% FTC available to C corps — which (as noted above in the Canadian context) leads, in general, to no net USA tax on the Canadian CFC's GILTI. Instead, the GILTI net of Canadian corporate tax (say, $73 per $100 of pre-tax GILTI) is taxed at ordinary rates (up to 37% plus health tax) in the hands of the individual.[15]

• Third, whether there would be further tax on distributions of GILTI is discussed in IV.D., below.

B. The Role and Effect of §962 Under Current Law

An individual is entitled to elect to calculate the tax payable on a Canadian CFC's GILTI by using certain of the rules including rates applicable to C corporations. Under current law, one rule the individual cannot use is the §250 deduction.

But notwithstanding the latter, the individual should pay no net USA tax on the Canadian CFC's GILTI where either the individual is not resident in Canada or, even if she/he is, the individual's CFC is not entitled to certain reduced rates of Canadian corporate tax discussed below. In either of these cases, the overall computation would be as follows where a §962 election has been made:

- include in individual's income, 100% of GILTI before Canadian corporate tax;
- apply the corporate rate of 21%;
- deduct the FTC — 80% of Canadian corporate tax (27%) or 21.6%;
- net USA tax — nil.

This leaves the one case, where under current law, a USA individual may be exposed to net USA tax on GILTI notwithstanding that a §962 election has been made. This arises where the USA citizen is a Canadian resident whose CFC is eligible to reduce the combined rate of Canadian corporate tax it pays on up to CDN $500,000 of annual profit from the normal 27% range discussed above to the 9–13% area.[16] In such case, the USA individual's FTC will only be 80% of such lower Canadian tax. For example, if the combined rate is 12.5% (e.g., in Ontario) there will be a net USA tax of CDN $55,000 (21% – 10% (80% of 12.5%) or 11% of CDN $500,000).

As discussed in next section, that exposure should be largely eliminated by a proposed March 4 regulation.

C. The March 4 Proposed Reg for §962

On March 4, the Treasury issued a proposed reg under §962[17] that will entitle §962 electors to use the §250 GILTI deduction.

Before 2026, that would see the above illustrative net USA tax spread of 11% basically eliminated as the tax on net GILTI inclusion of 10.5% would exceed the FTC of 10% (60% of 12.5%) by only 0.5%.[18]

[15] Non-deductible state taxes may also apply.

[16] The lower rates apply to a Canadian corporation's first $500,000 where it is not controlled by non-residents or publicly traded corporations (in which case it is a "Canadian-controlled private corporation") and it meets certain limitations respecting invested capital and investment income. See sections 125 of the *Canadian Income Tax Act* and comparable provincial tax provisions

[17] Prop. Reg. §1.962-1(b)(1)(i)(B)(3) (REG-104464-18).

[18] Obviously the low Canadian rate of 12.5% would render in-

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D. Tax on GILTI Distributions to Individuals

Whether there is USA tax when GILTI, net of Canadian corporate tax, is distributed by a Canadian CFC to a USA individual shareholder, will turn on the USA tax regime applicable to the GILTI in the year it arises and the results thereof.

Where the individual has not made a §962 election and has paid full USA tax on the net GILTI, there will be no USA tax on the distribution. But there will be Canadian tax — either by way of a 15% withholding tax under article X of the Canada-USA income tax treaty where the individual is not resident in Canada, or at rates that can range up to 45% if the individual is resident in Canada. Can any such taxes be credited or deducted under the Code where there is no base USA tax liability? They cannot, unless perhaps the individual has unrelated foreign-source income either in the year such Canadian tax arises or in the year before.

Where the individual has elected under §962 and as a result no USA tax arose in the year the GILTI arose the full amount of the distribution should be a dividend (to the extent of E&P?) that is eligible for the special 20% rate (plus 3.8% health tax). But if — as in the case seen above — where the CFC qualifies for low rates of Canadian corporate tax, but the proposed March 4 reg is not yet final there is USA tax on the GILTI and that tax reduces the amount of the distribution that is treated as a taxable dividend. Again in both cases there would be the Canadian distribution taxes to be considered under the Code FTC Rules.

V. CONCLUDING COMMENT

The foregoing makes clear that while the radical addition of the GILTI rules by the 2017 TCJA violates long-standing international tax norms, in most cases where the CFC is located and operating in Canada the rules, as modified or to be modified by proposed regulations issued earlier this year, should not, in principle, impose any or any material U.S. tax on U.S. shareholders of foreign operating companies.

But the foregoing does not probe the many situations where seemingly unintended tax will arise under the GILTI rules, or the extent to which the rules catch within its limitless net both foreign businesses which have been established without regard to tax planning (e.g., a resort in a tropical weather locale which may fortuitously impose little or no tax) or those that do not traffic offshore in intangibles, the mischief which apparently spawned these rules.

And in the latter context, the foregoing also does not examine the stimulant GILTI has provided to OECD-led countries to seek to emulate its "minimum tax" crusade, as now seen in the work being done on Pillar 2.[19]

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applicable the proposed HTKOR discussed above.

[19] OECD Public Consultation Document: *Global Anti Base Érosion (GLoBE) Pillar Two*, issued November 8, 2019.

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