Ecovis Global
https://www.ecovis.com/global/ordering-rules-for-distributions-from-us-corporations-to-foreign-shareholders/

Ordering rules for distributions from US corporations to foreign shareholders

5. April 2023

Foreign owners of US corporations seek to repatriate cash from the US entity in the most tax efficient manner possible. Owners of such companies must remember US ordering rules when it comes to determining the US income tax consequences of distributing cash or other property from a US corporation to a foreign shareholder.

In many foreign countries, a shareholder with capital invested in a corporation may designate a distribution as a return of capital, which can be received tax free in many jurisdictions. Return of capital distributions are typically possible even if the corporation has earnings available to distribute. The general premise is that if a shareholder has capital invested in a company, such capital or a portion thereof should be able to be returned first, if the shareholder so desires.

Profit distribution in American tax law

Under US tax law, however, corporate distributions to shareholders are first treated as dividends to the extent of the company's current and prior year undistributed earnings and may be subject to US withholding tax. Any distribution in excess of earnings is considered a tax-free return of capital on which no withholding tax may be imposed. Ultimately, distributions more than earnings and capital result in capital gain. Foreign shareholders realising capital gain with respect to stock of a US corporation are not subject to US tax on such gain unless the corporation owns predominantly US real estate. (The taxation of the disposition of US real property interests by foreign taxpayers is beyond the scope of this article.)

These ordering rules apply whether a distribution is intended to be a return of capital by the corporation's shareholders or directors and whether company minutes specifically designate a distribution as a return of capital. The US tax classification of a distribution can carry vastly different tax consequences to foreign shareholders.

Foreign shareholders of US corporations must be aware of the complex rules governing distributions. We're happy to explain.

Mark Chaves, Partner, Co-Leader International Tax Services, Marcum LLP*, Miami, Florida, USA

Example of a distribution calculation

Assume a non-US shareholder invested USD 1 million into a US corporation and that after the first year, the Company earned USD 500,000. The shareholder wishes to take a distribution of USD 750,000 as a return of some of the capital that was invested. The board of directors' minutes declared that the entire USD 750,000 is intended to be a return of capital. Under US tax law, SD 500,000 of the USD 750,000 distribution is treated as a dividend and subject to US withholding taxes. The remainder (USD 250,000) is treated as a return of capital upon which the US does not impose a withholding tax.

Depending on a shareholder's country of residence, US withholding tax on dividends may be as much as 30 percent (or lower if an income tax treaty exists between the US and the shareholder's country). The shareholder may or may not be able to take a tax credit in the resident country for the US tax withheld.

For further information please contact:

Mark Chaves, Partner, Co-Leader International Tax Services, Marcum LLP*, Miami, Florida, USA
Email: mark.chaves@marcumllp.com

*Marcum LLP is the exclusive associated partner of ECOVIS International for accounting, tax and audit in the United States of America.