US expat business owners have a new tax to worry about

- Americans with businesses abroad are on the hook for a new levy, known as the transition tax.
- This tax applies to foreign earnings of foreign corporations: 15.5 percent on earnings held in the form of cash and cash equivalents, and 8 percent on remaining earnings
- You can pay the tax in installments over an eight-year period.

Darla Mercado | @darla_mercado
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Tax planning for Americans abroad — particularly small business owners — is about to get a little more complicated.

That's because they are now facing a new tax that only took effect at the end of 2017, known as the transition tax.

This new levy — a 15.5 percent tax on foreign earnings held in cash and cash equivalents and 8 percent on other earnings — applies to U.S. shareholders of foreign corporations, including American owners of small businesses that are based overseas.

The tax “repatriates” money these businesses keep overseas. It applies to companies’ accumulated earnings and profits going back to 1986 and determined as of the end of 2017.

Large corporations are on the hook to pay taxes on cash held in foreign countries as well, but there's some good news for them: Going forward, they will be able to take advantage of the 100-percent dividends received deduction, said Richard Tannenbaum, a CPA and leader of the global mobility practice at Mazars USA.

This means they can repatriate their dividends without paying any taxes.

"It’s going to be a push in September to understand this and get the calculations in place."

-Richard Tannenbaum, CPA, leader of the global mobility practice, Mazars USA

The development is less than positive for expats with small businesses overseas: Their cash flow might be constrained by the transition tax, and they are grappling with added complexity.

“Getting clients to understand the law is the first battle, getting them to believe you is the second battle,” said Tannenbaum.

Indeed, one of his clients, an American entrepreneur residing in Belgium, has paid 35 percent taxes on his earnings every year. Though he’s repatriated some of his earnings, most of the money related to his business is offshore.

“Many European countries have high tax rates, and their idea is that they’ve been paying 35 percent taxes all along, why pay another U.S. tax on top of that?” said Tannenbaum.

Here’s what the new levy means for expat entrepreneurs.

Cash strain

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Small businesses may keep cash available to cover their ongoing needs, so a 15.5 percent tax on that pot of assets could put owners in a bind.

"For smaller companies, especially companies set up by expatriates, this could put people out of business and be a negative life-changing event," said David McKeegan, co-founder of Greenback Expat Tax Services.

"If you knew you needed to keep $100,000 on hand for working capital, it wasn't taxed by the U.S, but now, the U.S. government is taxing that $100,000 at 15.5 percent," he said.

Additionally, the 8 percent tax on non-cash earnings would affect illiquid holdings.

The transition tax is different from the requirement that Americans report their foreign financial assets and accounts, known as the Foreign Account Tax Compliance Act (FATCA) and the Report of Foreign Bank and Financial Accounts (FBAR).

"Whereas FBAR can apply to any individual who owns a foreign account, the transition tax is for controlled foreign corporations," said Tannenbaum.

There is the potential for overlap between the two tax requirements when it comes to small business owners: An American who owns at least 50 percent of a foreign corporation already has to report the company's overseas bank accounts on FBAR, he said.

That same company could be subject to the transition tax, too.

Installment payments

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The Internal Revenue Services offices in Washington, D.C.

To help ease business owners into the new tax, the IRS is permitting them to make installment payments over the course of eight years to pay off the liability.

For the first five years, a taxpayer would pay 8 percent of the bill owed. Payments would then increase in subsequent years: 15 percent in the sixth year, 20 percent in the seventh year, and 25 percent in the eighth year.

"You definitely want to start putting the money aside now, assuming you can do so," said McKeegan.

Moving forward

Individual taxpayers had until April 18 of this year to make the first of eight annual installment payments of the new tax, but the IRS granted a reprieve: The agency will waive the late payment penalty if filers make their installment payment by April 15, 2019.

Meanwhile, business owners who filed a 2017 return without electing to pay the transition tax in installments can do so by filing an amended return by Oct. 15, 2018.

"It's going to be a push in September to understand this and get the calculations in place," said Tannenbaum.

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Darla Mercado
Personal Finance Writer