US TAX UPDATE

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1. **Introduction**

The surprise election of Donald Trump in the 2016 US presidential election brought with it the potential for comprehensive and dramatic US tax reform. Prior to Trump's election, attempts at US tax reform had essentially failed due to partisan disagreement. The last major reform of the *Internal Revenue Code* ("Code") happened in 1986. A lot has changed since then. At the conceptual level, there is agreement amongst Republicans, and even amongst Democrats, that some major reform of the tax code is required. However, the specifics and method to achieve this reform remain ambiguous.

This paper summarizes the potential US tax reform and how this reform might affect Canadian individuals and businesses. Our approach is to generally summarize current planning and identify how proposed tax reform could alter the effectiveness of this standard planning and to outline what new strategies may become available. Given the range of material covered, and the uncertainty of the eventual outcome, we take a high-level approach with a view to identifying issues conceptually and addressing practical examples rather than providing an exhaustive technical discussion of each point. We focus on three topic areas:

1. Canadian resident US citizens and their US tax exposure
2. US tax issues for Canadian businesses doing business in the US
3. Canadians investing in US real estate

Before turning to these topics, consider first the state of US tax reform and some of the proposals discussed.

2. Status of US tax reform

As of writing, comprehensive US tax reform remains a moving target and it is unclear where it will end up. Other than agreement between Republicans on the need for key aspects of reform, such as reducing both individual and corporate tax rates, there is no consensus on any details of a plan. Prior to the 2016 election, Paul Ryan, Speaker of the House of Representatives, set out an ambitious *Blueprint* that would have departed radically from the current US tax system. This included a complete revision of the US corporate tax known as a “Destination Based Cash Flow Tax” (DBCFT) that would be unique in the world. A relatively more recent statement issued by President Trump was far less well developed. It focused mostly on rate reductions as opposed to tax reform. Although the Republican Party controls all three branches of government, what plans will get adopted and when is far from certain. One of the central obstacles is that any tax plan has to be revenue neutral over a 10-year period to avoid a having to rely on the support of the Democratic party.

a. Differing approaches to US tax reform

This section attempts to summarize the competing approaches at a high level.

i. President Trump’s tax plan

The most recent expression of tax reform from the White House comes in the form of a one page summary sheet released on April 27, 2017. The focus of the plan is the reduction of the tax rate at both the individual and business level. Given the brevity of the document, apart from the provided tax rates, the mechanism by which its broadly stated goals may be achieved is unclear.

At the individual taxpayer level, the plan calls for the reduction in the number of income tax brackets from the present seven to three, at 10%, 25%, and 35% respectively. This represents a 4.6% rate reduction at the top bracket from the current 39.6%. In addition, the plan includes doubling the standard deduction, repealing the Alternative Minimum Tax, repealing the estate tax, and repealing the 3.8% Net Investment Income Tax.

At the business level, the plan involves a significant cut to the corporate tax rate from the current top bracket of 35% to 15%, implementation of a territorial tax system, and imposition of a one-time tax on the accumulated profits of US companies overseas. Any details such as how this would be paid for are left out of the plan.

ii. Speaker Ryan's Blueprint

In contrast to President Trump's relatively undetailed tax plan, the Speaker of the House of Representatives, Paul Ryan, released the much lengthier Blueprint[1] for tax reform prior to the 2016 elections. Broadly, this plan involves similar goals of tax rate reduction at the individual and business level. Additionally, the Blueprint calls for a simplification of filing requirements with the goal of lessening the burden on individual taxpayers. Below, we summarize some of its key aspects.

a. Individuals

At the individual level, the Blueprint calls for the reduction of individual tax brackets to three: 12%, 25%, and 33%. Moreover, it calls for the repeal of the Alternative Minimum Tax and estate tax. It would also increase the standard deduction but would do so by consolidating deductions

[1] *A Better Way: Our Vision for a Confident America*, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

available under current law. All deductions except for the mortgage interest deduction and charitable contribution deductions would then be eliminated. In addition, the Blueprint includes a reduction in tax on investment income by granting a 50% deduction in net capital gains, dividends, and interest income.

b. Business

The Blueprint also proposes significant changes to not only the corporate tax rate, but also to the way taxable corporate income is calculated. The corporate rate cut is simply explained: the Blueprint proposes reducing the corporate tax rate to a flat rate of 20%. Additionally, the Blueprint proposes to cut "special interest" credits and deductions, examples of which could include the special credits for ethanol production and sales found under §6426 of the *Internal Revenue Code*. The DBCFT, however, requires further explanation.

c. Destination Based Cash Flow Tax

The DBCFT functions very similarly to a value-added tax (VAT), as is popular in Europe. However, given the unlikelihood that it would be adopted, we discuss the DBCFT only briefly.[2] As Professor Allison Christians summarizes, the DBCFT is a border adjusted tax with six main elements in calculating US taxable income.[3]

i. domestic sales are included

ii. foreign sales are excluded

iii. dividends from foreign subsidiaries are exempt

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[2] Those interested in the specifics of the DBCFT should refer to Professor Wei Cui's paper, *Destination-Based Taxation in the House Republican Blueprint.* Available at: http://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1067&context=fac_pubs

[3] Allison Christians, "Idiot's Guide to DBCFT, Ryan Style," *Tax, Society & Culture Blog* available at: http://taxpol.blogspot.ca/2017/01/idiots-guide-to-dbcft-ryan-style.html.

iv. all foreign costs are non-deductible

v. net interest is non-deductible

vi. allowable domestic costs are immediately deductible (expensed)

The following diagram prepared by Professor Christians nicely summarizes the DBCFT approach[4].

Recent pronouncements by key members of the Republican party involved in the tax reform effort state that Party leadership has abandoned plans to implement the DBCFT.[5] With that said, given the unpredictability of the current administration, the DBCFT should not be ignored at least in principle.

d. Conclusion

[4] Allison Christians *supra* note 2.

[5] Speaker Paul Ryan, "Joint Statement on Tax Reform," Press Release (July 27, 2017).

At this time, there lacks sufficient agreement in both the House and the Senate on the specifics of a tax reform plan, and while Speaker Ryan's Blueprint offers more details of the results sought from tax reform, without draft legislation, it remains unclear how these may be achieved. What is nonetheless apparent is that if Republican tax reform were to succeed, it would result in a large scale decrease to the US corporate tax rate, reduction of personal income tax rates, and possibly eliminate the estate tax altogether.

Having briefly summarized the competing plans, we next turn to their application in three areas important to Canadian tax advisors and their clients.

3. Individual Canadians who are US taxpayers

The first area of focus is on individual Canadians who are US taxpayers. According to a report published by the Federal Voting Assistance Program in February 2016 prior to the elections, an estimated 661,000 eligible US voters are resident in Canada, and of those approximately 183,155 in Vancouver, BC.[6] The actual number of US citizens in Canada is likely to be even higher considering the number of US citizens in Canada who are currently "flying under the radar". This section is organized as follows:

a. Who is a US taxpayer
b. Procedural problems; annual filing requirements
c. Substantive problems
d. Catching up on overdue US tax returns

[6] *Federal Voting Assistance Program: Overseas Citizen Population Analysis,* https://www.fvap.gov/uploads/FVAP/Reports/FVAP-OCPA_201609_final.pdf.

e. Renunciation

f. Relinquishment

g. Prospects for reform

a. **Who is a US taxpayer**[7]

To understand this, it is worthwhile to briefly outline the different categories of US taxpayers who may be Canadian residents. Under the Internal Revenue Code, all "US Persons" are subject to US tax obligations. US Persons can be defined as follows:[8]

1. US "factual" residents
2. Legal permanent residents (Green card holders)
3. US citizens, whether by birth or acquisition

"US persons" are liable to tax on their worldwide income, from whatever source derived. In addition, individuals who are not "US persons" but who earn income from US sources are, in some cases, subject to US tax.

i. US "Factual" Residents

All those who meet the "substantial presence test" are considered US tax residents and subject to US tax on their worldwide income. The substantial presence test requires someone to spend at least 31 days in the United States in the current tax year **and** have a total day-count of 183 tax days in

[7] From Thomson Reuters, "Advising Canadians before the IRS," by Max Reed. Used with permission.

[8] Only individual taxpayers are identified. Outside individuals, US Taxpayers are also:

1. Partnerships created or organized in the United States or under US law or the law of a US state;
2. Corporations created or organized in the United States or under US law or the law of a US state;
3. Trusts, if a US Court is able to exercise supervision over the Trust *and* if one or more US persons has the authority to control "all substantial decisions of the Trust";

the current and two prior years. The calculation to arrive at 183 days is less straightforward than one might think. Days in the current calendar year are counted day-for-day towards the 183 number. Days in the immediately previous year are valued at 1/3rd of their total. Finally, days spent in the United States two years prior to the current year are valued at 1/6th of their total.

ii. US Legal Permanent Residents ("Green card" holders)

Green card holders, whether or not they are located in the United States, are US residents for tax purposes. Note that those who hold a US Green card remain subject to the US tax authority until they surrender their Green card to the US authorities and notify the IRS. An individual who has simply let their Green card expire does not automatically terminate their US resident status for tax purposes.

iii. US Citizens

All US citizens, irrespective of where they live, are US persons and thus subject to US tax filing requirements. The determination of who is a US citizen is not always straightforward. US citizenship can be acquired through naturalization or by birthright. Those who have acquired US citizenship by naturalization have done so intentionally. This is not necessarily the case for citizenship acquired through birthright. Consider the two ways US citizenship is acquired as a birthright: first, by having been born on US soil or second, by descent. The full rules about who is and who is not a US citizen are complex and are beyond the scope of the paper.

b. Procedural Problems: Annual Filing Requirements

As discussed above, all US persons are subject to a US tax filing requirement, whether that individual be a US citizen, Green card holder, or simply a US resident as a result of the substantial presence day count test. US citizens in Canada are generally subject only to US federal taxation, and not state taxes. This is because the states impose tax on a residency basis while the federal tax system imposes tax based on citizenship as well as residency. Additionally, the US tax-related obligations of many Canadian residents are of a procedural and compliance cost nature, rather than any actual tax payable to the US government. Given that Canadian resident US citizens are subject to Canadian taxation (federal plus provincial) by virtue of their Canadian residency and this amount is generally higher than the US federal tax rate, availability of the foreign tax credit means that most Canadian residents owe little or no annual US tax. Their foreign tax credits are sufficient to cancel out that liability.

They must, however, annually submit US tax filings. This reporting can be complicated, time-consuming and expensive. Even where no tax monies are due, there are possible penalties for noncompliance if the taxpayer does not complete the appropriate filings on time. The following chart summarizes some of the required forms and their associated penalties.

TRANSACTION	FORM REQUIRED	Penalty for Non-Filing
Ownership/Signatory Authority over a Foreign Bank Account	FinCEN Form 114 ("FBAR")	Civil penalties of USD $10,000 for each non-willful failure to file; or greater of 50% of the account balance or USD $100,000 for a willful failure. Criminal penalties of up to $500,000 and 10 years imprisonment.
Receipt of large gifts from foreign persons (including foreign estates)	Form 3520	Up to 25% of the tax-free value of the transfer
Ownership interest in a foreign corporation	Form 5471	USD $10,000 for each initial failure, with maximum USD $50,000 continual failure penalty *Statute of limitations does not begin to run for the relevant tax year until Form 5471 is filed, if required
Ownership interest in a foreign partnership	Form 8865	USD $10,000 for each failure
Transfers of certain interests in a foreign partnership	Form 8865	USD $10,000 for each failure
Transfers to a foreign trust	Form 3520	Up to 35% of the value of the transferred property
Distributions from a foreign trust	Form 3520-A	Up to 35% of the value of the distributions
Transfers of assets to a foreign corporation	Form 926	10% of the value of the property transferred, maximum USD $100,000
Ownership in and transfers of certain foreign disregarded entities	Form 8858	USD $10,000 for each failure

		*Statute of limitations does not begin to run for the relevant tax year until Form 8858 is filed, if required
Renunciants (citizens and Green card holders)	Form 8854	Various
US Citizens with specified financial assets in a foreign country	Form 8938	USD $10,000 for each initial failure, with maximum USD $50,000 continual failure penalty *Statute of limitations does not begin to run for the relevant tax year until Form 8938 is filed, if required

c. Substantive Problems

Alongside the litany of filing requirements that accompany being a US person, there are a number of areas in which the mismatch between the Canadian and US tax systems can create a substantive problem for Canadian resident US persons. The following is a non-exhaustive list of the problems most often faced by these individuals:

i. **Tax on sale of principal residence.** The US capital gains exemption on the sale of a principal residence is capped at USD $250,000 per US citizen (USD $500,000 for a US citizen married couple) while the sale is entirely Canadian tax exempt. This potentially creates a substantial excess US tax liability given the large gains which have been seen in major Canadian housing markets.

ii. **Tax on corporate reorganizations.** Canadian tax deferred corporate re-organizations are often US taxable to US person shareholders, or are subject to special requirements to qualify as tax deferred.[9] This substantially limits the estate planning opportunities available to US persons in Canada who have already built up their wealth in a business. Worse, those individuals who have implemented this Canadian planning without obtaining US tax advice could be unknowingly exposed to a significant US tax liability and penalties.

iii. **Tax on mutual funds.** Investments in Canadian mutual funds have been identified to have a risk of being subject to passive foreign investment company ("PFIC") status and the punitive US tax consequences associated therewith. See, however, *The US Tax Classification of Canadian Mutual Fund Trusts*[10] for an in-depth discussion on the classification of most Canadian mutual funds as partnerships, and therefore not PFICs under the US default classification rules. Note that the small subset of Canadian mutual funds which are organized as corporations would generally be subject to PFIC status.

iv. **Tax on investment income.** US persons who have a high amount of annual investment income may be subject to the 3.8% US net investment income tax ("NIIT") which subjects them to double tax on that income. This tax was brought into the Internal Revenue Code ("Code") as part of

[9] For further reading, see *US Citizens as Shareholders of Canadian Companies – Impact on Reorganizations and other Canadian Tax Consequences.* Canadian Tax Foundation annual conference 2016

[10] *See* Max Reed and Stephen Albers, "The US Tax Classification of Canadian Mutual Fund Trusts," (2015) *Canadian Tax Journal* 63:4, 947-89.

the *Affordable Care Act* legislation, and is imposed under Chapter 2A of the Code, separate from other income tax or employment taxes imposed under Chapters 1 and 2. For this reason, a foreign tax credit is not available to be claimed under the Code against the NIIT. However, it is arguable that either a foreign tax credit may be claimed against the NIIT under the *Canada-US Tax Treaty* or that Canadian resident US citizens may be exempt from the NIIT under the Canada-US Social Security Totalization Agreement.[11]

v. **Tax at death.** While Canada imposes a deemed disposition tax on the unrealized capital gains at the date of death, the US has an estate tax regime which imposes a tax based on the fair market value of the deceased's property. While the US $5.49 million ($10.98 million for a US married couple) estate tax exemption means that most US citizens will not be subject to estate tax, at a rate of 40%, the tax bill can be substantial for high net worth individuals. Also note that the US also imposes the estate tax by virtue of ownership of US situs property. Therefore, Canadians with real estate holdings in the US, holdings in US securities, etc. would have US tax exposure.

vi. **Tax on Canadian tax-free accounts.** Unlike RRSPs, which may be US tax deferred under the terms of the *Canada-US Tax Treaty*, other Canadian tax free accounts (e.g. TFSA, RESP) do not qualify for these same US tax benefits. A tax benefit usually remains from utilizing these

[11] Kevyn Nightingale, *Americans Living Abroad and the Net Investment Income Tax*, http://www.thetaxadviser.com/issues/2014/apr/nightingale-april2014.html.

accounts as the Canadian tax rate is generally higher, but their use may mean that there will be US tax payable as foreign tax credits will be reduced where Canadian tax is reduced. Unlike the reporting of RRSPs for which the IRS has produced specific guidelines, there is uncertainty over how these accounts should be reported.[12]

vii. **Tax on employee stock options.** Stock options are a popular form of employee compensation, especially with tech start-ups where the growth potential is high and there is much cross-border movement for employment. Unfortunately, mismatches between Canadian and US timing rules may mean a risk of double tax and a large tax bill on one side of the border where a transaction remains tax deferred on the other. A mismatch between the rules may also mean tax at ordinary income rates in one country and at capital gains rates in the other.

Employers who intend on hiring cross-border and Canadian resident US persons who are recipients of stock compensation should seek cross border tax advice to ensure that the intended tax consequences of the compensation are achieved.

viii. **Tax on business income.** Given the favorable Canadian corporate tax rates and high individual income tax rates, many Canadian resident entrepreneurs and professionals choose to operate through a corporation. Unfortunately, where these individuals are also US persons, they can easily run afoul of the US anti-avoidance tax rules. The two major prongs

[12] Max Reed and Stephen Albers, "The US Tax Classification of the Canadian RESP," (May 5 2016) *Tax Topics* 2304 (Wolters Kluwer).

of this are the controlled foreign corporation ("CFC") regime and the PFIC regime. Rules in the area are lengthy and complicated, but very briefly, the CFC regime generally applies to foreign corporations which are controlled by US persons (more than 50% ownership) and the PFIC regime to foreign corporations which are not CFCs and primarily earn passive income. The basic consequence of application of the CFC regime is a mismatch where the US shareholder has Canadian individual tax deferral on corporate income, but is personally imputed the corporate income for US purposes and thus subject to tax. The basic consequence of the PFIC regime is a substantially higher rate of US tax on distributions from the corporation or at disposition of the shares, where the gains are taxed as ordinary income (no benefit of capital gains tax rates) and an imputed interest is charged on the deemed period of income deferral through use of the foreign corporation. There are strategies available to mitigate or even eliminate these negative tax consequences, but US persons who unknowingly own CFC or PFIC shares are more than likely exposed to these negative tax consequences.

There are other substantive tax problems caused by US citizenship, but the problems summarized above are the most often encountered.

d. Catching up on Overdue US Tax Returns

For those Canadian resident US persons who are not compliant with the numerous US tax requirements enumerated above, and thus exposed to both a large number and quantum of potential penalties, there is in fact a relatively simple solution available to most of them. Coming into compliance is a an effective remedy against future US tax problems (as well as associated immigration issues). To help US citizens abroad get caught up on overdue tax returns, the IRS has a number of voluntary disclosure programs. They are:

1. The Offshore Voluntary Disclosure Program (OVDP) for US taxpayers whose non-compliance has been willful;
2. The Streamlined Foreign Offshore Procedures ("Streamlined Procedure") for US taxpayers whose non-compliance has not been willful; and
3. Procedures for reporting delinquent information returns such as the FBAR.

A full discussion of the pros and cons of each option is beyond the scope of this paper. However, the Streamlined Procedure should be reviewed briefly. The Streamlined Procedure is available to US persons residing in and outside of the United States whose failure to be US tax compliant was non-willful. The non-willful standard in the Streamlined Procedure context is more lenient than the usual reasonable cause requirement for penalty protection, and a majority of non-compliant Canadian-resident US persons should qualify. To participate in the program, a taxpayer must submit the three most recent years of income tax and information returns and six most recent years of FBARs, along with remittance of payment for any tax and interest owed.

The taxpayer must certify that the failure to file tax returns and foreign financial disclosures as well as to pay taxes in respect of these is not due to willful conduct. Taxpayers under examination, whether civilly or criminally, by the IRS are ineligible. US Persons outside the United States must not have a US domicile and must be physically outside the US for at least 330 full days in any one or more of the most recent three years for which the US tax return due date has passed.[13]

A major upside of the Streamlined Procedure is that the successful taxpayer will not be subject to "failure-to-file and failure-to-pay penalties, accuracy-related penalties, information return penalties, or FBAR penalties," unless subsequent to an audit and examination the original noncompliance is found to be fraudulent or the FBAR violation is found to be willful.[14]

After catching up and becoming compliant under the Streamlined Procedure, the taxpayer is expected to regularly file and remain compliant with tax filing and information reporting obligations. While the ongoing duty is burdensome, the US citizen can enjoy US citizenship without worry.

e. Renunciation[15]

Given the procedural and substantive tax problems faced by Canadian resident US taxpayers as discussed above, it is not surprising that many of them choose to renounce their US citizenship. Although there are strategies by which to minimize those procedural and substantive tax problems, differences between Canadian and US law, and ultimately the fact that US tax law was not designed with the non-resident citizen in mind, leave difficulties that can pose a significant barrier for Canadian resident US citizens to organize their life as they wish in Canada. As discussed above, Canadian resident US citizens are constrained in making choices of how to structure their

[13] http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States.
[14] *Supra*, note 49.
[15] Max Reed, *Tax Consequences of Renouncing US Citizenship*, originally published at http://www.advisor.ca/tax/tax-news/tax-consequences-of-renouncing-u-s-citizenship-219916.

professional lives, investment decisions, and choices regarding their estate planning, (just to name a few). Nonetheless, renouncing is a personal decision – with a number of general pros and cons.

i. *The Pros and Cons of Renouncing US citizenship*

Put simply, the pros of renunciation are:

- **Form-free living.** A US citizen is rid of the complex annual US filings.
- **Free of complex US tax rules.** There is no upside to being taxed by two countries.
- **No problems at the border**. With proper advice, most people will be able to travel to the US without issue after renouncing.
- **No taxes on renunciation.** With proper advice, most people will not have to pay taxes as a result of renouncing.
- **Protection from future legal changes.** The situation for those residing outside the US may get worse. Renouncing now insures against this risk.

On the other hand, the cons of renunciation are:

- **Loss of benefits of US citizenship.** After renouncing, it is more difficult to move to the US and it is impossible to vote in US elections, have a US passport, or benefit from US consular services.
- **Cost.** The US government charges a fee of USD $2,350 to renounce. Additionally, some individuals may face an exit tax liability.

Of these, the tax and immigration need to be discussed further. For most people, it should be possible to renounce with few tax or immigration consequences.

ii. *Renouncing without exit tax*

To renounce US citizenship without adverse tax consequences, a taxpayer must not be a "covered expatriate." Covered expatriates ("CEs") are those individuals who meet one or more of the following criteria:

- A net worth exceeding USD $2 million on the date of expatriation;
- Average annual US income tax liability for the five years preceding the year of expatriation exceeding USD $162,000;
- Failure to file correct US tax returns for the five years prior to expatriation and/or failure to file Form 8854 for the year of expatriation.

Two classes of people can renounce without worry about their assets or average annual US income tax liability: 1) those who were born dual citizens of Canada and the US, and 2) those who are under age 18.5[16]. Both exceptions require the person to have not lived in the US for more than 10 of the past 15 years. Additionally, both exceptions still require that US tax returns were correctly filed for the past 5 years. In short, to get out of the US tax system without tax issues the taxpayer must catch up on taxes.

The consequences of being a CE are expensive. They include an exit tax and future taxes on gifts and bequests by the covered expatriate to US citizens. These taxes can be expensive. Take the following example of John Doe to illustrate the exit tax:

[16] In all cases, the renouncing individual must themselves be capable of expressing their intent to renounce and understanding of the consequences of renunciation. While minors may renounce their US citizenship, the renunciation of a minor may be subject to greater scrutiny to ensure the minor's intent and understanding regarding the renunciation. A parent or guardian may not make the decision to renounce on behalf of a minor and children under the age of 16 are presumed to not have the capacity to renounce.

> Assume John Doe's assets are a house worth CAD $ 1 million that has gone up in value by $500,000, an RRSP worth CAD $800,000, and a stock portfolio worth CAD $800,000 that has increased in value by $500,000. He is a covered expatriate because his net worth is over USD $2 million, and he will be subject to US tax on a hypothetical sale of all his assets when he renounces.
>
> While the first USD $699,000 of gain would be tax free, the exit tax would capture the increase in value of the house, the stock portfolio, and would tax the RRSP as if it had been withdrawn all at once. All of this is taxed at normal US tax rates, but may not immediately be taxed in Canada. This can lead to double taxation, as the tax will be paid in Canada later on when the assets are actually sold, without a credit for the US taxes already paid.

Avoiding CE status is thus key to renouncing without tax issues. Taxpayers should take care to ensure there are no errors in their tax returns for the 5 years prior to the renunciation. Those who are not caught up may be able to use the streamlined procedure to get caught up. Few US citizens in Canada will have an average US tax liability over USD $162,000 because of the US credit for tax paid to Canada.

The asset threshold is a different matter. With house prices at record levels in many places, more Canadian resident US citizens are above the USD $ 2 million threshold. These taxpayers will have to engage in some planning so as not to be subject to covered expatriate status. One strategy may include making gifts to a spouse. Such gifts will not generally be taxed in Canada, but may reduce the US citizen's lifetime estate and gift tax exemption. This is not much of a concern as, after renouncing, a taxpayer would not have gift and estate tax exposure on non-US assets anymore (given that they will no longer be a US citizen).

Consider again the example of John Doe outlined above, but with the added twist that John's spouse, Jane, is not a US citizen. If prior to expatriating, John gifts the house to Jane, he will no longer be subject to covered expatriate status. Given that there is a lifetime exemption from tax of up to USD $5.49 million, John can be significantly over the USD $ 2 million threshold before gifting and still renounce without paying any tax. As with complex tax matters, John should get some advice before he renounces, as there are traps to avoid when making these gifts.

Next, consider the immigration risks.

iii. Renouncing without problems at the border

The "Reed Amendment" allows the US government to deny entry into the United States to someone who has renounced US citizenship for tax reasons. The risk of the amendment applying is low. There are four reasons for this.

1. The Reed Amendment applies to those renunciants who are "avoiding taxation" rather than those annoyed by the filing obligations of dual citizenship.
2. The Reed Amendment lacks regulations to guide its application and there are no details on how it should be applied.
3. The branch of the US government, the Attorney General, tasked with enforcing the amendment does not have the power to get the tax information required to make a determination that someone has renounced for tax purposes. By law, the IRS is prohibited from sharing tax information with the Attorney General.

4. Even if the taxpayer consents for the IRS to share the information, additional barriers exist. A report released on November 30, 2015 regarding the enforcement of the Reed Amendment notes that those in charge of making the determination do not have the necessary expertise to analyze complex US tax information.

The difficulty of applying the Reed Amendment is evidenced by the few times it has been applied. There have only been two documented invocations of the Reed Amendment to deny entry to an individual between 2002 and 2015, even though thousands of people renounced during this period.

As a caveat, there is still some chance of an awkward encounter at the border. A foreign passport may identify a US birthplace, which is a telltale sign of US citizenship. Because a US citizen is required under US law to enter the United States with a US passport, this may start a line of questioning regarding that person's US citizenship. But a properly prepared reply should satisfy any questions.

f. Relinquishment[17]

In addition to the renunciation process discussed above, there are a subset of foreign resident US citizens who may qualify to lose their US citizenship another way. This process is known as relinquishment. In contrast to the renunciation process which is something a US citizen elects to do presently, relinquishment refers to losing US citizenship due to a prior external event called an

[17] Max Reed, *Can Clients Ditch US Citizenship Retroactively?* originally published at http://www.advisor.ca/tax/tax-news/is-it-possible-to-ditch-u-s-citizenship-retroactively-212929.

"expatriating act." In effect, those who seek to relinquish their citizenship are seeking recognition that they are already no longer a US citizen.

It is possible – although not without tax risk – to have lost US citizenship for both tax and immigration reasons due to an "expatriating act" that occurred prior to 2004. The tax and immigration consequences of relinquishment are complex, and only summarized briefly below.

i. Common scenario

First, consider an example which is representative of many long-term Canadian resident US citizens. Caroline was born in the United States, and came to Canada in 1968 because of her ideological opposition to the Vietnam War. She became a Canadian citizen in 1978. At that time, she thought she could only hold one citizenship and that she was trading her US citizenship for Canadian. As a result, after obtaining Canadian citizenship Caroline never used any benefits of US citizenship, such as renewing her US passport or voting in a US election. However, she never got any official proof of her loss of US citizenship such as a certificate of loss of nationality (CLN).

Fast forward a few decades. As a result of their FATCA due diligence, Caroline's bank asks if she is a US citizen. She thinks not, but has no proof. The bank informs her that unless she gets a CLN, it will report her to the IRS. The trouble is, since 1978, Caroline has become financially successful. Consequently, catching up on her tax obligations to the US would be extremely expensive and potentially expose Caroline to significant penalties.

In September 2016, she goes to the US State Department to get a CLN to document her loss of US citizenship in 1978. But what is the exact date of Caroline's loss of US citizenship for both US tax and immigration purposes?

This rather common situation lends itself to an analysis of both immigration and tax issues.

ii. *Losing US citizenship for immigration purposes*

The US *Immigration and Nationality Act* (INA) sets out a variety of expatriating acts that could cause a US citizen to lose their citizenship. For Caroline, the most relevant options are "becoming a citizen of another country after age 18" and "swearing an oath of allegiance to a foreign state." Caroline technically did both these things when she became a Canadian citizen in 1978. However, due to case law which has developed in this area, in order to lose her US citizenship under either of these prongs, Caroline must also prove that she intended to lose her US citizenship in 1978 upon becoming Canadian.

Intent can be proven in two ways. First, Caroline can state that she lost her US citizenship. Second, she can point to the fact that since 1978, she has never taken advantage of the citizenship (e.g., she hasn't voted, she doesn't hold a US passport and she's never used US consular services). If she can successfully prove her intent, she would be eligible for a CLN indicating that she lost her US citizenship in 1978.

Unfortunately for Caroline, that's not the end of the story. Caroline, along with the many US citizens in a similar situation, needs to consider the possible tax consequences as well.

iii. *Losing US citizenship for tax purposes*

Under current US tax law, it's uncertain when Caroline is considered to have lost her US citizenship for tax purposes. There are two competing views:

1. The literal approach; and
2. The common sense approach.

Many experienced US tax lawyers support both views. There is no official IRS position or binding legal precedent – although clarifying this is on the IRS's to-do list. Let's look at both views.

The literal approach is based on a strict reading of the law. Since 2008, US law has set the date that a person loses US citizenship for tax purposes as the earlier of the date that he applies for a CLN at the Department of State or the date the CLN is issued. But many people in Caroline's situation never obtained such a certificate. Under the literal approach, because Caroline never obtained a CLN, she remains a US citizen until her State Department visit in September 2016. This means she would have had tax obligations to the US government for the previous 38 years – despite losing her citizenship for immigration purposes in 1978. The financial consequences would be dire.

The common-sense approach, on the other hand, relies less on the literal text of the law and more on its spirit. Among the numerous technical legal arguments in favour of this view is that courts are not supposed to interpret the law in ways that create absurd results. And the result of the literal approach would be absurd. Caroline went about her life thinking she had given up her US citizenship (and *had in fact done so* for immigration purposes), but she still has US tax obligations for 38 years after she lost her citizenship. Applying the common-sense approach means somebody in Caroline's situation would have lost her US citizenship for tax purposes at the same time she lost it for immigration purposes – in this case, 1978.

Sorting out whether the literal or common sense approach applies is ultimately the task of the IRS or a US court. Until that happens, uncertainty remains. Arguments in favour of both positions are sound, although the common-sense view is more likely than not to prevail. What should those in a situation like Caroline's do?

iv. Moving forward

Those who, like Caroline, think they lost their US citizenship prior to 2004 have three options:

1. *Obtain a CLN confirming the loss of nationality (for Caroline, in 1978) and take the position that the tax obligations terminated then.* However, getting a CLN is a public act that might invite IRS scrutiny.
2. *Do nothing and wait for any IRS inquiry or clarification prior to obtaining a CLN.* This has the advantage of not inviting IRS scrutiny as the former US citizen remains underground. The disadvantage here is the person has no formal proof. One option in this scenario is to obtain and rely on a legal opinion if the person is ever asked about US citizenship status by either a bank or the US government.
3. *Catch up on US tax returns and renounce citizenship.* This option has the least risk but the most expense. It eliminates any argument that citizenship was lost many years ago and requires the US citizen to catch up on five years of tax returns prior to renouncing to avoid a big tax bill.

Ultimately, anybody in a situation similar to Caroline's ought to seek professional advice on how to navigate the interplay between immigration and tax citizenship.

g. Prospects for Reform

Since the compliance requirements for Canadian resident US taxpayers are so onerous, and the substantive rules are often quite punitive, the default solution is often to renounce US citizenship. Our view is that any forthcoming US tax reform will not alter the situation materially for Canadian resident US citizens because:

- *There is almost no discussion of moving to residency based taxation.* While there was a brief mention of ending citizenship based taxation in the Republican Party platform[18], most discussions of tax reform do not present this as an option. There are three reasons for this. First, the US has had citizenship based taxation for 150 years and as such abandonment of it would constitute a substantial change. Second, the expat US tax community does not carry much political influence. Third, eliminating tax obligations for foreign resident US citizens brings with it polemical, and false, cries of allowing tax evasion.

- *FATCA is unlikely to be repealed.* FATCA is one of the primary causes of an increased attention to the US tax exposure of non-resident US citizens. Thus, if FATCA were repealed, the risks of non-compliance amongst Canadian resident US taxpayers may drop. Although some Republicans would like to repeal FATCA, there is limited discussion of this. Foreign financial institutions have already adapted to FATCA and so they are not motivated to press for its appeal. Domestic financial institutions are largely unaffected. Rightly or wrongly, the repeal of FATCA is associated with charges of facilitating domestic tax evasion, making it politically unattractive to do so.

- *Eliminating the estate tax.* Although the estate tax may be eliminated, this would not be a significant benefit for the majority of Canadian resident US taxpayers. The high exemption, currently USD $5.49 million or approximately CAD $6.9 million per US citizen, subjects only very high net worth taxpayers to the US estate tax.

[18] "We call for [FATCA's] repeal and for a change to residency-based taxation for US citizens overseas," Republican Party Platform 2016, pg. 13, https://prod-cdn-static.gop.com/media/documents/DRAFT_12_FINAL[1]-ben_1468872234.pdf.

- *Eliminating the 3.8% net investment income tax.* It is likely that any tax reform would eliminate the 3.8% net investment income tax. Although the NIIT currently may cause some double tax exposure for Canadian resident US taxpayers, for most the exposure is not so material. Further, there are already arguments available to mitigate the double tax exposure. This change would marginally improve the current situation of most Canadian resident US citizens.

- *Lower personal tax rates.* It is likely that any US tax reform will involve a reduction in personal tax rates. This is of limited benefit to most Canadian resident US citizens. Canadian personal tax rates are already generally higher than the US rates and so most Canadian resident US taxpayers do not pay US tax, because the US offers a credit for Canadian tax paid on Canadian source income. A reduction of US personal rates would generally result in a greater foreign tax credit carryforward to future tax years.

h. Conclusion

Forthcoming US tax reform is unlikely to improve the situation for most Canadian resident US taxpayers. Given the problems faced by these individuals, renunciation may still be an attractive option. Even high net worth US citizens may renounce without US tax exposure if they were a) born a dual Canadian/US citizen or b) make a gift prior to expatriation to reduce their net worth to below USD $ 2 million.

4. Canadian companies doing business in the US

Under the current system, because of the rate differential between the Canadian and US corporate tax rates, the goal of most Canadian companies doing business in the US is to either avoid US corporate tax exposure or minimize it through a variety of techniques. The following chart presents the rate differential under the current system.

Country	Business Income	Capital gain	Max possible rate including state/provincial rate
Canada	26%	23.8%[19]	26%
US	35%[20]	35%	47%[21]

While Canada will generally give a credit for any US corporate tax paid, the rate differential means that US corporate tax exposure ultimately represents a net tax cost to a Canadian business. Thus, it is preferable to either avoid or minimize US corporate tax exposure. This section reviews, at a high level, the following issues:

a. Threshold for US federal corporate income tax exposure

b. Compliance requirements

c. Threshold for US state tax exposure

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[19] Overly simplified. Assumes CCPC status and integration, as well as BC provincial rates.
[20] Does not include Branch Profits Tax for simplicity
[21] 35% top federal rate + 12% top state corporate tax rate (Iowa). Note that the actual combined rate is generally lower than the sum of the federal and state rate as state income tax may be deducted against federal income tax in most circumstances.

d. State sales tax

e. State corporate income tax

f. Conclusion on state tax exposure

a. Threshold for US federal corporate income tax exposure

Put simply, there is a two-step inquiry to determine whether a Canadian corporation that does business directly in the US (i.e. not through a US subsidiary) has US federal corporate income tax exposure. First, we must ask whether the Canadian corporation is engaged in a US trade or business ("USTB"). If so, the next inquiry is whether the Canadian corporation has a permanent establishment ("PE") in the United States. If a Canadian corporation has a US trade or business, but no PE, its US business profits are not subject to US taxation under the *Canada-US Tax Treaty* but it is subject to certain filing requirements discussed below. Next, consider the USTB threshold.

i. *Step One: US Trade or Business*

The term "US trade or business" is not precisely defined in the Code. Instead, case law outlines that foreign corporations are typically considered to be engaged in a US trade or business if their activity is "considerable, continuous, and regular."[22] This definition requires some unpacking. There is no objective test as to what constitutes considerable, continuous, and regular business activity; instead, it is a question of fact.[23] It is unlikely that a foreign corporation making occasional unsolicited direct sales to US customers would be considered engaged in a US trade or business.[24]

[22] *De Amodio v. Commissioner*, 34 T.C. 894 at 905; *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) at 719. *See also* Office of Chief Counsel Memorandum AM2009-010 in which analysis is set forth regarding lending activity by foreign corporations.

[23] Alan B. Stevenson, "Is the Connection Effective? Through the Maze of Section 864," (1983) 5:2 *Northwestern J. of International L. and Business* at 227; Rev. Rul. 88-3, 1988-1 C.B. 268.

[24] Linen Thread, 14 T.C. at 737 (where two sales in the United States did not constitute a "trade or business" when the US office did not solicit the business).

Activities in the US which are incidental and are not connected to the profit-producing aspect of the business also should not meet the USTB standard.[25]

A Canadian corporation which directly has activities in the US is likely to be aware of the above and to have sought advice. What many Canadian businesses may not be aware of, is that they may have an imputed USTB on the basis of the actions of their agent – even if that agent is acting in an independent capacity. In *Inverworld*, a foreign company used an independent contractor in the United States to carry on the US side of its business[26], and was found to have a USTB due to the independent contractor's activities.[27] In *Handfield*, a Canadian greeting card manufacturer was found to be engaged in a USTB for card sales made through an independent distributing agent.[28] The same principle applies to partners and partnerships: partners are presumed to be acting as agents for their partnership, and can therefore impute a USTB to their foreign partners if any partner or the partnership itself engages in a USTB.

From a practical perspective, the safe route is to always assume a Canadian corporation that does some sales into the US will be considered as engaged in a USTB, but rely on *Canada-US Treaty* protection to insulate it from US income taxation on the basis that it does not carry on business through a PE in the United States. The PE rules are discussed in the next section.

[25] *Scottish American Investment Co. v. Commissioner*, (1949) 12 TC 49 at 58-59.
[26] *Inverworld, Inc. v. Commissioner*, T.C. Memo. 1996-301.
[27] *Ibid.*
[28] *Handfield v. Commissioner,* 23 T.C. 633 (1955).

ii. Step Two: Permanent Establishment

Even if a Canadian resident corporation is engaged in a USTB, Article VII of the *Canada-US Tax Treaty* protects the corporation from US federal income tax on its business profits unless it carries on business through a PE in the United States. Put generally, there are usually three types of possible PEs: a fixed place of business PE, a dependent agent PE, and a services PE. Each is discussed in turn below.

a. Basics of fixed place of business PE

A PE is defined in Article V(1) to mean "a fixed place of business through which business is wholly or partly carried on."[29] This has both a geographic element, and a temporal element, as the terms "permanent" and "establishment" might suggest. The OECD commentary offers some guidance, suggesting that the word "fixed" means some definite spatial point.[30] The IRS has expanded on this definition somewhat, indicating that if a fixed point is not necessary to the business but that the business is effectively operated out of the United States, this too can constitute a "fixed" location.[31] The temporal element defining "permanence" is somewhat more subjective: if a fixed location is intended to be permanent, it will be a PE.[32]

b. Treaty Definitions on fixed place of business PE

The *Canada-US Tax Treaty* specifically defines a PE as including, but not limited to, the following:

- a place of management;
- a branch;
- an office;

[29] *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* ("Treaty"), article V(1).
[30] OECD Commentary, 1992 and 2005, art. 5 at para 5.
[31] Rev. Rul. 56-165, 1956-1 C.B. 849.
[32] OECD Commentary, 1992 and 2005, art. 5 at para 6.

- a factory;
- a workshop; or
- a mine, oil or gas well, a quarry or other place of extraction of natural resources.

For completeness, the *Canada-US Tax Treaty* explicitly sets out that a PE does not include:

- the use of facilities for storage, display and delivery of goods or merchandise;
- the maintenance of a stock of goods or merchandise for storage, display or delivery;
- the maintenance of a stock of goods or merchandise for purpose of processing by another person;
- the purchase of goods or merchandise for an enterprise;
- advertising, the supply of information, scientific research which have preparatory or auxiliary character to the enterprise.

c. Treaty definitions of dependent agent PE

An agent can impute a PE to a Canadian corporation that does not otherwise have one. For instance, the actions of a partnership will be imputed to all partners. Unlike under the USTB analysis, it is unlikely that a truly independent agent acting in its ordinary course of business will impute a PE to its principal. If the agent is a dependent agent, such as an employee, that has the authority to sign contracts, then the agent's PE will be imputed to the principal.

The following example should illustrate the distinction. ABC Inc., a Canadian corporation, manufactures widgets. ABC Inc. hires XYZ Inc., a US fulfilment centre to ship the widgets to its US customers. Assuming that XYZ Inc. is acting in its normal course of business, ABC Inc. should not have a PE. However, if ABC Inc. hires a Ms. D, a US resident employee to sell the widgets directly to customers and gives Ms. D the power to negotiate and sign contracts with those customers, then Ms. D will impute a PE to ABC Inc. To avoid PE status, ABC Inc. should ensure that all sales leads generated by Ms. D will be finalized and signed by a Canadian resident.

d. Service Providers

The provision of services in the US can create a PE where one does not otherwise exist if:

a) The services are performed by an individual who is present in US for more than 183 days during any 12-month period and more than 50% of the enterprise's gross active business revenues (i.e. revenues excluding investment activities) are derived from such services; or

b) The services are provided in the US for more than 183 days during any 12-month period and the services relate to the same project or a connected project for a customer who is either a US resident or who has a US PE.[33]

Note that with respect to these definitions a 12-month period is not defined according to the calendar year, but rather is a rolling period.

e. Servers

A server in the US can constitute a PE. There is a distinction between a web site, for instance, and the servers on which that web site is stored. Generally, the server will be the PE whereas the website will not (regardless of the domain name: ".ca" versus ".com," for example).[34] The Canadian company must likely own or operate the server directly in order to create a PE or have control of it. Further, the server must in fact perform business services for it to qualify as a PE.[35] Using a hosting company based in the US that is operating in its ordinary course of business will not constitute a PE.

b. Compliance requirements

A common mistake amongst Canadian companies is to simply assume that because they do not have a US PE, they have no US tax compliance obligations. This is incorrect. The US requires

[33] Treaty, Article V(9).
[34] OECD Model Treaty Commentary (July 2017): 124.
[35] OECD Model Treaty Commentary (July 2017): 126.

forms to be filed on an annual basis to claim *Canada-US Tax Treaty* benefits. Thus, a Canadian resident corporation engaged in a US trade or business should file Form 1120-F to indicate that it does not have a PE. A Form 8833 should also be filed with Form 1120-F in order to disclose a treaty based position being taken on the return. A Canadian corporation that has not filed Form 1120-F can likely catch up on overdue Form 1120-F without being denied treaty benefits. [36] There may, however, be a penalty of $10,000 per unreported item of income for a late filed Form 1120-F with an attached Form 8833.

c. Threshold for US state tax exposure

Each of the 50 states has its own set of rules that determine when it will impose tax or a filing requirement, subject to constitutional limits. The states are not bound to follow the US federal rules or tax treaties, although some choose to do so. This means that, even if a Canadian corporation has no US PE, it may nonetheless have US state corporate income tax exposure or filing requirements.

This section of the paper is only meant to serve as a very brief introduction to US state tax and to point out key areas of which to be aware. There are an estimated 10,000[37] different US state and local tax jurisdictions. Any business considering expansion into the US, particularly one which intends on having a physical presence, (even if only periodic visits of a salesperson), would be well advised to obtain specific state and local tax advice in addition to US federal tax advice.

Briefly, we will discuss imposition of state sales taxes and income taxes.

[36] *Pekar v. Commissioner* 113 T.C. 158 (1999).

[37] Joseph Henchman, State Sales Tax Jurisdictions Approach 10,000, https://taxfoundation.org/state-sales-tax-jurisdictions-approach-10000/.

d. State sales tax

Many Canadian businesses making sales of tangible goods into the US do not consider sales taxes, but this is an evolving area in the US. Close attention should be given to this area. Unlike income tax which is imposed upon the earnings of a business related to a given taxing jurisdiction, sales tax is generally a tax imposed on the consumer which the business is required to collect and remit to the taxing jurisdiction. Failure to collect and remit sales tax where required can potentially expose a business to significant tax risk, as the business is generally liable for the amount of the uncollected tax plus interest and penalties.

Traditionally, sales tax has not been an area of obvious concern. Brick and mortar retailers are obviously aware of requirements to collect sales tax, and retailers (which operate through mail or now more commonly through internet orders with no physical presence), were exempt from collecting sales tax. In *Quill*, the US Supreme Court held that North Dakota could not impose a duty on Quill Corp., an office supply company which only solicited and delivered products through mail and common carrier from out of state, to collect sales tax as this was in violation of the Commerce Clause.[38] However, the tremendous growth of internet based sales from out of state retailers has caused many states to enact laws which seek to impose a requirement on out of state retailers to collect sales tax.

Most aggressive among these is South Dakota Senate Bill 106, which imposes a requirement upon any retailer who grossed more than $100,000 in sales of tangible personal property in South Dakota or who had over 200 sales transactions in the state to collect sales tax, even if the retailer had no

[38] *Quill Corp. v. North Dakota*, 504 US 298 (1992).

physical South Dakota presence. The South Dakota law clearly violates the limits set by *Quill* and a lawsuit challenging it is headed to the South Dakota Supreme Court at the time of writing.[39] If the South Dakota law is ultimately upheld – i.e., *Quill* is effectively overturned – then the added compliance burden on Canadian businesses selling online to the US may substantially increase.

e. **State corporate income tax**

Each US state may set its own rules concerning income taxation and many states choose not to follow the federal rules and tax treaties. States which do not follow federal tax treaties include California, New Jersey, Alaska, and Connecticut, to name a few. Below the state level, local cities and counties may also impose an income tax.

Simplified, state corporate income taxation falls into three categories: i) those states that impose a net income tax, ii) those that impose a gross receipts tax, and iii) those that neither impose a net income tax nor a gross receipts tax.[40] Where a business has connections to a state which imposes either a net income tax or a gross receipts tax, that business could potentially be subject to that state's tax if it has nexus. Put simply, nexus is a minimum contacts requirement which if satisfied, begins to subject a business to tax in a particular state. The nexus requirements for each state are different.

[39] *South Dakota v. Wayfair, Inc.*, S.D. Cir. Ct., No. 32 Civ. 16-000092, notice of appeal filed 3/8/17.

[40] Only South Dakota and Wyoming impose neither an income tax nor a gross receipts tax. Nevada, Ohio, Texas, and Washington are commonly cited as states which do not impose an income but all four do impose a gross receipts tax.

Nexus is generally triggered in one of two ways: through physical presence or through economic presence. Common forms of physical nexus include the presence of an agent of the business acting in the state, including independent agents, or goods or equipment of the business being located in the state. Economic nexus is commonly triggered by some revenue threshold.

As the imposition of state income tax is generally independent of federal income tax, a Canadian business operating in multiple US states can be subject to numerous income tax filing requirements. Many states even impose a minimum tax where income tax nexus is met. Therefore, failure to keep track of state income tax requirements can result in substantial tax exposure plus interest and penalties.

Take California as an example of the potential traps in the state tax area and why ignoring them is not wise. California does not follow the US federal tax treaties. It has its own nexus rules for corporate income tax purposes. The California corporate income tax is divided into the corporation franchise tax (which applies to corporations that do business in California) and the corporation income tax (which applies to corporations that receive California source income but do not do business in California). The rate of tax for both the corporation franchise tax and the corporation income tax is 8.84%.

Although the application of the nexus laws is more nuanced, the corporation franchise tax and the corporation income tax simply demonstrate how income tax nexus may be either physical (doing business in California) or economic (earning California source income). Under current California law, a business which makes sufficient sales in California (more than $500,000 or 25% of their total sales)[41] would fall under the definition of "doing business in California." This means that a foreign business without *any* physical presence in California may owe California state corporate income tax.

Here is an example to illustrate the low threshold required for sales and corporate income tax exposure. Assume ABC Inc. manufactures widgets in Canada and has no physical presence in the US. ABC Inc. makes 205 widget sales to South Dakota and sells USD $ 1 million in widgets to California. Although ABC Inc. has no US federal tax exposure, because it does not have a PE, it must collect and remit South Dakota sales tax and pay California state corporate income tax.

f. Conclusion on state tax exposure

Subject to certain constitutional limitations, each of the 50 US states can set their own sales and corporate income tax rules and rates. These rules are separate from the federal rules. Thus, a Canadian business that makes sales into the US *must* examine its US state sales and corporate income tax exposure even if has no physical presence in the US. Failure to comply with filing and tax obligations in each applicable state can result in substantial penalties across multiple states.

g. Use of a US subsidiary

This section discusses when and how to use a US subsidiary to manage US corporate tax exposure. For Canadian corporations that have a US PE, it may be preferable to set up a US subsidiary to manage their US tax exposure rather than simply having a US branch.

i. Advantages of using a US subsidiary

[41] California R&TC section 23101.

The advantages of a US subsidiary are:

- Avoids complex branch accounting
- Avoids branch profits tax
- Transfer pricing rules apply to the subsidiary, but do not apply to a branch
- US entity useful for US payroll
- Can be financed through a mix of debt and equity
- Can deduct intercompany charges

The disadvantage of the subsidiary option is that the branch's losses are not deductible against the parent's income.

ii. Shifting income back to Canada

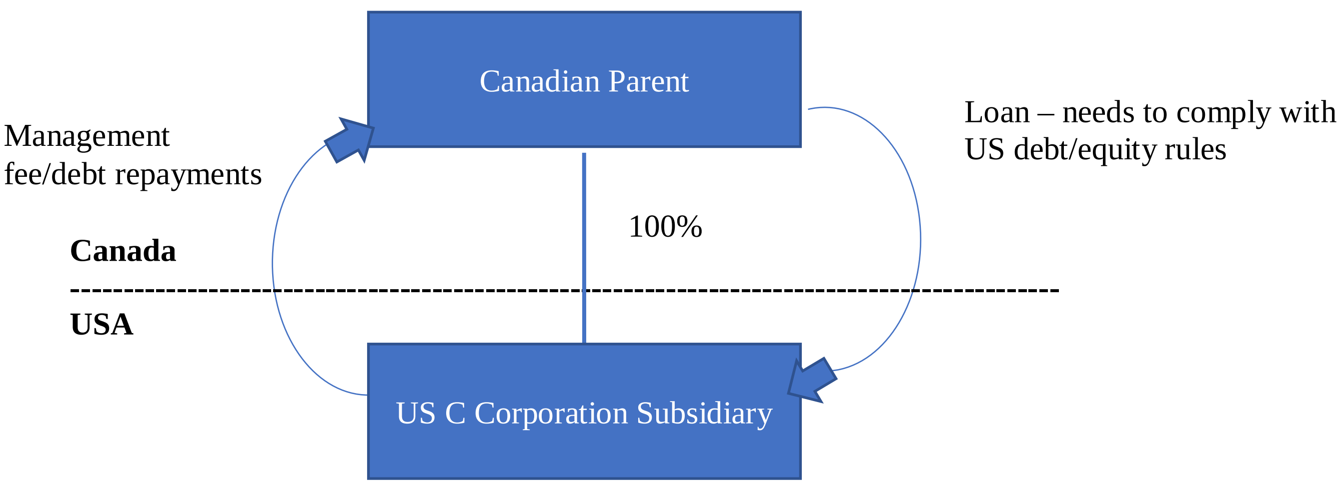
If a US subsidiary is established, it is taxable on its worldwide income at the normal corporate tax rates. These are considerably higher than the corresponding Canadian rates. Therefore, there is an incentive to have profits of the subsidiary be taxable in Canada instead of in the US. There are a number of strategies to consider:

- *The US subsidiary corporation can be funded through a mix of debt and equity.* The benefit of properly funding a US subsidiary through a mix of debt and equity is that repayments of interest and principle arising from a qualified debt obligation from the US subsidiary to its Canadian parent should not require withholding. Interest payments may also be deductible by the US subsidiary corporation if the underlying obligation qualifies as a debt instrument for US federal tax purposes and the US earnings stripping rules are met. However, there are complex US tax rules that govern whether an instrument would be classified as debt or equity that are beyond the scope of this paper. Put simply, if the debt-equity ratio is no more than 1.5:1, then interest should be deductible. In considering the use of funding a US subsidiary with a mix of debt and equity, no assumptions should be made that applicable rules would mirror what qualifies as debt for Canadian tax purposes. For instance, it is unlikely that a shareholder loan with no repayment terms would qualify as debt for US tax purposes. The analysis of whether an interest is appropriately treated as stock or indebtedness of a corporation and whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists is governed under Section 385. Final and temporary Section 385 regulations were just introduced in October of last year and set out among other substantive requirements detailed threshold documentation requirements for related party interests to be treated as debt for US federal tax purposes. Section 385 regulations must be considered where a mix of debt and equity will be used to fund a US subsidiary.

- *The US corporation's taxable income could be further reduced by paying a management fee (i.e. a deductible corporate expense) to the Canadian parent.* If successfully executed, this would constitute a US corporate tax deduction and taxable income to the Canadian parent. However, this engages complex transfer pricing rules. The transfer pricing rules seek to ensure that transactions between related parties occur at a market price so that profits may not be improperly shifted between related parties to improperly avoid or minimize US tax. Substantial potential penalties apply if the IRS determines that related party transactions do not reflect the market price. Specifically, a 20% addition-to-tax penalty applies where an IRS price adjustment results under Section 482, and the penalty increases to 40% where the misstatement constitutes a gross valuation misstatement. A business may qualify for a safe harbor under Section 482 if it obtains a transfer pricing study in accordance to methods outlined in the regulations, but a transfer pricing study requires special economic expertise and could cost in the tens of thousands, if not more.

iii. Structure chart

The following diagram illustrates the use of a US subsidiary – a very common business arrangement.



h. Changes to common planning

Under the current rates and rules, the general thrust of a Canadian corporation operating a US business is to either avoid US tax entirely by having no PE or to shift as much income back to Canada as possible. A cut in the US corporate tax rate may alter this – depending on the rate chosen. There are a number of implications including:

- *States may increase their tax rates.* State tax may become more important as states seek to fill the gap left by the federal government.

- *It will become more advantageous to have income taxed in the US rather than Canada.* This would suggest an end to the very common transfer pricing arrangement and debt financing arrangements discussed above. Many existing corporate structures will have to be revisited.
- *Canadian companies may want to shift their headquarters and taxable operations to the US.* If the US corporate rate really drops to 15%, there may be a flight south and Canadian exit tax consequences would have to be considered.
- *The US will generally be a more attractive HQ jurisdiction.* If in conjunction with lowering the corporate tax rate, the US implements a territorial tax system, it will become an even more attractive HQ jurisdiction. Currently, many US based multinational corporations have implemented complex structures to avoid US income tax on their worldwide income. With a territorial system in place where only US source income would be subject to US tax, this would no longer be a business concern.

i. Conclusion

Currently, many Canadians who choose to do business in the US rely heavily upon the benefits of the *Canada-US Tax Treaty*, namely the PE rules. Under the Treaty, a Canadian corporation with no PE in the US, i.e. no fixed location with some exceptions discussed above, would not be subject to US federal income tax. This produces a substantial tax savings when compared to operating a business through a corporation subject to US corporate tax (i.e. either a US domestic corporation or Canadian corporation with a US PE) given the much higher US corporate tax rates.

Where a US PE is unavoidable, many Canadian corporations choose to establish a US subsidiary in order to simplify the accounting requirements and also to reduce US taxable income by implementing strategies such as funding the subsidiary with debt and instituting management agreements between the corporations. However, as discussed above, such strategies are subject to complex US rules and failure to comply with these rules can result in substantial penalties. Efforts to comply with these rules can themselves be costly, such as with obtaining a transfer pricing study. This has in fact created an environment which discourages corporate investment in the US to a degree, as expansion of business in the US would likely ultimately lead to the loss of *Canada-US Tax Treaty* benefits.

US corporate tax reform would essentially reverse this calculus. A combination of a reduction in the corporate tax rate and a territorial tax system would largely eliminate these concerns.

5. Canadians investing in US real estate

The final area of focus is Canadians (who are not US Persons) investing in US real estate. There are three primary US tax factors that impact how Canadians invest in US real estate:

- US federal capital gains tax;
- US federal estate tax; and
- US federal income tax.

This section starts with a review of those tax regimes and how they compare with the Canadian tax regime. It then reviews common structures that Canadians use to own US real estate, and their impact for the taxpayer. The paper does not review the procedural aspects of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) regime.

a. US capital gains tax and income tax

The following chart outlines the applicable US federal income tax considerations to non-residents

Taxpayer	Maximum tax rate on income	Maximum tax rate on capital gain
Non-resident Individual (including trust)	39.6%	20%
Foreign Corporation	35%[42]	35%

State tax rates are in addition to this. By contrast, dramatically simplified, Canada has a system of integration so that the maximum Canadian tax rates should be more or less 47% on income and 23.8% on capital gain whether earned personally or through a corporation. A Canadian corporation would receive a credit for the US tax paid, but only to the extent of the Canadian tax imposed. Thus, the higher US tax rate would be a net tax cost. The all-in tax cost for various structures will be explored below.

b. US federal estate tax

This section outlines the basics of the US federal estate tax for non-residents, the credit available under the *Canada-US Tax Treaty*, and the procedural difficulties with the Treaty credit.

[42] Ignores potential application of 5% Branch Profits Tax

i. US federal estate tax for non-residents

The US, currently, has a gift and estate tax. The estate tax applies to non-residents of the United States who die while owning US "situs assets." US situs assets include stock in US corporations, debt obligations of US persons and US governmental entities (with certain broad exceptions), real property located in the United States, tangible personal property located in the United States, and contractual rights enforceable against US persons. Generally, only $60,000 of a US non-resident's US situs assets are exempt from US estate tax. However, Canadian residents are eligible for a larger exemption through the Treaty.

ii. Basics of the Treaty credit under the Canada-US Tax Treaty

Canadian residents are subject to US estate tax on their US property only if the fair market value of their worldwide assets (including life insurance proceeds) exceeds the US estate tax credit equivalent (the "Exemption"). The amount of the Exemption is currently US $5.49 million, indexed to inflation. The Treaty allows a Canadian resident a portion of the Exemption based on a fraction. The applicable fraction is determined by dividing the date of death value of the US property owned by the decedent by the date of death value of worldwide assets (calculated using US tax principles not Canadian tax principles):

Exemption x (Value of US Property ÷ Value Worldwide Assets)

Therefore, if at death the value of a taxpayer's US property is USD $1,000,000 and the value of his/her worldwide assets is USD $8,000,000, then they will be subject to US estate tax on the difference between $1,000,000 and the eligible amount of an exemption $686,250 [$5.49 million x ($1,000,000 ÷ $8,000,000)], or $313,750. The effective US estate tax rate is 40%. The US tax payable would therefore be $125,500 (40% x $313,750).

However, if the total value of the estate is less than US $5.49 million, then there should be no US estate tax exposure under the Treaty. Additionally, if a spouse leaves property to their surviving spouse, then that property is eligible for twice the US estate tax exemption. However, when the surviving spouse later passes away, the property is only eligible for the individual credit.

iii. Problems with the treaty credit

Taking the Treaty credit requires filing Form 706-NA. If it is not filed within 9 months of death the Treaty credit will be denied. While an extension for the filing of the Form is possible, there is no extension for payment of estate taxes due. Filing the Form requires detailed information and valuations of all assets in the estate according to US tax principles. This includes not just US situs assets, but rather, all assets in the estate. Late-filing of the Form, or undervaluation of estate assets, can result in onerous penalties.

Additionally, failure to file Form 706-NA would result in the estate beneficiaries inheriting the US property with a basis of zero. This would bar them from claiming any US tax depreciation deductions on the property and would result in the entire sales price being classified as a capital gain for US tax purposes when the property is sold. Therefore, while a Canadian resident has additional protections against the US estate tax under the Treaty, there remain a number of potential pitfalls whereby the Canadian resident's death can produce substantial US tax liabilities. Ultimately, if the estate tax is repealed as per the Trump proposals, this would eliminate all of these pitfalls. However, while it remains in force, Canadian residents who own US situs assets should be careful to organize their affairs in such a way as to allow for the timely filing of Form

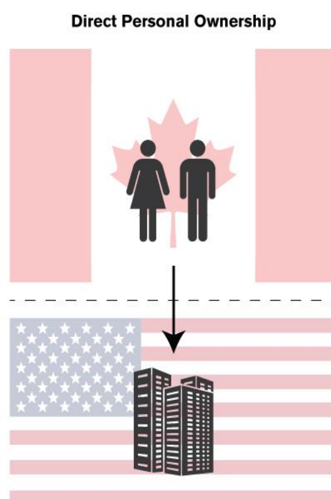
706-NA. Alternatively, a Canadian resident may invest in US situs assets through a structure which would not be subject to US estate tax at their death.

c. <u>Overview of different ownership structure options to invest in US real estate</u>

What follows is an overview of the pros and cons of each structure to invest in US real estate.

i. Direct Personal Ownership

Perhaps the simplest structure possible is direct personal ownership. There is no double taxation, as income flows directly to the owner. Furthermore, individuals benefit from a preferential US capital gains tax rate.



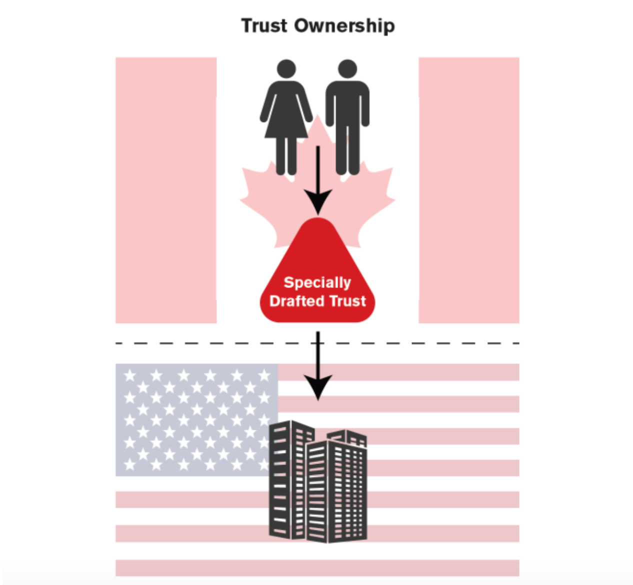
Consider the downsides of personal ownership. There is no probate or estate tax protection, aside from the general Treaty rules. Additionally, a direct personal owner must file US taxes personally. Lastly, the main deterrent for personal ownership of US real estate is the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Though a detailed analysis of the FIRPTA rules is beyond the scope of this paper, generally a buyer must withhold 15% of the sale price of the real estate in question and the Canadian resident would have to later apply for a refund.

The general tax rates applicable for personal ownership are as follows:

Income, if any (for example, rent)	47.7%
Capital Gains	23.8%
Obligation to File US Returns?	YES
Estate Tax Exposure?	YES

ii. Trust

It is possible to set up a specially drafted trust through which to own US real property. Note that a typical Canadian family trust would not work as that would still result in US estate tax exposure. The precise mechanics of the trust are complex and are described elsewhere.[43]



[43] Selected Issues for Canadians Holding and Disposing of US Vacation Property Carol A. Fitzsimmons, Philip Friedlan, and Adam Friedlan, Canadian Tax Foundation, Ontario Tax Conference, 2015

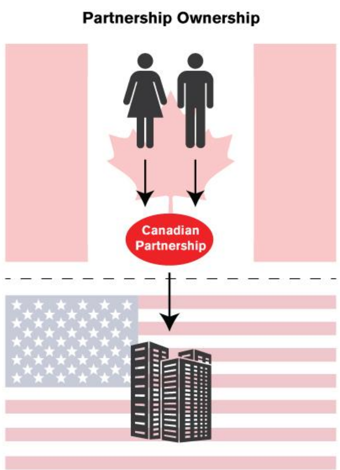
When drafted properly, a specially designed trust can block the US estate tax. Additionally, it entails the lowest capital gains rate in Canada and the US, and the annual tax returns are simple by comparison to many of the other possible structures.

The major downside of the trust option is that it is difficult to use once a contract to purchase real estate has been entered into or for real estate already owned. Additionally, to achieve protection from the US estate tax, the person who contributes the property generally must give up control of the property. Further, the trustee's powers must also be limited. Finally, it is unclear how much liability protection the trust affords, making it suboptimal for rental property ownership.

The following chart summarizes the integrated Canada and US tax rates of the trust option:

Income, if any (for example, rent)	47.7%
Capital Gains	23.8%
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

iii. Canadian Partnership



A Canadian partnership can be used to own US real estate. The Canadian partnership may own the real estate directly, or may own a US Limited Liability Partnership ("LLP") that owns the real estate. The advantage of adding the US LP is that there would be an entity available to seek US financing if necessary. In BC, it is possible to use either a BC LP or a BC LLP. The advantage of the LLP is that it has fewer compliance requirements than the BC LP does.

The advantages of the partnership structure start with the fact that it, unlike direct ownership or ownership through a trust, provides liability protection to the owners of the property. This can be very helpful with rental real estate. Additionally, unlike the trust option, no loss of control is required. As far as the estate tax is concerned, on its own, a partnership provides reasonably good (though not perfect) estate tax protection. Following the death of a partner, an election can be made to strengthen the estate tax protection. Finally, the partners benefit from the lowest possible capital gains tax rates on the sale of the asset in both Canada and the US. Annual income is also taxed in the most efficient manner possible.

The downsides of the Canadian partnership option are that, as the law is somewhat unclear in this area, the partnership option may not provide perfect US estate tax protection. The election to provide perfect estate tax protection must be made within 75 days of the death of one of the partners. From an accounting perspective, the annual accounting fees are usually higher for the partnership option than the other options and the partnership may have to withhold US income tax on distributions to non-US partners.

The following chart summarizes the highest integrated Canada and US federal tax rates of the partnership option:

Income, if any (for example, rent)	47.7%
Capital Gains	23.8%
Obligation to File US Returns?	YES
Estate Tax Exposure?	POSSIBLE, but UNLIKELY

iv. *Hybrid Canadian Partnership*

A Canadian partnership may elect under US tax rules to be taxed as a corporation while remaining a partnership in Canada. Again, either a BC LP or BC LLP can be used.

The advantages of this option include both protection from the US estate tax without any time sensitive election at the death of one of the partners and lower total capital gains tax than under the corporate option (below).

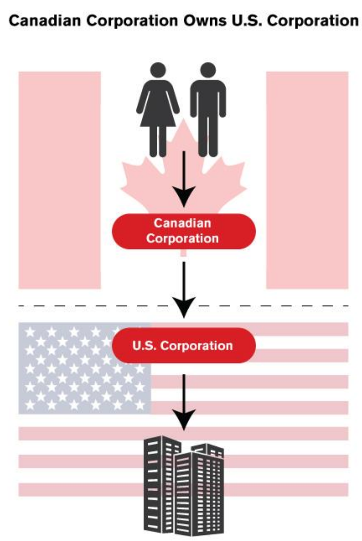
The disadvantages are substantially higher capital gains tax rates relative to the partnership or trust options, that it is expensive to set up, and it has high annual compliance costs.

The following chart summarizes the integrated Canada and US federal tax rates of the hybrid partnership option:

Income, if any (for example, rent)	47.7%
Capital Gains	35%
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

v. Canadian Corporation that owns a US corporation

The final option is to use a Canadian corporation that owns a US corporation that in turn owns the real estate. The following graphic demonstrates this structure:



The advantages to this are both perfect protection from the US estate tax and excellent liability protection, and well as relatively simple annual filings in the United States.

The downsides include a substantially higher capital gains tax relative to the other options and the fact that the company cannot own property that is personally used by shareholders. Thus, for a vacation home, this structure is not ideal.

The following chart summarizes the integrated Canadian and US federal tax rates of a Canadian corporation that owns a US corporation:

Income, if any (for example, rent)	~60%
Capital Gains	~60%
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

d. Restructuring existing ownership to avoid the US estate tax

Many Canadian residents directly own US real estate and will want to restructure ownership to avoid the US estate tax upon their passing. While this is a very complex area, there are two very common options. First, US real estate can generally be transferred to a Canadian partnership or corporation without triggering capital gains tax. This may entail a local property transfer tax, but this will be significantly less than the possible estate tax exposure. Second, US real estate owned personally can be sold to a specially drafted trust at fair market value in exchange for a promissory note. This is a particularly good strategy if there is no accrued gain on the real estate.

e. Traps to avoid when investing in US real estate

It is worthwhile to briefly review some of the traps to avoid when investing in US real estate.

- *Assuming a normal Canadian family trust will provide the desired estate tax protection.* Many Canadian residents are simply told that a trust is the preferred method of investing in US real estate. They, perhaps logically, assume that a garden variety Canadian family trust will do the trick. Unfortunately, with almost all normal Canadian family trusts the trustee will have what is called a "general power of appointment" which means that when the trustee passes away, the trustee will be subject to the US estate tax exposure on the underlying US assets.

- *Using US LLCs*. An LLC is usually a flow through entity for US tax purposes, but is not for Canadian tax purposes. This is a function of the fact that a US LLC may elect its method of taxation (normally this is used to elect a flow through model, taxable in the hands of the shareholder). In Canada, an LLC is a foreign corporation and shareholders are subject to tax as such.[44] This leads to all kinds of problems including: double tax exposure on distributions, potential Canadian corporate tax exposure if the LLC is managed from Canada, FAPI, and US estate tax exposure. While a full explanation of these issues is beyond the scope of this paper, it is an accurate summary that a Canadian resident individual or corporation should *never* own US real estate through an LLC.
- *Using US LLPs or LLLPs*. CRA has recently classified several US LLPs and LLLPs as corporations for Canadian tax purposes. This means that they should be avoided for many of the same reasons as US LLC. CRA has recently issued an administrative grandfathering, whereby the LLP or LLLP will be treated as a partnership provided it was formed before April 26, 2017 and all members have always taken consistent positions on tax treatment and entity classification, the entity has not had a significant change in membership or activities, and the entity is not used to facilitate abusive tax practices.[45]
- *Joint tenancy*. US tax law assumes that property owned in this way is 100% included in the gross estate of the first joint tenant to pass away. If this presumption is not rebutted with evidence, eventually the entire property would again be included in the estate at the second death. This means twice the estate tax exposure and twice the cost of filing Form 706-NA along with the associated problems mentioned above.

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[44] *T.D. Securities USA (LLC) v The Queen* 2010 TCC 186.
[45] *See* Nathan Boidman, Esq., Peter Glicklich, Esq., and Michael Kandev, Esq., "Canada's New Approach to US LLPs and LLLPs," (2016) 45 Tax Mgmt. Int'l J. 479.

- *US revocable trust.* These trusts are very common for US estate planning purposes as they avoid probate. For US tax purposes, since the trusts are generally disregarded entities, there is no US tax exposure upon transfer to the trust. For Canadian tax purposes, however, the trust will be recognized and unless it qualifies as a spousal trust, alter ego trust, joint partner trust, or self-benefit trust, there will be Canadian tax on the transfer. This can result in double tax. Further, the US revocable trust offers no US estate tax protection.
- *Life insurance.* Some people have the instinct to purchase Canadian life insurance to insure against their US estate tax exposure. This is problematic because personally held life insurance is includible in the gross estate for US estate tax purposes. This means that the US estate tax exposure could increase as a result of the life insurance purchase. Instead, the life insurance may be held by a life insurance trust.

f. Implications of US tax reform

Forthcoming US tax reform may change the way that Canadians invest in US real estate in the following ways:

- *Estate tax repeal*. If the estate tax is fully repealed, and that repeal is extended to non-residents, then that would cease to be a consideration during common planning. Of course, it is entirely possible that the US estate tax could later be re-instated so it may be hasty to ignore it entirely.
- *Use of corporations*. Under current rates, it is generally more expensive to use a corporate structure to invest in US real estate because of the high US corporate capital gains rate. If the US corporate tax rate is closer to, or below, Canada's, then the use of corporations may become more attractive.

6. Conclusion

Ultimately the prospects for a complete overhaul of the US tax system are very slim. It is unlikely, given the political instability since the election of Donald Trump, that the Republican Party (which controls the House, Senate, and Presidency) can agree on any kind of major legislation to this end.[46] Despite this, there are plans to release some kind of legislation in September, though there is no telling how comprehensive this legislation will be.[47] All indications from the administration point to some incremental changes.[48] The most likely outcome is a corporate rate cut. The implications for individual Canadian resident US taxpayers are quite low. For Canadian businesses, however, the effect of a corporate rate cut may encourage businesses to keep their profits in the United States for as long as possible. Finally, for Canadians who invest in US property (whether real estate or otherwise), the possible repeal of the estate tax represents a major change for only the wealthiest of investors. Regardless of the specific outcomes, advisors who have clients with US exposure would do well to keep a close eye on developments south of the border.

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[46] Brian Faler, "GOP Leaders Hope for Green Light to Release More Tax Plan Details Next Month," (August 23 2017) *Politico*, available at: http://www.politico.com/story/2017/08/23/tax-plan-details-gop-leaders-241955.
[47] David Morgan, "White House Plans to Release Tax Reform Framework in September: Sources," (August 10 2017) *Reuters Online*, available at: https://www.reuters.com/article/us-usa-tax-idUSKBN1AQ2QL.
[48] Sahil Kapur, "GOP Leaders Don't Expect White House Tax-Plan Details," (August 24 2017) *Bloomberg Online*, available at: https://www.bloomberg.com/news/articles/2017-08-24/gop-leaders-are-said-not-to-expect-white-house-tax-plan-details.