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US Tax Update

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Introduction

- The US tax code underwent its last significant overhaul in 1986
- Widespread agreement it needs an update; far less agreement about what that overhaul looks like
- Republicans control US government
- Uncertain whether they can agree on tax reform, a rate cut, or anything at all
- Tax reform/rate cut could have huge implications for Canadian businesses
- Presentation reviews reform proposals and implications
- Very high level overview – breadth not depth

Today's agenda

- Presentation tracks paper
- Review existing items; then outline how reform would change them
- Overview of different plans for tax reform
- Predictions
- Topic area 1: Canadian resident US taxpayers
- Topic area 2: Canadian companies doing business in US
- Topic area 3: investing in US real estate
- Conclusions

Competing theories of tax reform

- House Speaker Paul Ryan's Blueprint
- President Trump's one page outline

Trump's One Pager

- Literally one page
- Three individual tax brackets -- 10%, 25%, and 35%
- Eliminate estate tax
- No DBCFT; rather 15% corporate tax rate
- Move to territorial corporate tax system

The Blueprint

- 36 page comprehensive proposal
- Eliminate estate tax
- Simplify individual tax brackets - 12%, 25%, and 33%.
- Eliminate most personal deductions
- Reduce tax on investment income by 50%
- Replace corporate income tax with destination-based cash flow tax (DBCFT)
- DBCFT would have dramatic implications

Status of Reform

- "Group of six" working group statement of principles – July 27, 2017
  - DBCFT is dead
  - No concrete details
- Health care reform bill collapse made things more complicated
- Reform needs to be revenue neutral in 10 year window
- No bill, no details, no timeline

Prognostications

- No DBCFT
- No comprehensive tax reform
- Rate cuts
  - 25% corporate rate
  - Temporary repatriation holiday for foreign corporate profits
  - Substantially increase estate tax exemption
  - Lower individual rates
  - 10 year time horizon
- Blows up deficit

Topic area 1 – Canadian resident US citizens

- Who is a US taxpayer
- Problems faced by Canadian resident US taxpayers
- Renouncing US citizenship
- Implications of tax reform

Who is a US taxpayer

- A “US Person” has to file a US tax return
- A “US Person” defined as:
  - US citizen
  - US Greencard holder
  - US resident (meets the day count test)

Tax problems

- Two sets of competing tax obligations
- No upside to being taxed by two countries
- Have to file annual US tax returns – complex and expensive
- Big fines for failing to file – Pommerantz case
- Substantive problems
  - Capital gains on sale of principal residence
  - Complex corporate anti-deferral rules
  - Sometimes imperfect double taxation relief
  - 40% estate tax at death

Renouncing US citizenship

- An increasingly popular solution – **2,365 renunciations in Q4 2016 alone**
- Weigh tax and compliance cost against value of citizenship
- Consider tax and immigration aspect if wish to renounce
- Renunciation in a prior year (”relinquishment”) of US citizenship possible but complex

Renunciation: Tax considerations

- No capital gains tax upon renunciation if:
  - 5 years of returns done perfectly (a review is worthwhile)
  - Less than USD $ 2 million net worth
  - Less than USD $ $162,000 in average annual tax liability
- If born a dual citizen and live in Canada, no exit tax as long as returns done properly
- Pre-expatriation gifting – transfer to non-US spouse prior to renunciation
  - No tax (provided below gift and estate tax exemption)
  - Tax deferred in Canada

Renunciation for HNW clients

- Renunciation viable solution for high net worth clients
- Dual citizen from birth exception: net worth test not applicable
- Pre-expatriation gifting – net worth of up to USD $7.49 million
- Exit tax creditable in Canada (simple pre-payment of capital gains tax)

Immigration aspects of renouncing

- Under current law basically zero risk at US border
- Reed Amendment – 1996 law can prevent entry to US
  - No regulations
  - Bureaucratically cumbersome
  - Only applied twice in last 20 years
  - Easy to advance non-tax avoidance purpose

Implications of tax reform

- Eliminate estate tax – not so helpful given already high exemption
- Almost no discussion of eliminating citizenship based taxation
- Some discussion of eliminating FATCA -- quite unlikely
- Plight of Canadian resident US citizens very unlikely to improve
- Renunciation remains an attractive option for many

Canadian corporations doing business in US

- Rate differential
- When does a Canadian company owe US tax?
  - US trade or business
  - Permanent establishment
  - State tax exposure
- Use of a US subsidiary
  - Advantages + strategies
- Implications of reform

Rate differential

- US corporate tax rates higher than Canada
- General strategy – avoid PE or shift income back to Canada

Country	Business Income	Capital gain	Max possible rate including state rate
Canada	26%	23.8%	26%
US	35%	35%	47%

US federal corporate tax exposure

- Two stage inquiry:
  - Is there a US trade or business (USTB)?
  - Is there a permanent establishment (PE)?
  - If yes to both, then US federal corporate tax exposure
- USTB threshold is low and unclear
  - If sell regularly into US, assume USTB
  - Must file Form 1120-F annually if USTB but no PE
  - Can be back filed if missing

Basics of PE

- There is a PE if there is a fixed place of business i.e.
  - Office
  - Factory
  - Place of Management
- But not
  - A location used exclusively for marketing or storage of goods
- Pay attention to
  - A US based server can trigger PE
  - Certain agency relationships
  - Providing services for > 6 months in any 12 month period

State Tax Exposure

- State tax exposure not governed by PE rules
- Governed by nexus
- Can owe tax without physical presence in a state (economic nexus)
- **Key point – can owe state tax even if no PE**

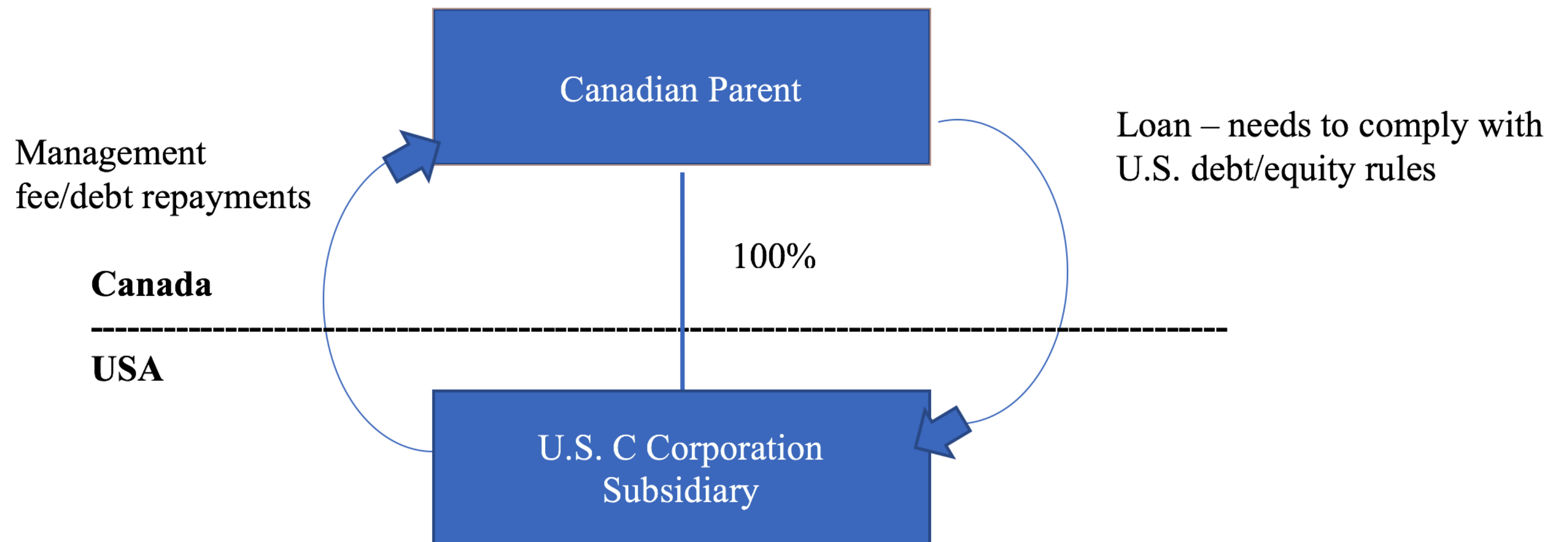
Using a subsidiary

If there is PE, a subsidiary has several advantages:

1. Avoid complex branch accounting
2. Avoids branch profits tax
3. Transfer pricing rules apply to the subsidiary, but do not apply to a branch
4. US entity useful for US payroll
5. Can be financed through a mix of debt and equity
6. Can deduct intercompany charges

Shifting profits to Canada

- Higher US tax rate provides incentive to shift profits to Canada
  - Transfer pricing (management fees)
  - Inter-company debt



Implications of tax reform

- Most likely tax reform – corporate tax rate cut
- Exact rate unknown
- If US rate = Canadian rate -> no incentive to avoid PE or shift profits back to Canada
- If US rate < Canadian rate
  - Incentive to have profits taxed in US
  - Might see Canadian companies move to US permanently
- **Once rate changes, all clients should review planning and operations**

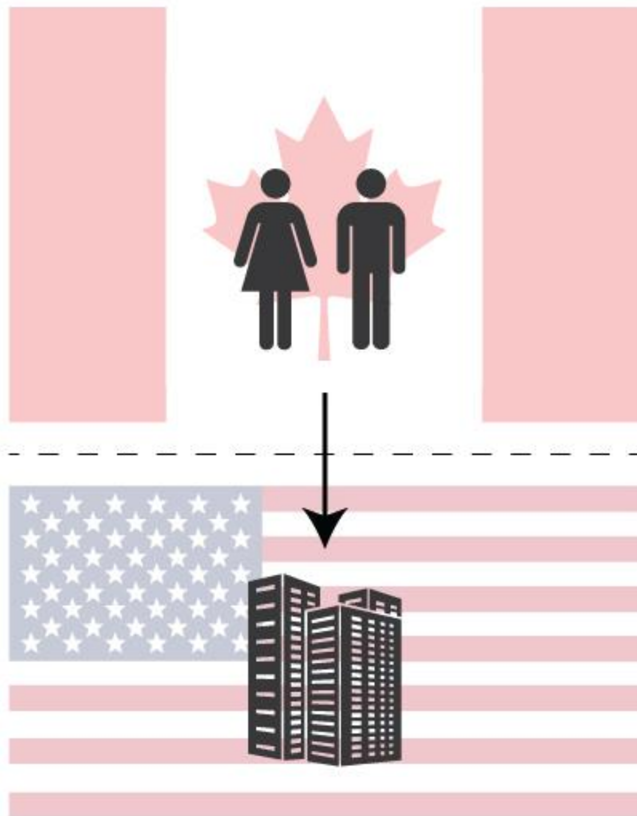
Investing in US real estate

- Applicable tax regimes to consider
- Review of current structures
  - Direct personal ownership
  - Specially drafted trust
  - Canadian partnership
  - Stacked corporations
- Traps for the unwary
- Implications of tax reform

Applicable tax regimes

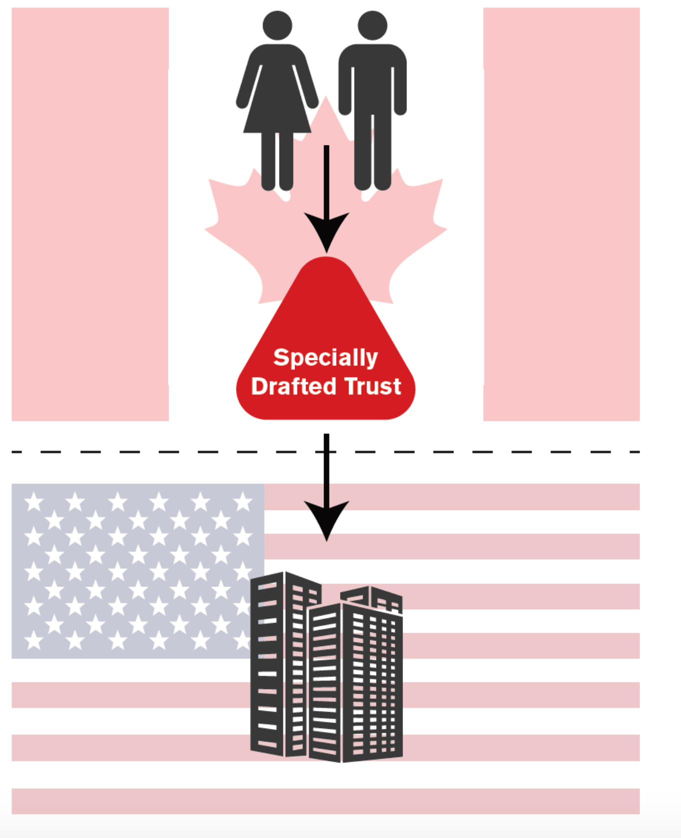
- US estate tax
  - 40% tax that applies at death of owner of real estate
  - Significant exemption in Canada-US Tax Treaty
  - Exemption requires complex paperwork after death of owner
- US income tax
  - Recall no integration in US; corporate capital gains rates higher

Direct Ownership



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

Specially drafted trust



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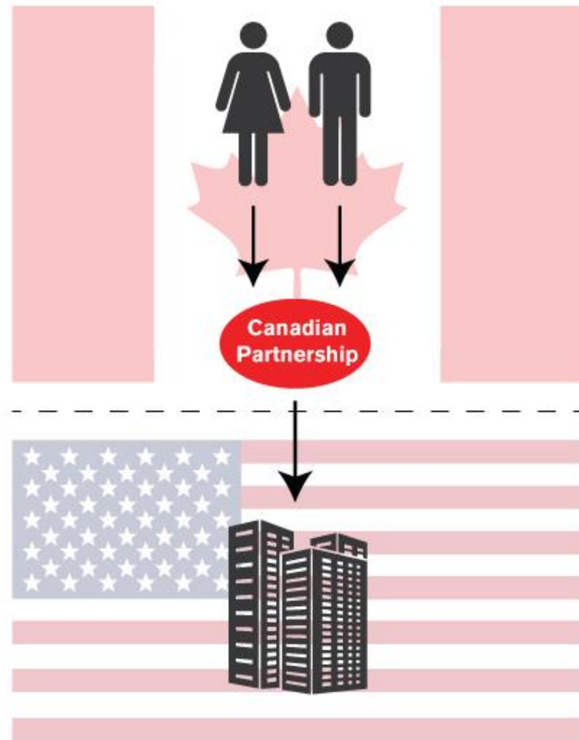
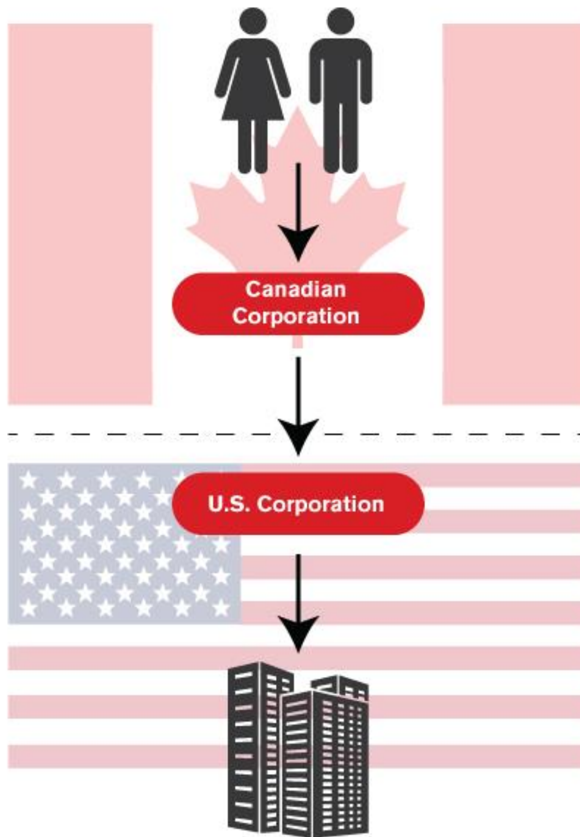
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

Canadian partnership



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

Stacked Corporations



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

Traps for the Unwary

- Avoid joint tenancy -> may lead to double estate tax
- Canadian individuals and corporations should *never* own LLCs
- Avoid US LLPs/LLLPs -> similar problems to LLCs
- Don’t own US real estate through US revocable trusts -> double tax exposure
- Most Canadian trusts do not provide US estate tax protection -> only ones that meet certain criteria

Implications of tax reform

- Estate tax repeal means structuring real estate investments is simpler
  - Always unclear if repeal is permanent or extended to non-residents
- A lower corporate tax means corporate ownership is more attractive
  - Use of Holding Companies to buy US vacation and investment property
- Lower capital gains tax rate may spur investment in US real estate

Conclusion

- Prospects for US tax reform are uncertain given political instability
- Most likely reform -> a temporary rate cut
- Implications of a rate cut in 3 key areas:
  - Canadian resident US taxpayers -> very little impact
  - Canadian companies doing business in US -> potentially transformative impact depending on exact corporate tax rate
  - Canadians investing in US real estate -> significant impact if estate tax repealed; rates lowered
- Those who advise clients with US tax issues should keep tabs on tax reform