Highlights of American Tax Reform for Canadians

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Topics to Discuss

1. Introduction: Tax Reform in U.S.A. and Internationally
2. Corporate tax rates
3. Individual tax rates
4. Estate tax
5. Limits on interest deductibility
6. Territorial system of international taxation
7. Capital gains on sales of U.S. partnership interests

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Corporate Tax Rates

- Top federal rate of 35% reduced to 21%
- In states with high state taxes, such as New York and California, the combined federal and state tax rate is in the range of 25%-27%, comparable to Canada's combined federal and provincial rates
- Accordingly, the previous cross-border tax rate arbitrage in favour of Canada is gone

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Individual Tax Rates

- Top federal rate lowered from 39.6% to 37% but "sunset" in 2025
- In states (and even in some cities, such as New York) with local income taxes, the combined top rate is in the range of 42% to 44%
- Long-term capital gains and qualified dividends still taxed at 20%
- Net investment income tax unchanged at 3.8%

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Individual tax rates on pass-through income

- U.S. individuals have used pass-through entities to earn business income and obtain limited liability protection where possible, e.g. partnership, “S” corporation, limited liability company
- Individuals can now deduct up to 20% of their domestic “qualified business income”, and 20% of their aggregate “qualified REIT dividends”
- As a result, the effective top individual tax rate on this pass-through income is 29.6% (using 37% as the top rate)
- 20% deduction expires in 8 years

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Estate/Gift/Generation Skipping Taxes

- The exemption for estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2017 and before January 1, 2026 is doubled
- For 2018, the exemption is approximately USD$11.2 million (approximately USD$22.4 million for a married couple) and is indexed for inflation each year

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Domestic And International Tax Reform

- Limit on Interest Deductibility
  - Every business (excluding business with gross receipts of USD$25 million or less and certain real property trades or businesses that elect out) can only deduct business interest equal to sum of business interest income plus 30% of adjusted taxable income (generally taxable income before (a) any of income or expense not properly allocable to trade or business, (b) business interest expense or business interest income, (c) NOL deduction, (d) 20% deduction for certain pass-through income, and (e) for years beginning before January 1, 2022, any deduction for depreciation, amortization or depletion, (i.e, before 2022 calculation is EBITDA, after 2021 it is EBIT).

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Domestic and International Tax Reform…cont'd

- Limit on Interest Deductibility
  - Follows BEPS initiative of OECD on the assumption that companies borrow excessively to reduce taxes
  - Implication may be negative for Canada, as U.S. companies shift their borrowings to subsidiaries, such as in Canada where there is no 30% limitation, thus eroding the Canadian tax base

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International Tax Reform

- Transition tax
  - Every U.S. shareholder of a "specified foreign corporation" is subject to deemed subpart F inclusion of accumulated foreign income, provided that an individual is only subject to this tax if the SFC is a *controlled foreign corporation* or a foreign corporation with at least one corporate U.S. shareholder
  - Rate of 15.5% on cash and equivalents, and 8% on other foreign assets
  - Limited foreign tax credit availability for corporations but not available for individuals

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International Tax Reform…cont'd

- Participation Exemption
  - 100% deduction for U.S. corporation (excluding "S" corporations) in respect of foreign-source dividends paid from 10% owned foreign corporation
  - Major change towards a territorial system
- Global Intangible Low-Taxed Income ("GILTI")
  - Inclusion in income of U.S. shareholder (including U.S. citizen resident in Canada) equal to excess of net controlled foreign corporation's "tested income" over deemed tangible income return
  - Excludes high-taxed income of CFC (e.g. Canadian subsidiary with tangible assets)
  - A U.S. corporate shareholder can deduct up to 50% of GILTI inclusion, resulting in an effective tax rate of 10.5%
  - Generally, the break even foreign tax to avoid GILTI is 13.125%

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International Tax Reform…cont'd

- Foreign-Derived Intangible Income ("FDII")
  - Favourable tax rate on income from exports related to U.S.-owned intangibles
  - A U.S. corporation can deduct 37% of FDII (and 21.875% after 2025)
  - FDII is income attributable to (a) sale of property to foreign persons for use outside the U.S.A., (b) provision of services to any person with respect to property located outside the U.S.A.
  - Effective tax rate on FDII is 13.125% (16.406% after 2025)
  - Likely to be challenged at WTO as export subsidy

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Capital Gains On Sales Of U.S. Partnership Interests

- For Canadians investing through an LP or LLC in a non-real estate investment in the U.S., the rules have changed
- The disposing partner will be treated as if it sold the underlying business assets and, therefore, becomes subject to tax at ordinary rates (21% for corporations and up to at least 37% for individuals) rather than long-term capital gains rates for individuals (20%)
- Choose to have Canadian corporation invest in a U.S. corporation instead

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Questions?

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