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US tax reform and the impact on cross-border individuals

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Tax Alert

The Tax Cuts and Jobs Act was signed into law on December 22, 2017. Several significant changes arose out of this tax legislation. Some changes contain sunrise provisions (i.e. delayed effective dates) while most of the individual changes contain sunset provisions (i.e. expiry dates), making planning rather difficult. All but two of the personal tax changes sunset in the year 2026. Furthermore, the law contains multiple instances where Treasury is directed to issue regulations to clarify the law. That process will take some time and result in ambiguity on some items until completed. In this alert, we outline the more significant items impacting US citizens living in Canada and Canadians investing in the US.

Key provisions for Canadians investing or working in the US

The provisions impacting Canadians investing or working in the US may not have a net tax impact given that, as Canadians, you are still taxed on your worldwide income in Canada. Increasing or decreasing US taxes impacts the amount of credit available on your Canadian tax return. If your Canadian tax rate has typically been greater than your effective US tax rate, you will likely only see a shift in which country gets their share of the tax. Managing that shift with your 2018 instalment or estimate payments becomes important.

Personal exemptions

Starting in 2018, the personal exemption has been eliminated. In 2017, the personal exemption amount was $4,050 for most non-resident filers. That meant that if you owned a rental property, you could shelter $4,050 of net rental income from federal US taxes. As part of the simplification of personal taxes, the standard deduction was increased to compensate for the elimination of the personal exemption, but the standard deduction is not available to non-resident filers. This will also impact non-resident wage earners who will not have access to an exemption amount either.

State tax deduction

Prior to 2018, state income, sales and property taxes were deducted separately, without much limitation. The bill combines these deductions and implements an annual limit of $10,000.

Sale of partnership interest

Whether or not the sale of a partnership interest by a non-resident is subject to US tax was left with some room for interpretation due to conflicting results between a Revenue Ruling and a Tax Court case. The inconsistency has been removed by codifying the Revenue Ruling which subjects the sale to US tax to the extent it relates to US effectively connected income. This is effective for sales occurring on or after November 27, 2017. Starting in 2018, a sale of a partnership interest by a non-resident is subject to a 10% withholding tax on the amount realized on the sale.

Pass-through deduction

For those Canadians that are invested in US businesses or real estate investments through partnerships or LLCs, a new deduction from income is included in the Bill. The deduction is equal to 20% of qualified business income which includes rental income, but does not include investment income such as capital gains, interest and dividends. Qualified business income is subject to a W-2 wage limitation or 2.5% of the original cost basis for depreciable assets with lives of 10 years or greater. The depreciable asset provision permits the deduction for real estate investment pass-throughs that would not otherwise have W-2 wages.

Depreciation

Personal property (e.g. furniture and appliances) used in furnishing lodging (i.e. real estate rentals) is now eligible for s.179 current year expensing. Bonus depreciation is set to 100% until 2023 when it starts a five-year phase down. Used property is now eligible for bonus depreciation.

Estate and gift taxes

The lifetime gift, estate and generation-skipping transfer tax exemption is doubled from 2018-2025 and continues to be indexed by inflation. For 2018, this limit is $11.2 million. Non-residents may be subject to US estate tax on US situs assets on death to the extent that worldwide net worth exceeds the limit. That worldwide net worth limit doubles on first death if assets pass to a surviving spouse. Access to the worldwide limit occurs as a result of a provision in the Canada-US Income Tax Treaty. US estate returns are still required to claim the increased exemption for decedents passing away with more than $60,000 in US assets. There was no change to gift taxes applicable to non-residents of the United States.

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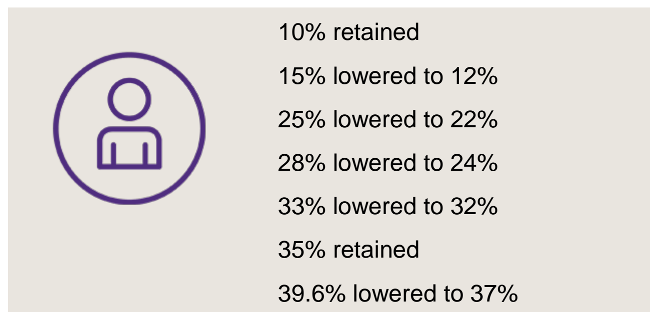
Key provisions for US citizens[1] living in Canada

The provisions impacting US citizens living in Canada will have a varying impact depending on each individual's personal situation. US citizens who control Canadian companies will see the biggest and most immediate impact. The changes outlined above, with the exception of the sale of partnership interest apply equally to US citizens and should be referenced in context with the provisions that follow.

Tax rate changes

The top tax rate is cut from 39.6% to 37% with modifications to the other tax rates. The income levels for the top brackets increase to $600,000 for joint filers and $500,000 for single filers. No changes were made to the capital gains tax rates (0, 15%, 20%), but the tax brackets do not line up exactly with the regular tax brackets. The Net Investment Income Tax (NIIT) remains.



Personal exemptions and standard deduction

As outlined above, the personal exemption has been repealed and the standard deduction increased to $12,000 for single, $18,000 for heads of household and $24,000 for joint filers. A significant amount of US citizens in Canada file as Married Filing Separate in the US. The annual filing threshold for those filers is based on gross income exceeding the personal exemption. With the repeal of the personal exemption, it appears that even $1 of gross income will now require the filing of a US tax return.

Child tax credit

Some US citizens residing in Canada with US citizen children may have already been benefiting from a refundable credit when they file their tax returns. The bill increases the child tax credit to $2,000 with $1,400 being refundable and increases the phase-out threshold to $400,000 for married filers and $200,000 for all other filers. We could see the number of filers who benefit from this refundable credit increase as a result of these changes.

Alimony

The deduction and income inclusion for alimony payments/receipts has been repealed for agreements executed after **December 31, 2018**. This may trigger a US tax payable for those expecting to pay significant alimony payments and receiving a significant deduction against their Canadian income. Depending on income levels, the amount of Canadian taxes paid may not be sufficient to offset the US payable due to the lack of deduction state side. Since this provision sunsets in 2026, it is still important to structure agreements to meet the US deductibility requirements should the payments continue past 2026 or in case the deduction is reinstated under a future government. If possible, attempts should be made to try and finalize agreements prior to December 31, 2018.

Miscellaneous itemized deductions

All deductions subject to the 2% Adjusted Gross Income (AGI) limitation are repealed (tax preparation fees, unreimbursed employee expenses and investment fees and expenses). Commissioned employees that rely on significant deductions on their Canadian return may see an impact on their US tax return as a result of the repeal of the deduction for employee expenses. This may require a renegotiation of the employment agreement.

[1] These rules may also apply to Canadians who meet the tax residency test in the US or green card holders. Consult with your advisor with respect to how these rules may apply to you.

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Alternative Minimum Tax (AMT)

AMT has limited impact on most US citizens living in Canada. The bill increases the exemption amounts by 39% and increases the income phase-out limits. With a number of the AMT adjustment items being repealed or reduced (e.g. state tax deduction) and increased exemption and phase-out limits, even fewer individuals will be impacted by this additional level of tax.

Other

The limit on cash contributions has increased from 50% to 60% of AGI, mortgage interest deductions are limited to $750,000 of home acquisition debt (down from $1,000,000), and the medical expense AGI threshold is reduced back down to 7.5%.

Estate and gift taxes

As outlined above, the estate exemption has doubled. US citizens wishing to minimize the impact of the gift and estate taxes should consider revisiting their estate plan and making additional lifetime gifts, where possible. There were no changes made to the annual gift tax exemptions.

Changes impacting business owners

Controlled Foreign Corporation (CFC)

How a Canadian corporation is classified under US tax law is an important determination for the US citizen business owner, particularly if the CFC classification is met. Under current law, the definition of a US shareholder for purposes of the CFC test is limited to a US person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote. Effective for tax years beginning after December 31, 2017, the bill expands the definition to also include a US person owning 10% or more of the total value of all shares of stock of a foreign corporation. Planning around the voting power limitation was often done to avoid the CFC classification. The expansion of the definition will mean more corporations will be CFCs.

The effective rate for individuals is not as straight-forward. At the top end would result in rates of 16.4% and 8.4% respectively.

The next two provisions rely on the classification of a CFC therefore it is very important to revisit the assessment of the Canadian corporation to confirm or adjust the previously determined classification.

Transitional tax

Taxation of corporations, especially in the international tax context, is changing to a territorial system. This change requires a deemed repatriation of foreign earnings to the United States during the 2017 tax year in order to clear the system out for the new taxation regime. Unfortunately, the taxation of US citizens abroad did not move to a territorial system. US citizens are still taxed on their worldwide income yet are still subject to this transitional tax.

How does it work?

If a Canadian company is controlled by US persons, there is a deemed income inclusion on the US person's 2017 or 2018 US tax return of their share of the post-1986 earnings and profits (E&P). E&P is a calculation of accumulated profits inside the corporation somewhere between income subject to tax and book-retained earnings. The measurement is the greater of the E&P as of November 2, 2017 or December 31, 2017 and certain 2017 distributions are disregarded.

This income inclusion is taxed at reduced tax rates. Essentially, accumulated cash and cash equivalents will be taxed at an effective rate of 15.5% and other accumulated income at a rate of 8% when received by US corporations. To avoid double tax, a taxable distribution in Canada in 2018 is likely required to create enough Canadian tax to absorb the US tax generated on this income pick-up. A lot of factors influence the amount of taxable distribution required, such as the amount of foreign tax credit carryovers on the US tax return and the overall effective US tax rate. This deemed income inclusion will not be eligible for the Qualified Dividend tax rate and will instead be subject to marginal tax rates in the United States.

The transitional tax can be paid over eight years. We anticipate that individuals impacted by this provision in 2017 will be out of pocket 16% of the tax until the amended 2017 return can be filed to claim the refund.

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Global Intangible Low-Taxed Income (GILTI)

As if the transitional one-time hit was not enough, the bill also introduced an annual deemed income inclusion based on the excess of the corporation's income (not including Subpart F or US effectively connected income) over 10% of its adjusted tax basis in depreciable tangible property. The spirit and intent of this provision was to target US companies shifting intellectual property outside of the US to low-tax jurisdictions. This will create a significant impact for service companies and any company without significant hard assets on their balance sheet. Calculations prior to year-end will need to be performed to ensure that a distribution is made out of the company to trigger enough Canadian tax to offset the US payable. These provisions are effective starting in 2018.

US citizen business owners should discuss re-structuring opportunities to manage around the GILTI provisions, where possible.

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