# U.S. Tax Update

*October 19, 2021*



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# Politics, Politics, Politics

- "Hung" Congress
- House of Representatives – 435 members
  - 220 Democrats
  - 212 Republicans
  - 3 Vacancies
- Senate
  - 50 Democrats
  - 50 Republicans
  - Ties decided by the Vice-President - Democrat



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For any U.S. legislation to become law, it must pass both Houses of Congress and then signed it law by the President

Currently the Democrats control both Houses but the Democrats are not unified.

The House of Representative (Nancy Pelosi) has deferred the House Vote on the Infrastructure bill (which as passed the Senate) because they don't have all Democrats on side.

If the Democrats cannot pass Biden's agenda, they run the risk of losing the upcoming midterm elections (November 2022).

 

# A Divided House

- House Democrats are divided
  - Moderates
  - Progressives – Congressional Progressive Caucus
    - "Left leaning" Democrats
    - 95 House Members
    - 1 Senator
- Two major pieces of legislation
  - Infrastructure Investment and Jobs Act: $1.2 trillion bipartisan bill, and
  - Build Back Better Act: $3.5 Trillion Budget Reconciliation Bill - investment in America's social safety net



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The Infrastructure Investment and Jobs Act passed the Senate on August 10, 2021 by a vote of 69 to 30. All 50 Democrats Senators supported the bill as well as 19 Republican Senators. The House, however, has NOT yet passed the bill. The "Progressive" Democrats want both bills passed together.

The $3.5 trillion investment in America's social safety net is opposed by the Republicans. The Democrats have an 8 seat majority in the House but they need all 50 Democratic Senators to pass this legislation.

Members of the Congressional Progressive Caucus, however, have threatened to hold their support until they receive assurances from Democrat Senators on the moderate side of the party (including Joe Manchin of West Virginia and Krysten Sinema of Arizona) that the larger budget package (the $3.5 trillion investment) will not be watered down by the Senate.

Joe Manchin has proposed lowering the investment from $3.5 trillion down to $1.5 trillion.

# Proposed Tax Changes - Biden

- The American Family Plan
  - Increase in top marginal tax rate from 37% (back) to 39.6%
  - Increase in top marginal capital gains rate from 20% to 39.6% when taxable income exceeds US $1 million. With the Net Investment Income Tax (NIIT) of 3.8% pushed federal rate to 43.4%
  - NIIT expanded to include active pass-through business income over US$400,000



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# Proposed Tax Changes – Biden Continued

- Limitation on IRC §1031 like-kind property exchanges
- Increase in US corporate rate from 21% to 28%
- Increase in GILTI rate from 10.5% to 21%
- Reduced unified credit from US$11.7 million down to US $3.5 million
- Increase top estate tax rate from 40 to 45%





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# The House Proposals – Relevant Highlights

- Tax law originates in the House Committee on Ways and Means
- Reconciliation Bill to Target Trusts, Estates, and the Wealthy released on September 12, 2021
  - Increase to personal tax rate from 37% (back) to 39.6%
  - Increase the top capital gains rate from 20% to 25%, with NIIT 28.3%
  - Increase corporate tax rate from 21% to 26.5%
  - GILTI rate would increase from 10.5% to 16.5625%
  - Reduce the estate tax exemption from $11.7 million back to the 2010 exemption limit US $5 million, indexed for inflation



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The **Committee on Ways and Means** is the chief tax-writing committee of the United States House of Representatives. The Committee has jurisdiction over all taxation, tariffs, and other revenue-raising measures, as well as a number of other programs including Social Security, unemployment benefits, Medicare, the enforcement of child support laws, Temporary Assistance for Needy Families and foster care and adoption programs.

Members of the Ways and Means Committee are not allowed to serve on any other House Committee unless they are granted a waiver from their party's congressional leadership. It has long been regarded as the most prestigious and most powerful committee in Congress.

The United States Constitution requires that all bills regarding taxation must originate in the U.S. House of Representatives, and House rules dictate that all bills regarding taxation must pass through Ways and Means. This system imparts upon the committee and its members a significant degree of influence over other representatives, committees, and public policy.

The Committee consists of 42 members – 25 Democrats and 17 Republicans.  The Chair is Richard Neil – D – Massachusetts – since January 3, 2019.

# The House Proposals
# The 12 Most Impactful Provisions

1) Individual rate increases
2) Expansion of net investment income tax
3) Limitations on qualified business income (section 199A deduction)
4) Permanent limitation on excess business losses (section 461(l)
5) Corporate tax rate increases
6) Changes to IRA rules





 

# The House Proposals
# The 12 Most Impactful Provisions

7) Research and experimental expenditures amortization requirement delayed
8) Temporary ability for certain S corporations to reorganize as partnerships without tax
9) Changes to gain and loss recognition rules
10) Changes to gift and estate taxes
11) Modification of carried interest rules
12) Senate Finance Committee “discussion draft” of partnership legislation





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# What's Relevant for Canadian Practitioners?

1) Individual rate increases
   a) capital gains tax
   b) new 3% surtax
2) Changes to gift and estate taxes
3) Corporate tax rate increases
4) Reminder – impact of Grecian Magnesite




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# Changes to Capital Gains Rate

| Currently | Single | MFJ |
|---|---|---|
| 0% | Up to $40,400 | Up to $80,800 |
| 15% | $40,401 to $445,850 | $80,801 to $501,600 |
| 20% | Over $445,850 | Over $501,600 |

Proposed

- Increase top rate from 20% to 25%
- Lower threshold at which top rate applies



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# Changes to Capital Gains Rate Impact for Canadians

- Increase in top marginal capital gains tax rate from 20% to 25%
- New rate would apply where the taxpayer has taxable income in excess of US$400,000 (single), US$425,000 (HOH) or US$450,000 (MFJ) – lower than current threshold
- NIIT does NOT apply to nonresident aliens (Filing Form 1040NR). As such top federal rate would be 25% NOT 28.8%
- Don't forget state taxes!! No preferential capital gains rate at state level – California – 13.3% (though there are proposals to raise the rate to 16.8%), New York – 10.9%, New Jersey – 10.75%
- Top Ontario capital gains rate currently 26.765%
- What about if the Liberal government increases the capital gains inclusion rate?



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Based on US federal rates alone and current Canadian capital gains inclusion rates – all of the US federal tax would be eligible to be claimed as a foreign tax credit. If there are significant state capital gains taxes, however, the combined US federal/state rate may be in excess of the Canadian tax otherwise payable with respect to the capital gain.

Currently the ability to deduct ALL state taxes (income, personal property, real estate) as a federal itemized deduction are limited to US $10,000 (MFJ) or $5,000 single. As such, in most cases, the stated state rate represents the marginal cost.

If the Liberals increase the capital gains rate inclusion to 66 2/3% the effective top marginal federal/Ontario tax rate would increase to 35.686%. If the inclusion rate is increased to 75% the effective top marginal federal/Ontario tax rate would increase to 40.1475%. At these rates it is likely that all US federal and state taxes may be claimed as a foreign tax credit (though not all re California if they do increase the top marginal rate to 16.8%).

## New Surtax

- 3% surtax on individual's modified adjusted gross income (AGI) exceeding US $5 million, starting in 2022
- Applies to ordinary income and investment income including *capital gains*





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# Changes to the Estate Tax

- Currently unified exemption amount equal to US$11.7 million
- Due to sunset as of January 1, 2026 – revert to pre TCJA levels – US$5.49 million (as adjusted for inflation) – 2017 pre TCJA exemption amount
- Reduces the exemption amount to US $5 million (as adjusted for inflation) after December 31, 2021
- Estimated exemption amount, for 2020, US $6.02 million





Other proposed changes

- Restricting valuation discounts
- Eliminating gift tax advantage of grantor trusts
- Eliminating advantages of sales to grantor trusts

Notable exceptions

- No repeal of the Step-Up in basis rules
- No federal rule against perpetuities for Dynasty Trusts
- No increase in estate tax rates
- No death recognition events

# Changes to Corporate Tax Rates

- Pre- Tax Cuts and Jobs Act (Trump)
  - Graduated rates up to 35% (plus surtax)
- Tax Cuts and Jobs Act – reduced to a flat 21%
- House proposals
  - 18% rate on taxable income up to US $400,000
  - 21% rate on taxable income above US $400,000 to US $5,000,000
  - 26.5% rate on taxable income above US $5,000,000





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# Changes to Corporate Tax Rates US Persons - GILTI

- GILTI may apply to Canadian residents who are US persons who own Canadian corporations
- Effective GILTI rate would become 16.5625% up from 10.5%
- Reduce the qualified business asset investment (QBAI) deduction from 10% to 5% (meaning more income subject to GILTI)
- Increase the allowed foreign tax credit to 95% - up from 80%
- Carry forward of excess FTCs and NOLs (currently no carry forward)
- Country by country – potential increase on complexity
- High tax exceptions





GILTI only applies (realistically) to controlled foreign corporations. Form 5471 is becoming increasingly complicated to account for all of these changes and reporting requirements.

Is the use of a Canadian corporation the best solution for your client? Are there other alternatives – such as an Unlimited Liability Company (ULC) is liability is not an issue?

# Grecian Magnesite A Quick Reminder

- *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Comm'r,* 149 T.C. No 3 (2017)
- DC Circuit Court of Appeals – June 11, 2019
- Whether a sale or redemption of a U.S. partnership interest was subject to U.S. taxation
- Taxpayer won – ***WHAT HAPPENS WHEN THE TAXPAYER WINS***?
- ***CHANGE THE LAW*** - The 2017 Tax Cuts and Jobs Act (TCJA) made the sale or redemption of a US partnership interest effectively connected income (ECI) subject to US taxation
- Why should I care?





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When structuring a client's new investment into the U.S., should you set any new U.S. entity up as a U.S. corporation or as a U.S. partnership?

Under U.S. domestic law, the sale of personal property (which includes shares of a U.S. domestic corporation) is sourced to the residence of the seller. As such if a Canadian resident sells shares of a U.S. company, the gain (loss) is considered foreign source for U.S. tax purposes meaning that the sale is not taxable in the U.S.

With the above change, however, the sale or redemption of a U.S. partnership interest is deemed to be effectively connected income resulting in a U.S. tax liability, usually as a long term capital gain (as long as the partnership interest is held for longer than one year).

As long as the Canadian effective capital gains rate is higher than the corresponding U.S. capital gains rates there should be NO additional Canadian tax liability. There will, however, be increased compliance costs for the client and potential U.S. nonresident withholding on the gross proceeds.

Per previous slides, the House is proposing to increase the maximum U.S. long term capital gains rate to 25%. Combined with state taxes, depending on state nexus, the combined federal/state capital gains rate may exceed the current top Canadian rates. May not, however, be an issue if the Liberal government increases the capital gains inclusion rate from 50%.