The top ten US tax reform changes that will impact everyday Canadians

James Meadow CA, CPA (NC), LLM (US TAX), MBA
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Contributors: Kenneth Keung CA, CPA (CO, USA), TEP, CFP, MTAX, LLB, and Cooper Xu EA, CGA

We needed to catch our breath before we could write about the Tax Cuts and Jobs Act of 2017-2018 (interchangeably, "**TCJA**" or "**Act**"), the massive tax reform bill that President Trump signed into law on December 22, 2017.[1] Why? Because we haven't exhaled since the Act was introduced on the House floor as H.R. 1 last November 2, 2017.

Like many of you, we wished that it would go away, because clearly, it had to be some nightmare bill that would be quickly extinguished before the holiday season got into full swing. Alas, it was not to be. Instead, week after week for the next six weeks, we sat transfixed before our computer monitors, watching the House and Senate webcasts on H.R. 1 as it dramatically swept through the U.S. Congress with the trademark plot twists and turns of a daytime soap opera.[2] Even better than a soap opera, it was like watching a PBS Masterpiece Theatre production that nearly shared the same opening day as the film Star Wars: The Last Jedi ("**TLJ**"). [3] Except of course, Star Wars TLJ brought in more than US $1.2 Billion[4] worldwide, whereas H.R. 1 is expected to cost US $1.5 Trillion over the next decade.[5]

Love it or hate it, the fact is that the TCJA provisions are now law and, unless modified, will be in place for at least another 10 years.[6] The much-maligned tax reform bill that no one thought would someday become law has now reached its full stature as statutory tax law.[7] Like it or not, it's time to buckle down and start dealing with the immediate tax consequences of this monumental shift in U.S. tax policy.

Where to start? Like you, we are transitioning from holiday-mode to work-mode and we thought it best to try and keep this commentary simple by providing a list of the top ten tax changes that will impact Canadians, Australians, and U.S. expats worldwide.

1. **Transition Tax.** New Code[8] Section 965 imposes a one-time transition tax payable by U.S. persons, including individuals, who own at least 10% voting stock in a foreign corporation. A passive foreign investment company ("**PFIC**") that is not a controlled foreign corporation ("**CFC**") is excluded from transition tax,[9] while S corporations can indefinitely defer net transition tax liability.[10] The tax is imposed on the deferred foreign income of such foreign corporation which constitutes accumulated post-1986 earnings and profits ("**E&P**") at two different rates – cash assets are subject to a 15.5% rate equivalent percentage and non-cash assets at 8% rate equivalent percentage. The E&P measurement date is the greater of the E&P balance as of November 2, 2017 or as of December 31, 2017. This means that the clock has generally run out on any planning techniques to reduce the balance of E&P subject to the transition tax. Every U.S. person[11] who owns an interest in a CFC or owns at least 10% voting stock in a foreign corporation[12], will have to pay this one-time tax either as a lump-sum or in instalments spread out over eight years.[13]

   MGTL Comment: From our perspective, the transition tax is particularly onerous because it

applies not only to cash and cash equivalents held outside the United States but also to non-cash "hard" business assets representing an investment of earnings in the business. Moreover, this transition tax appears to penalize individual U.S. shareholders whereas corporate U.S. shareholders will generally be able to repatriate foreign earnings through dividends on a tax-exempt basis thanks to the generous dividend received deduction, described below.

Individual U.S. shareholders are offered no such relief and must continue to rely on the foreign tax credit to avoid double-taxation. From a policy perspective, the application of the transition tax to individual U.S. shareholders is suspect because there is no evidence or even assertion, to our knowledge, that the current Subpart F[14] and PFIC anti-deferral regimes have been inadequate in preventing undue deferral of foreign earnings in the hands of individual U.S. shareholders.

While this may be reason to despair, we need to remind ourselves that the devil is in the details. And in this regard, there are enough details that present planning opportunities. We certainly would not condone any half-baked and ill-advised actions to back date transactions to avoid the transition tax. The committee reports acknowledge the potential mischief and has warned us that Internal Revenue Service ("**IRS**") will be issuing anti-abuse regulations to curb such predispositions.

We quote:

The conferees are also aware that certain taxpayers may have engaged in tax strategies designed to reduce the amount of post-1986 earnings and profits to decrease the amount of the inclusion required under this provision. Such tax strategies may include a change in entity classification, accounting method, and taxable year, or intragroup transactions such as distributions or liquidations. The conferees expect the Secretary to prescribe rules to adjust the amount of post-1986 earnings and profits in such cases to prevent the avoidance of the purposes of this section.[15]

Without missing a beat, the IRS recently issued Notice 2018-07 which explicitly stated that any transactions undertaken for the principal purpose of reducing the aggregate cash position subject to the transition tax will be disregarded.[16] Take heart, we can face this challenge and overcome it with just a little more diligence than usual. Just remember, the transition tax turns on the presence of a 10% U.S. shareholder and a robust accumulated post-1986 E&P base comprised mostly of foreign cash positions.[17] Therefore, shareholders of foreign corporations should determine if there are indeed U.S. persons in their ranks, and if so, if such U.S. person is a domestic U.S. corporation. The reason is that a foreign corporation that is not CFC will only fall under transition tax rules if at least one of its U.S. shareholders is a U.S. domestic corporation.

Moreover, U.S. persons with foreign corporations based in Canada and Australia would be well-advised to take a closer look at the manner in which their foreign corporation has calculated its E&P for U.S. tax purposes.[18] There is likely going to be some slippage due to divergence in local country tax accounting rules and U.S. tax rules (in particular, translation of retained earnings in the financial statements into E&P for U.S. tax reporting purposes, reconciliation of fiscal year income with calendar-year income, depreciation deductions etc.) and the manner in which assets are classified under cash or non-cash positions. To date, the only guidance on transition tax that addresses some of the above issues is Notice 2018-07. Lastly, it is useful to know that all E&P that is subject to the transition tax will be treated as previously-taxed income.[19]Therefore, future distributions of these amounts to U.S. corporate shareholders would

not trigger any further U.S. tax upon actual receipt, although a dividend distribution is likely to be subject to foreign withholding tax.

As we have previously noted, the transition tax impacts individual and corporate shareholders alike, notwithstanding that U.S. individual shareholders would not be able to participate in the dividend exemption regime. This appears to be a clear tax grab that does not reflect any consistent tax policy. This transition tax could be particularly hard to swallow for a Canadian resident who happens to be a U.S. citizen or green-card holder and holds shares of a Canadian controlled private company with significant retained earnings or a Canadian holding company to which the earnings of a Canadian operating company have been distributed over time. If nothing is done, the transition tax would occur on the U.S side of the equation without any corresponding Canadian tax. The transition tax would not be recognized as a foreign tax credit for Canadian tax purposes because the tax does not relate to a foreign source of income (from the Canadian perspective).

This essentially leads to double tax for these U.S. citizens residing in Canada.

Presumably, most U.S. shareholders will elect to pay the U.S. transition tax ratably over eight years rather than fall under the general instalment schedule which is back-loaded. Perhaps if an actual dividend is paid in those years and Canadian tax is triggered, it may be possible to obtain foreign tax credit relief against the U.S. transition tax owing (although we deem this outcome unlikely). To date, the IRS has yet to issue much-needed guidance on how the transition tax and existing complex foreign tax credit rules would interact and coordinate. Once these complex rules have been harmonized and they become effective, cross-border tax practitioners will want to study these rules carefully to identify ways of reducing or eliminating double taxation of foreign deferred earnings in the case of a U.S. individual shareholder who is also a Canadian tax resident.

2. **Dividend Received Deduction.** The transition tax applies on a one-time basis and is best thought of as a one-time charge[20] to participate in the new dividend participation exemption regime that provides for a 100% dividend-received deduction with respect to the foreign-source portion of dividends received by U.S. shareholders that are corporations (not individuals). Amended Code Section 245A exempts from the U.S. tax base foreign-source portion of dividends from 10% owned foreign corporations that are not PFICs. The new dividend participation exemption regime generally operates similarly to the Canadian rules for dividends paid out of exempt surplus. Hybrid dividends are not eligible for the 100% dividends-received deduction.

   MGTL Comment: We stress that the newly-enacted dividend participation exemption regime is available only for corporations and not individuals who are U.S. shareholders. Corporate shareholders however are not left completely unscathed. Any loss arising from the subsequent sale of the foreign subsidiary stock would be calculated using the U.S. corporate shareholder basis in the foreign subsidiary stock after it has been reduced by dividend participation exemption amounts previously claimed. Canada has a similar stop-loss regime for foreign affiliates of Canadian corporations.[21]

For U.S. individual shareholders, the dividend received from a foreign corporation gives rise to gross income subject to current tax with no participation exemption available. However, foreign taxes paid by the U.S. individual shareholder may be utilized to offset some or all the U.S. tax on such foreign dividend.

A notable change to the subpart F regime relates to the new "semi-territorial system" implemented in part through the dividend participation exemption mechanism of Section 245A. In the past, U.S. shareholders, particularly U.S. corporate shareholders, tried to avoid dividend income by having the subsidiary make a loan to its U.S. parent or otherwise invest in U.S. property that the U.S. parent could lease. The subpart F rules were broadened to treat these kind of repatriation techniques involving investment in U.S. property as a "deemed dividend" (think of the Canadian rules for upstream loans). To the extent that foreign dividends received by the U.S. parent corporation are now tax-exempt under the Act, it appears that there is no longer any incentive to avoid dividend treatment. As a corollary, upstream loans and other investments in U.S. property no longer need to be treated as "deemed dividends" to prevent avoidance of dividend treatment. Therefore, the subpart F provision that deems a dividend to occur with these forms of repatriation has been repealed under the TJCA.

3. **Subpart F Income.** The Subpart F regime applies to foreign corporations in which U.S. shareholders own (through direct, indirect, or constructive ownership) more than 50% of the total combined voting power of all classes of stock entitled to vote or total value of stock in the corporation. Such corporations are classified for U.S. tax purposes as CFCs. If the CFC earns passive-type income such as interest, dividends, rents or royalties and certain other kinds of income (again, subject to complex rules) (collectively, "**Subpart F income**"), the U.S. shareholders are generally required to include their pro rata share of such Subpart F income, which is taxed at rates of up to 37%.[22] This Subpart F income inclusion results in the U.S. shareholder recognizing income and paying tax on such amount even though there has been no distribution from the CFC.

MGTL Comment: For a long time, one of the keys to planning around Subpart F income (at least from a structural risk perspective) was to work around the definition of "U.S. shareholder." After all, a 10% U.S. shareholder is the prerequisite to determining CFC status. If a foreign corporation did not have any U.S. shareholder that owned at least 10% of its voting stock, the entity could not be a CFC.

However, for taxable years beginning after January 1, 2018, the definition of the term "U.S. shareholder" has been expanded. Amended Code Section 951(b) now defines a U.S. shareholder as a U.S. person who owns, directly or indirectly, 10% or more of the total combined voting power of all classes of stock entitled to vote or total value of all shares of classes of stock of the foreign corporation.

MGTL Comment: We consider this change a significant definitional shift which potentially extends the Subpart F anti-deferral regime to U.S. person shareholders of Canadian companies

who hold non-voting preferred shares. For Canadian tax and estate planning purposes, non-voting preferred shares are often issued to freeze the value held by a shareholder. Previously, such shareholders would not be considered a “U.S. shareholder,” but this is no longer true going forward. It is now more important than ever to monitor each shareholder’s U.S. or non-U.S. status for tax purposes and as a corollary, their relative percentage ownership of the foreign corporation in terms of vote and value. Failure to do so may result in additional U.S. income tax and reporting obligations of U.S. shareholders of foreign corporations.

Another significant change in the Subpart F regime which would expand its reach pertains to constructive ownership rules under Code Section 958(b). Generally, the stock ownership rules under Code Section 958(b) worked to determine when foreign corporate stock owned by another person or entity could be attributed as owned by a U.S. person for purposes of determining if such person was a U.S. shareholder of a CFC, or to treat a foreign corporation as a CFC.

MGTL Comment: Many U.S. expats have structured their shareholdings to prevent their foreign corporations from being classified as CFCs. Of note is Section 958(b) (1) which clearly established that stock owned by a nonresident alien individual would not be considered owned by a U.S. individual. This provision has helped structure many foreign corporations owned by married couples as non-CFCs where one spouse was not a U.S. citizen. The good news is that this provision has been preserved.

However, the stock ownership rules no longer contain Code Section 958(b) (4) which was previously used by tax planners to de-control foreign corporations (from CFCs to non-CFCs) so that stock of a foreign corporation owned by a foreign business entity (and not an individual) can now be attributed to a related U.S. person for purposes of whether such U.S. person is a U.S. shareholder of the foreign corporation and ultimately, if such corporation is a CFC. In other words, there is now “downward attribution” which can be quite tricky and lead to more foreign subsidiaries of non-U.S. corporations to be treated as CFCs. Consequently, there would be more foreign subsidiaries potentially subject to the Subpart F regime, as well as recently-enacted provisions under the Act such as global intangible low-taxed income (“**GILTI**”) (discussed below). We suppose that where subpart F is concerned, it pays not to be overly aggressive. The Subpart F regime has a well-developed playbook that has now been revised to take away planning tools utilized by tax practitioners to manage Subpart F income risks.[23] Be wary of overzealous tax practitioners who tell you otherwise.

4. **The new GILTI regime.** Effective for taxable years after December 31, 2017, all U.S. shareholders of CFCs with foreign intangible assets will be subject to a current minimum tax of 10.5% on their global intangible low-tax income (“GILTI”). New Code Section 951A provisions lay out the new rules for determining GILTI, which is derived from the net CFC tested income base minus a deemed minimum return on tangible assets. The net CFC tested income base is supposed to capture the offshore intangible income not subject to U.S. tax.[24] Only U.S. domestic corporate shareholders can avail of certain deductions to reduce the GILTI amount to tax under Section 951A. Specifically, U.S. domestic corporate shareholders can claim a special

deduction for 37.5 percent of foreign-derived intangible income (“**FDII**”) provided under new Code Section 250 and a 50 percent deduction for GILTI for taxable years beginning after December 31, 2017 and before January 1, 2026.[25] Corporate shareholders can also claim foreign tax credits of up to 80 percent of foreign taxes paid on such CFC-tested income based on the inclusion ratios provided under Code Section 951a such that no residual U.S. tax would be owed on GILTI to the extent that the foreign tax rate is at least 13.125%.[26]

Unlike corporate U.S. shareholders, individual U.S. shareholders cannot claim any of the deductions available to corporate shareholders (i.e., the 37.5% FDII deduction and 50% GILTI deductions as discussed above). What is even worse, the definition of CFC-net tested income includes virtually all forms of income, including services income and operating income from businesses that require little or no fixed assets that would be qualified business asset investment.

MGTL Comment: GILTI tax provides a strong incentive for U.S. multinational companies with substantial intellectual property (“**IP**”) outside the United States to rethink the residency of their IP and consider domesticating it to maximize the FDII deductions and minimize GILTI tax base. This is because the FDII deduction is only available to U.S. corporate shareholders of U.S. corporations earning income from the licensing of U.S.-based IP to non-U.S. persons or using IP to service non-U.S. persons. Bottom line is that U.S. corporate shareholders have a few options available to manage GILTI tax.

However, U.S. individual shareholders of CFCs that own off-shore IP appear to be at a disadvantage because they would be ineligible to claim the FDII or GILTI deductions (including foreign tax credits for foreign taxes paid) altogether. Therefore, their only option is to work within the GILTI provisions itself, which provided very limited options to manage GILTI tax except to load up on tangible property investments to increase its specified tangible property basis which would lead consequently to decrease the net CFC tested income base for the GILTI tax.

Along with the U.S. transition tax, the GILTI tax is likely going to have widespread adverse implications for U.S. citizens living in Canada or Australia who own non-U.S. corporations, particularly those in the service industry due to typically lower tangible property requirements. For example, a U.S. citizen doctor residing in Canada who operates her practice through a Canadian professional corporation may be subject to full blown GILTI tax if the practice does not have tangible property. In that case, even though the professional corporation would have paid Canadian corporate income tax on its income, the doctor would also be required to include this corporate income on her U.S. personal income tax return with no deductions or foreign tax credits permitted. Canada, on the other hand, will not grant any foreign tax credit for the U.S. GILTI tax paid because it sees the source of income as Canadian, and Canada will tax the same income again when it is paid out to the doctor as a dividend leading to straight-out double taxation. In such cases, the better result may be to pay all corporate income out as a salary to the doctor.

5. **Pass-Through Entities.** New Code Section 199A provides a 20% deduction on qualified business income (“**QBI**”) received by a U.S. individual taxpayer from non-corporate taxpayers

such as partnerships, S corporations, trusts and estate and sole proprietorships. A full 20% deduction would effectively reduce the maximum marginal personal income tax rates on such QBI from 37% to 29.6%. The deduction is the lesser of: (a) 20% of the taxpayer's combined qualified business income; or (b) the greater of (x) 50% of the W-2 wages paid with respect to the qualified trade or business; and (y) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition of all qualified property (currently being used and depreciated as part of a qualified business). The relevant W-2 wages base includes all wages, including withholding amounts and deferred compensation amounts. The deduction expires after December 31, 2025.

We note that QBI for purposes of this deduction (with certain exclusions) is income that is effectively connected to a U.S. trade or business other than: (1) specified trade or business; or (2) the trade or business of performing services as an employee. The specified trade or business expressly includes health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principal trade or business is the reputation or skill of one or more of its employees. It also includes services such as investing and investment management, trading or dealing in securities, partnership interests or commodities.[27] We further note that QBI excludes guaranteed payments, and compensation paid to a partner.

MGTL Comment: Based on the above rules, the predominant strategy for U.S. partners and shareholders of pass-through entities (which are not engaged in a specified trade or business) to qualify for the 20% QBI deduction would be to invest in tangible depreciable property and generate W-2 wages. However, this strategy would not only involve a shift in the way some cross-border entities conduct their U.S. business from Canada but also increase their exposure to permanent establishment risk. Moreover, such shift in business operations may spread capital too thinly just to avail of reduced rates facilitated through the Section 199A deduction.

Moreover, the taxable income limitation placed on partners and shareholders of certain service-based pass-through entities provides a clear message for foreign inbound businesses in these fields to restructure their U.S. operations. This can be done either structurally, by (a) isolating the service-based components of the business from real property and other tangible assets of the business by placing the service and non-service categories into separate pass-through entities; or (b) diluting the service-based business with other business activities which are not restricted, consequently transforming the specified trade or business into a non-restricted service line. Another alternative is for partners and shareholders of service-based pass-through could reduce their taxable income base to qualify for the 20% QBI deduction. One obvious way to reduce taxable income would be to renegotiate their existing partner/shareholder compensation arrangements such that their taxable income would not exceed US $157,000 (or US $315,000 for joint returns) and ultimately become eligible to claim the 20% QBI deduction.

New Code Section 1061 requires a minimum three-year holding period for carried interests to be treated as net long-term capital gain treatment regardless of whether a Code Section 83 election is in place or not. This rule applies to taxpayers receiving partnership interests about the performance of substantial services in any applicable trade or business consisting of (1) raising or returning capital and either (2) investing in (or disposing of) specified assets or developing specified assets. The term specified assets means securities, commodities, real estate held for

rental investment, cash or cash equivalents, options, or other derivative contracts with respect to such assets, as well as interests in partnerships. Holders of partnership interests that transfer their interests to related parties before the three-year holding period expires will trigger immediate gain taxed as short-term gain. This new section is effective for taxable years beginning after December 31, 2017**.**

There is no specific regime that applies to carried interests under Canadian tax law. The receipt of partnership interests about work performed will generally be fully includable in income. Canadian tax treatment of any gains on the subsequent sale of these interest will depend on common-law principles on capital versus income characterization. Therefore, careful consideration is needed to create a match between Canadian and U.S. tax treatment for U.S. citizens residing in Canada.

At the end of the day, a U.S. citizen residing in Canada will often be indifferent to the amount of QBI deduction. This is because a Canadian resident individual investing in a U.S. flow-through, e.g. partnership, will be subject to Canadian worldwide taxation on the income in any case. Any reduction in U.S. tax payable though the QBI deduction will correspondingly decrease the available foreign tax credit for Canadian tax purposes, and the individual will still end up with the same global tax bill. Where the QBI deduction could make a difference though is in situations where there is a foreign tax credit mismatch, such as where a Canadian individual is investing in a U.S. LLC. In those cases, a reduction of U.S. tax burden could lead to a reduction of global tax payable.

6. **Goodbye Grecian Magnesite.** It was a pyrrhic victory after all. In July 2017, the United States Tax Court issued a landmark decision in *Grecian Magnesite v. Commissioner*[28] which settled a long-standing dispute between the IRS and taxpayers concerning the capital versus ordinary treatment of the sale of a foreign partner's interest in a U.S. domestic partnership. In *Revenue Ruling 91-32*,[29] the IRS took the position that a foreign partner's share of gain from a partnership interest would be treated as effectively connected income ("**ECI**") to the extent the seller would have been allocated ECI if the partnership sold its underlying assets (and ultimately, subject to ordinary tax rather than capital gain treatment). This revenue ruling had become so entrenched and well—settled over 23 years that it was given appropriate deference in the tax communities. However, in *Grecian Magnesite*, the Court disagreed with the IRS position and held that the foreign partner's gain from the sale of its partnership interest (to the extent not attributable to U.S. real property interests) is not ECI. On December 15, 2017, the IRS filed a notice of appeal seeking review of the Grecian Magnesite decision with the U.S. Court of Appeals for the District of Columbia Circuit.[30]

   MGTL Note: Prior to *Grecian Magnesite,* there was confusion on whether Canadian partners gain from the sale or disposition of their U.S. partnership interests constituted ordinary versus capital gain under conflicting partnership and international tax provisions of the Code. There was no consistency of outcome. U.S. tax advisors to such Canadian partners would look to the treaty provisions under the Canada-U.S. Tax Treaty[31] ("**Treaty**") to allocate the foreign partner's non-real estate gain from the sale of U.S. partnership interest to Canada and taxed pursuant to Canadian capital gain tax rates accordingly.

   The Act however, amended Code Section 864 which codified the IRS position in *Revenue Ruling*

91-32. This is an unfortunate development for foreign partners of U.S. partnerships. Section 864(c) treats gain from the sale of U.S. partnership interests by a foreign partner as income that is effectively connected with the underlying U.S. trade or business of the partnership. Foreign partners must therefore pay U.S. tax on such gain at ordinary income tax rates rather than preferential capital gain rates. Furthermore, a new withholding rule was enacted that would require the transferee of a partnership to withhold 10% of the amount realized from the sale or exchange of a partnership interest absent a partner certification claiming exemption from the withholding. Like a Foreign Investment in Real Property Tax Act of 1980 ("**FIRPTA**") mechanism which now applies to a broad range of transactions that do not necessarily involve direct real estate transfers, including many tax-free transfers in which taxpayers continue to retain indirect partnership interest.

As discussed above, gains on disposition of partnership interest may be treated as either capital gain or income under Canadian tax law, depending on the facts and circumstances. Again, careful consideration will be needed to promote a tax efficient result.

7. **Taking Care of Business.** One of the most dramatic provisions in the TCJA is the reduction of the corporate income tax rate from 35% to 21% for taxable years beginning after December 31, 2017. It is worth noting that with this momentous cut in corporate tax rates, the combined U.S. federal and state effective tax rates have now come to an average all-time low of 27% which is like Canadian combined federal and provincial corporate rates. Meanwhile both U.S. and Canadian tax rates for individuals remain high at 43% and 47% respectively. Consequently, optimal cross-border tax structures for U.S. inbound business may now likely favor corporate structures rather than pass-through structures to realize significantly lower effective tax rates on U.S. source income.

   MGTL Comment: There are certain traps for the unwary that require careful consideration. We previously mentioned in our U.S. Tax Reform webcast last December 19, 2017 that the low U.S. corporate tax rate regime would likely cause corporate earnings to be deferred within a U.S. corporate structure rather than distributed out to Canadian or Australian shareholders who would be subject to higher rates of personal tax upon distribution. The likely increase in corporate earnings and profits may trigger the application of these corporate tax provisions in the Code which aim to prevent the accumulation of E&P beyond the reasonable business needs for this very reason. We note further that in this regard, the IRS has not been very successful in litigating what "reasonable business needs" are. In any event, you should watch out for the 20% accumulated earnings tax imposed on corporate accumulated income, as well as a 20% penalty tax on personal holding company income which constitutes undistributed passive income held by a closely-held C corporation such as dividends, rents, and royalties. Passive earnings inside the U.S. corporation may also run afoul of foreign anti-deferral regimes such as the Canadian foreign accrual property income rules and perhaps even the proposed Canadian corporate passive income rules the details of which is yet to come but expected in the 2018 Budget likely released in the first quarter of this year.

8. **Business Deductions.** The Act contains many generous business provisions that would impact Canadian businesses seeking to expand operations into the United States. For example, amended Code Section 168(k) allows for full expensing of property acquired and placed in service between September 27, 2017 and December 31, 2022. Current expensing phases out after these dates. These provisions apply to new business property that already qualified for bonus depreciation under the old rules as well as used business property, which now qualifies under the new rules. Qualified film, television and theatrical performances are also eligible for full expensing.

   Section 168(k) also increases depreciation limitations under Code Section 280F for passenger automobiles placed in service after December 31, 2017 up to US $10,000 for the first year, US $16,000 for the second year and so forth. Amounts will be indexed for inflation for automobiles placed in service after 2018.

   Code Section 179 limits for first-year business write-offs have been also increased to US $1M for taxable years after December 31, 2017. This includes improvements to non-residential real property placed in service after the placed in-service date of the real property such as roofs, heating, ventilation, air conditioning, fire protection alarms and security systems.

   MGTL Comment: Canadian companies with U.S. subsidiaries that are eligible for current full expensing of business costs under Code Sections 168(k) and 179 will likely have greater incidence of mismatches between taxable income and E&P for U.S. tax purposes because of differences in how taxable income and E&P are calculated. Claiming full deductions for qualifying business expenditures will reduce taxable income but such deductions must be backed out for E&P purposes. Rather these business expenditures are generally depreciated on a straight-line basis over the corresponding asset's class life. Consequently, a U.S. subsidiary's ability to repatriate cash back to the Canadian parent may be compromised in any given year where it has substantial E&P and yet very little taxable income (due to the full expensing of its business expenditures). Under such circumstances, intercompany debt arrangements between the Canadian company and its U.S. subsidiary to repatriate cash back to Canada would likely remain relevant notwithstanding the new Section 163(j) interest limitations introduced in the Act and discussed immediately below.

   Code Section 163(j) contains new interest expense limitations that would apply to deductibility of interest payments on debt with related and unrelated lenders, and to individuals, partnerships and corporations. Before you roll up your sleeves to dig into the intricacies of the new Section 163(j) limitations, it's worth pointing out that these new interest limitations apply only to U.S. taxpayers with average annual gross receipts of $25M or more and certain real property, farm and utility businesses. Those who do not meet the $25M gross receipts threshold need not worry any further regarding interest deduction limitations. However, if you do fall within that group of businesses with average annual gross receipts of $25M or more, the future is not all bleak. Taxpayers in certain trades or business such as auto dealers and lessors are exempted from Section 163(j) such that they can fully deduct interest on debt used to acquire motor vehicles. There are silver linings behind the interest deduction limitation rules. Indeed, disallowed interest under Section 163(j) can be carried forward indefinitely and used in certain corporate acquisitions subject to Code Section 382 limitations. Also, if you are a partner in a partnership with Section 163(j) interest limitation, you will be able to carry over the disallowed interest notwithstanding that

the interest limitation itself is calculated at the partnership level. Whether you, as a partner, can use the disallowed interest expense carryover is contingent on your share of the partnership's excess taxable income in later years. Lastly, the disallowed interest amounts would also effectively reduce your partnership interest tax basis subject to certain conditions.

9. **Individual Income Tax Changes:** The TCJA's individual tax provisions have received a lukewarm reception overall. While the Act reduced individual income tax rates (generally from 39.6% to 37%, 35% and 32%, 24%, 22%, 12% and 10%) and doubled the income threshold amounts for each rate bracket, such reduction was not achieved without costs. Indeed, the elimination of personal exemptions and suspension of certain itemized and miscellaneous deductions caused much controversy notwithstanding the increase in standard deduction amounts. Below are some provisions that would impact U.S. taxpayers living in Canada, Australia and elsewhere outside the United States.

   Code Section 164(b) provides limits to the state and local tax deduction for U.S. individual taxpayers. Effective for the next ten years[32], state, local and foreign property taxes and sales taxes are deductible only when paid or accrued in carrying on a trade or business or production of income. Deductions for state and local income, war profits and excess profits taxes are now significantly limited. However, U.S. individual taxpayers are allowed to itemize deductions of up to US $10,000 for aggregate state and local property taxes not paid or accrued in carrying on business; income war profits and excess taxes. It's important to note that this itemized deduction does not apply to foreign real property taxes at all.

   Code Section 163(h) reduced the mortgage interest deduction to interest on US $750,000 of acquisition indebtedness for debt incurred after December 15, 2017. No more home equity debt interest deductions will be available. However, the deduction is not limited to interest on a taxpayer's principal residence and could potentially apply to second homes and investment property. Moreover, the $1M limitation remains for debt incurred prior to December 15, 2017.

   MGTL Comment: Interest expense for a trade or business or for investments for the production of income is generally not subject to this particular limitation. One may speculate as to whether interest on a home equity loan, the proceeds of which are used to invest in a business or corporation might be otherwise deductible under a tracing principle like that found in Canadian taxation.

   Provisions in the Act suspend the limitation on itemized deductions under Code Section 68 for the next ten years. The Act also suspended all miscellaneous itemized deductions that are subject to the two percent floor under Code Sections 212, 62 and new Code Section 67(g). We note that this would impact the ability to deduct tax preparation services for taxable years beginning after December 31, 2017 and ending before January 1, 2026.

   While personal exemptions have been suspended, the standard deductions for individual taxpayers have been increased to the following amounts: $24,000 (joint return or a surviving spouse); $18,000 (unmarried individual with one qualifying child); $12,000 (for single filers).

MGTL Comment: For a married couple in which both spouses were residents of a foreign country such as Canada and one spouse was a U.S. citizen, it was sometimes advantageous to make a tax election under section 6013(g) to treat the non-U.S. spouse as a U.S. resident, particularly if that spouse had low income because the status of married filing jointly gave access to lower tax brackets, an additional personal exemption and a more generous exemption amount for the alternative minimum tax. Sometimes this kind of planning could be coupled with the foreign earned income exclusion of section 911 if the effect was to produce very low or no taxable income. This kind of planning will likely survive tax reform changes, but the calculations have changed since there are no longer personal exemptions and the standard deduction is more generous. Even if the U.S. citizen spouse continues to have itemized deductions in excess of the standard deduction and alternative minimum tax is not an issue, an existing Code Section 6013(g) election for the non-U.S. spouse may need to be re-examined to determine whether it is still beneficial in light of the loss of the personal exemption. In some cases, this may come down to measuring the interplay between the amounts of income contributed by the non-U.S. spouse versus the advantage of accessing the more generous brackets for married filing jointly.

Moving expense deductions have been eliminated under Code Section 217 for the next ten years. However, the deduction is still available for active duty members of the Armed Forces pursuant to their work assignments. It remains to be seen to what extent the loss of the moving expense deduction will affect employee mobility, including employer-sponsored moves.

Deduction for alimony payments are no longer available under Code Section 215. Effective for taxable years ending after December 31, 2017, alimony and separate maintenance payments will no longer be deductible by the payor spouse and not includible in the gross income of the recipient. This includes any divorce or separation instrument executed after December 31, 2018 as well as any divorce or separation instruction executed on or before December 31, 2018 and modified after such date.

MGTL Comment: This result is at odds with the Canadian treatment of alimony, which may lead, in some cases, to unfavorable tax results. Note, however, Article XVIII:6(b) of the Treaty which provides that if the recipient is a Canadian resident and the right to receive payment arose in the U.S., the payment will not be taxable by Canada.

Code Section 170 provision increases the adjusted gross income limitation (from 50% to 60%) on cash contributions made to public charities and certain organizations by individuals in tax years after 2017 and before 2026. However, charitable deductions for college event seating rights are no longer allowed. Certain high-tax states like California are likely to attempt to recast a portion of state income taxes as a voluntary contribution to the state, which they hope will be deductible as a charitable contribution, thereby skirting the $10,000 limitation on state and local taxes. Such a move is likely to lead to controversy and litigation.

10. **Estate Tax**. The TCJA increased the federal estate and gift tax unified credit equivalent amount for estates of decedents dying and gifts made after December 31, 2017 and before January 1, 2026, from the inflation-indexed amount of US $5.49M to US $11.18M.[33]

MGTL Comment: With proper planning and execution, this increase of the unified credit equivalent increases the amount of U.S. situs property Canadians may own before they are exposed to the U.S. estate tax. Article XXIX-B of the Treaty allows Canadian residents a pro-rata portion of the unified credit. Therefore, under the TCJA Canadians will be subject to estate tax on U.S. situs property only if their worldwide net worth at death exceeds US $11.18M. With proper planning, a husband and wife would be subject to the estate tax only if their worldwide net worth exceeds US $22.36M. Note, however, in order to obtain the benefit of the increased credit equivalent the Canadian decedent must file a U.S. estate tax return, or the estate's (or beneficiary's) basis in the property will be US $0.00.[34]

Further, for U.S. citizens who are interested in renouncing their U.S. citizenship the increased credit equivalent will make it easier for them to avoid the U.S. exit tax imposed by IRC 877A by allowing them to gift an additional US $5M without the imposition of gift tax. Thus, with proper planning, a U.S. citizen could avoid the U.S. exit tax if her net worth were US $11.99M by making a gift of US $10M. On such a gift, there would be no U.S. gift tax payable and she would be under the US $2M net-worth threshold for application of the U.S. exit tax.

Well, there you go, folks. We've covered the Top Ten provisions in the TJCA that will most likely impact Canadians. Just like Star Wars TLJ, the final official version of the TJCA generated much controversy and surprise due to the bold tax twists and surprise implications embedded within its provisions. Like Star Wars TLJ, the TJCA is complicated and will require further clarification and guidance from the Force which will likely come in the form of technical corrections to the TJCA statutory language.[35] Whether or not such corrections will temper the impact of these provisions on Canadian businesses and individuals as we have identified, remains to be seen. We no longer have the luxury of simply sitting back and watching the events unfold in that galaxy far, far away because the TJCA has landed on our border and the challenge to our tax destiny is underway. Borrowing from the words of that small yet powerful Grand Jedi Master Yoda, ***"Much to learn you still have….my old padawan…this is just the beginning!***"[36]

[1] Formally titled as "H.R.1 – An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[2] Indeed, there were a total of 29 roll call votes in the House and Senate proceedings to pass this act. The Senate had 23 total roll call votes, three of which occurred on the eve of December 20, 2017 amidst much grandstanding on the Senate floor and ongoing protests outside on Capitol grounds… https://www.congress.gov/bill/115th-congress/house-bill/1/all-actions?q=%7B%22roll-call-vote%22%3A%22all%22%7D

[3] Except of course, it wasn't signed into law on December 15, 2017 on the same day that Star Wars: The Last Jedi was released in the United States. Rather, it was the Joint Committee Conference Report to accompany H.R. 1 that was filed on December 15, 2017 and not the final version of the TCJA itself which was presented to President Trump on December 21, 2017. It was signed into law on December 22, 2017.

[4] Based on IMDB and IMDB Pro, Star Wars: The Last Jedi has a cumulative worldwide gross of US $1.2 billion in box office proceeds, with $556 million from US and $973 million from international sales as of January 5, 2018. https://www.imdb.com/title/tt2527336/?ref_=nv_sr_2 and https://pro-labs.imdb.com/title/tt2527336?rf=cons_tt_bo_tt&ref_=tt_pub_upslb_login

[5] U.S. Congressional Budget Office, *Estimated Deficits and Debt under the Conference Agreement of H.R. 1* (Jan. 2, 2018)

[6] i.e, 2018-2027.

[7] Public Law 115-97.

[8] Code means the *Internal Revenue Code* of 1986 as amended from time to time; Title 26 of the United States Code.

[9] Section 2.02 of Notice 2018-017, IR-2017-212 (December 29, 2017).

[10] We also note that S corporations that are flow-through can elect to defer transition tax net tax liability indefinitely until a triggering event occurs (such as a termination of S corporation status, liquidation, sale, or transfer of stock).

[11] US person means a US citizen, lawful permanent resident, or US tax resident under the substantial presence test of Code Section 7701(b).

[12] With at least one U.S. domestic corporation shareholder.

[13] We note that the U.S. shareholder must affirmatively elect to pay the net tax liability in eight equal installments or risk being subject to the general installment schedule which is structured such that the more substantial payments of tax are due at the back end. To wit: Years one through five – 8%; Year six – 15%; Year seven – 20% and Year eight – 25%.

[14] 26 U.S. Code Section 952

[15] See p. 619 of the Conference Report to Accompany H.R. 1, H. Rept. 115-466 Tax Cuts and Jobs Act (December 15, 2017)

[16] See IR -2017-212 (December 29, 2017).

[17] Unfortunately, if the foreign corporation holds an interest in a passthrough entity, the cash position of such passthrough entity would also be included in the calculation of foreign earnings for purposes of the Transition Tax.

[18] Accumulated post-1986 E&P will be calculated based on Code Section 964 and 986 rules.

[19] In Notice 2018-07, the IRS stated its intent to issue regulations to clarify the interaction between the rules under Code Section 959 (distributions out of previously taxed income) and Section 965 (transition tax), among others.

[20] As explained above, individual U.S. shareholders, who are simply not allowed to play, are still subject to transition tax.

[21] Subsections 93(2) to (2.32) of the Canadian *Income Tax Act*.

[22] We note that Subpart F income of foreign corporations in higher tax rate jurisdiction would not trigger Subpart F income tax to its U.S. shareholder if such income was subject to an effective rate of income tax greater than 90 percent of the maximum U.S. domestic corporate tax rate under Code Section 954(b)(4).

[23] For example, the Act also terminated the 30-day CFC rule which had been previously used by tax practitioners to avoid recognition of Subpart F income.

[24] The new definition of intangible assets under PL 115-97 greatly expanded the existing definition of intangible property under the 1982 Tax Equity and Fiscal Responsibility Act. Basically, intangible property is now anything that is not tangible property.

[25] The deduction is reduced to 37.5 percent for years after December 31, 2025.

[26] See The Conference Report to Accompany H.R. 1, H. Rept. 115-466 Tax Cuts and Jobs Act (December 15, 2017) available at https://www.congress.gov/congressional-report/115th-congress/house-report/466/1.

[27] Whether engineering or architectural services fall within the general definition remains to be clarified as the Conference Agreement did exclude these fields (yet somehow arguable fall within the general definition).

[28] *Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner*, No. 19215-12, 149 T.C. No. 3, 2017 BL 243353 (July 13, 2017). Full docket history and party submissions available at: https://ustaxcourt.gov/USTCDockInq/DocumentViewer.aspx?IndexID=7153838

[29] 1991-1 C.B. 107 corrected by Ann. 91-86.

[30] https://ustaxcourt.gov/USTCDockInq/DocketDisplay.aspx?DocketNo=12019215

[31] The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC, on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 herein referred to as (the "**Treaty**")

[32] Taxable years beginning after December 31, 2017 and before January 1, 2026.

[33] See, Section 11061 of the TJCA amending Code Sections 2010(c)(3) and 2001(g).

[35] Or in the Star Wars universe, the “technical corrections” would come in the form of never-ending sequels such as the Hans Solo movie (scheduled for worldwide release this 2018).

[36] https://www.yodaquotes.net/page/6/.