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Tax

U.S. tax law reform means Canada has lost 'competitive advantage': experts

By **Ian Burns**

(January 15, 2018, 11:24 AM EST) -- The U.S. Congress made the biggest change to the American tax system in 30 years last month, the reverberations of which are still being felt across the country. And although individual Canadians will not be affected at nearly the same level, there are still aspects of the plan people residing inside Canadian borders should be aware of.

The *Tax Cuts and Jobs Act* was signed into law by U.S. President Donald Trump on Dec. 22. Among some of its bigger provisions, it reduced the corporate tax rate from 35 per cent to 21 per cent, and changed the highest personal income tax bracket to 37 per cent, down from 39.6 per cent.

Alexey Manasuev of U.S. Tax IQ said both U.S. citizens residing in Canada and Canadians with U.S. connections will be affected — and some not so favourably. He noted there is a transition tax being imposed on certain controlled foreign corporations and U.S. shareholders, and accumulated earnings and profits (known as "retained earnings") post-1996 will be taxed up to a 15.5 per cent rate for earnings held in a corporation by U.S. citizens living abroad.

"If you think about doctors who are U.S. citizens or any other business owners [in Canada] who have interests in foreign corporations and who have been accumulating earnings for all those years, and now all that money will be subject to tax," he said. "That's one huge impact of the legislation."

David Rotfleisch, taxpage.com

David Rotfleisch of taxpage.com called this measure "quite an outrageous move" but "pretty typical of the way the U.S. treats its citizens who are resident in the rest of the world."

"If I have to specify a single most pervasive effect on Canada, that's it," he said. "U.S. citizens living anywhere in the world are required to file U.S. personal tax returns and these tax reform measures are possibly a big whammy for them."

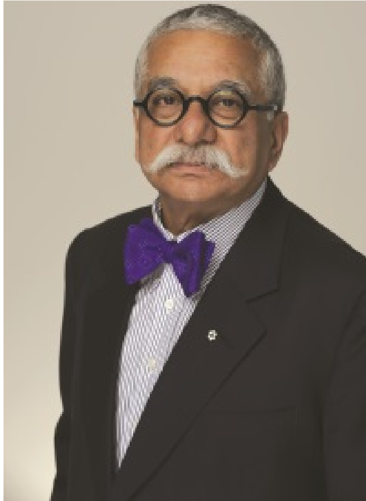
Rotfleisch said this provision goes back to "pure Trump policy."

"He was elected on the basis of 'all these U.S. corporations have offshore profits and we want to tax them,' but unfortunately the implementation affects U.S. citizens who may have no nexus to the U.S. at all except for their

passport, but now they potentially get taxed," he said.

Manasuev also noted the definition of U.S. shareholder in a controlled foreign corporation has changed. The Internal Revenue Service (IRS) defines as a controlled foreign corporation in which more than 50 per cent of stock is owned by U.S. shareholders, and these corporations are subject to special tax considerations known as Subpart F, which limits the deferral of U.S. taxation of income earned outside the U.S.

"The threshold [before triggering Subpart F] was 10 per cent ownership of voting stock but the new law has been changed to include ownership by value," he said. "So that's why whether or not something is a controlled foreign corporation is critical, because potentially it could be considered Subpart F income and that's not good news. Everybody should be evaluating their structures to make sure they're not caught by this new rule."



Vern Krishna, TaxChambers LLP

In combination with the micro-level effects of the tax changes, there are also items in the *Tax Cuts and Jobs Act* that could have an impact the Canadian economy as a whole, in particular the 14 per cent reduction in the U.S. corporate tax rate. Vern Krishna of TaxChambers LLP called the differential between the old and new rates "huge," and Canadian businesses may very well reconsider where they carry on operations.

"We know business will relocate for things smaller than just a 14 per cent differential," he said. "This is why business goes to Ireland, because their 12.5 per cent [corporate tax rate] is pretty spectacular. It's a small percentage, but when you apply large revenues it becomes a big number."

Veronika Chang of Toronto's MKW Tax Lawyers said Canada has "lost its competitive advantage" in terms of corporate tax rates.

"So it's good for Canadians who have business in the U.S. to take advantage of lower tax rates," she said. "Plus I don't think we're going to see too many more Tim Hortons-Burger King mergers, with companies taking advantage of [Canada's] lower tax rates. It's certainly an incentive for U.S. business to stay in the U.S."

Veronika Chang, MKW Tax Lawyers

Manasuev noted before the changes Canadian parent companies with U.S. subsidiaries would often repatriate income from the U.S. to Canada in order to take advantage of lower rates.

“I think now you will see the trend shifting and profits going to be staying in the U.S., or there will be more incentive to move profits to U.S. and subject them to lower tax rate,” he said. “You would be likely to see businesses expanding into the U.S. even more. It is a bigger market, and a lot of businesses when they do expand they usually see huge growth because of market size in U.S. I think you will see that trend increasing and that’s significant.”

Krishna said it is necessary for Canada to have competitive tax rates to stem the flow of capital to the United States.

“Ireland went from a potato famine to one of the most successful economies in the world,” he said. “They’re doing very well and managed to do so with a 12.5 per cent tax rate.”

But Rotfleisch said “a race to the bottom” with Canada cutting its corporate tax rates in order to match the U.S. is not advantageous.

“There’s a limit to how far down we can go, and I don’t know that if Canada lowers its rates by two points, is that going to make any difference,” he said. “Before we had a huge spread and that’s a significant factor of where you’re going to do business. But a two or three-point spread is offset by other factors. So I don’t know if tax rate deductions just to try to be more attractive is going to make much of a difference.”

But whether it's a corporation doing business in the U.S. or an American citizen residing in Canada, significant planning needs to be done to fully understand the impact of the U.S. tax changes. Due to the speedy way the tax bill made its way through Congress, the IRS is still clarifying its impacts to the public. Manasuev said it is important for people who may be affected by the changes to contact financial professionals.

“They should be able to find in general over the next month or so, how it would affect different categories of individuals and also businesses overall,” he said. “But because everyone’s facts are different you need to go through [each situation] to see if there is any planning opportunity or any negative impact of the provisions.”

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