

U.S. Tax – Recent Developments, Real Estate, and Trump Proposals

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Agenda

1. Selected Recent Developments in U.S. Tax
2. Trump Tax Proposals
3. U.S. Tax on Real Estate



Selected Recent Developments in U.S. Tax



Selected Recent Developments

- OVDI / Streamline – current status
- New U.S. Model Income Tax Treaty
- Reporting obligations of disregarded entities
- Crowd funding – tax treatment for investors and issuers
- Debt characterization rules



OVDI - Streamlined

- IRS IR 2016-137 – October 21, 2016
- 55,800 taxpayers have gone into the various OVDI programs since 2009
- \$9.9 billion in taxes, interest and penalties
- 48,000 taxpayers have used the various Streamlined Compliance Filing Procedures
- \$450 million in taxes, interest and penalties
- No end date announced but...FATCA



New Model Treaty

- The Model Treaty reflects the current treaty negotiating position of the U.S.
- Announced in February, 2016
- Contains several B.E.P.S. and other comparable measures to prevent double non-taxation
- Addresses some technical issues in favor of taxpayers



New Provisions

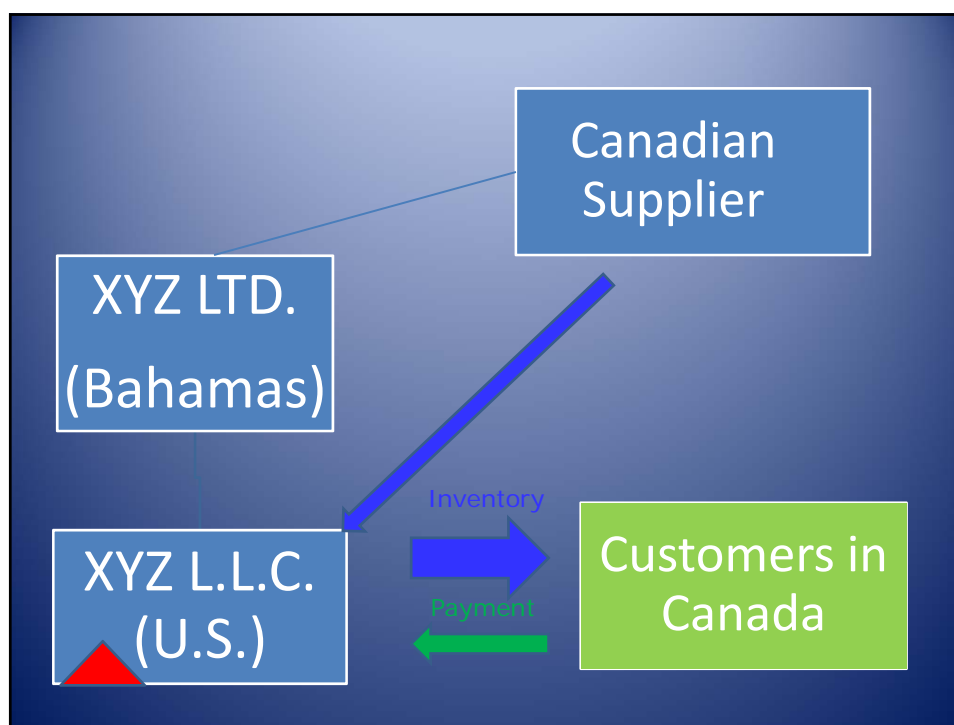
- **Special Tax Regimes**
 - Denial of Treaty benefits for a treaty resident benefitting from special tax regimes for highly movable income such as interest, royalties, and guarantee fees
- **Subsequent Changes in Domestic Law**
 - Notification and consultation to amend a treaty is required when changes in domestic law affect balance of benefits and creates the potential for double non-taxation
- **Derivative Benefits**
 - Expansion of the derivative benefits coverage
 - Dividends paid to an individual who is an equivalent beneficiary resident in a different E.U. country will qualify for treaty benefits



New Provisions

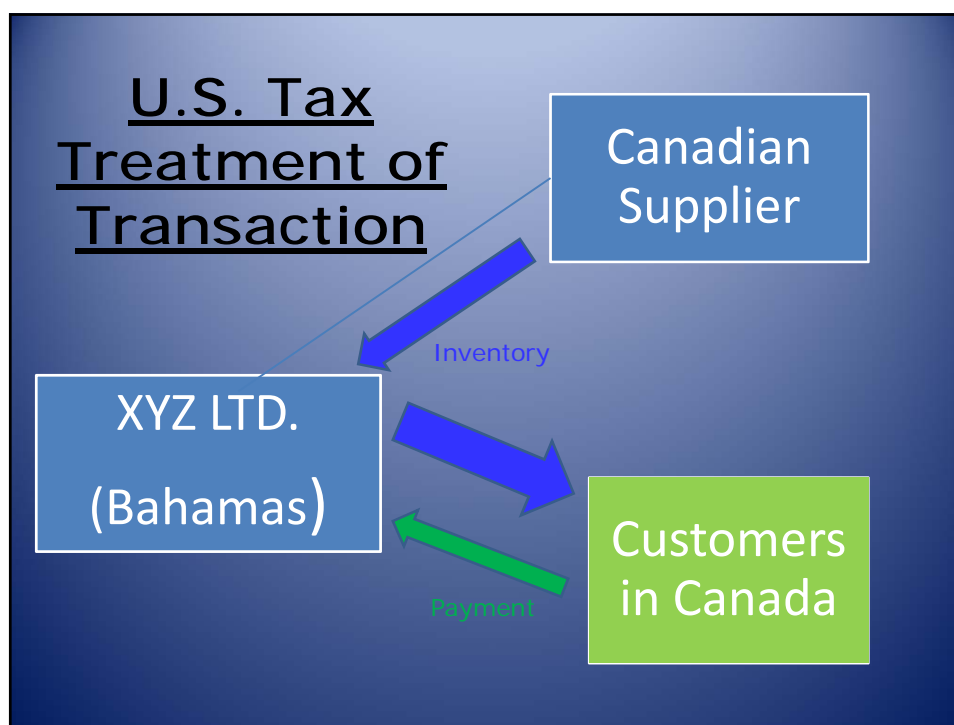
- **Anti-Inversion Rule**
 - Treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by an expatriated entity that continues to be treated as U.S. corporation
 - Applies only to payments to related parties
- **Mutual Agreement Procedure**
 - MAP to provide for mandatory binding arbitration
 - This follows four treaties that await the advice and consent of the Senate
- **B.E.P.S.**
 - Prevention of double non-taxation now an overall purpose of an income tax treaty
 - Not all of the recommended permanent establishment provisions have been adopted





Tax treatment for structure

- Price charged XYZ L.L.C. is low
- XYZ L.L.C. is a disregarded entity
- Price charged customers in Canada is high
- No tax in U.S. if no office is maintained
- No tax filing in U.S.
- No U.S. tax identification number
- No information to provide to tax authority in country of residence of Canadian supplier



DRE Proposed Information Reporting Regulations

- Regulations proposed in May will mandate information reporting by a disregarded entity (“DRE”), but no change in U.S. tax treatment
- The regulations will be effective in 2018
- U.S. tax identification number will be required of DRE
- Record maintenance will be required of DRE
- Failure to comply can result in a \$10,000 civil penalty, which can be increased if the failure continues after notification by the I.R.S. and criminal penalties

DRE Proposed Information Reporting Regulations

- Form 5472 filing obligation will cover a DRE and the following must be reported annually
 - Direct foreign 25% shareholders and ultimate 25% foreign shareholders:
 - Name, address, countries where business is conducted, country of citizenship, country where income tax return is filed
 - Transactions:
 - All related party sales, assignments, leases, licenses, loans, advances, contributions, transfers of property, transfers of right to use property, services for the benefit of, or on behalf of, another taxpayer



Indirect Application to Trusts

- Another typical fact pattern where a DRE is used involves trusts
 - Often a DRE is placed underneath the trust to limit the scope of trustee obligations
- Today we see an influx of U.S. foreign trusts formed by non-U.S. individuals
 - Once the reporting rule applies, the compliance question involves the identification of the ultimate 25% shareholder
 - This involves the application of constructive ownership rules, that attribute ownership from the trust to the beneficiaries and if the beneficiaries are members of the settlor's family, from family member to family member



Indirect Application to Trusts

- Typical fact pattern:
 - Settlor and beneficiaries are non-U.S. persons
 - Trust is formed in New York, Delaware, or South Dakota
 - For U.S. tax purposes, the trust is a foreign trust because, *inter alia*, protector is a foreign person and holds the power to trigger trust distributions
 - The beneficiaries are three children of settlor, his wife, and his sister, whose interest is capped at 5%
 - The trust is fully discretionary, subject to power of the protector
- Who is the direct 25% foreign shareholder and who are the ultimate 25% foreign shareholders?



Application to Trust + Beneficiaries

- The direct 25% foreign shareholder is the U.S. foreign trust – for tax purposes it is a foreign trust in this fact pattern
- The ultimate 25% shareholders are each of the children and the wife
 - Each is deemed to own 23.75% of the L.L.C. by attribution from the trust
 - Each child is deemed to an additional 23.75% from their mother
 - The wife is deemed to own an addition 71.25% from her children



Crowd Funding

- An internet-based form of raising capital for businesses and other endeavors
- Utilizes social media to communicate with potential sources of capital based on political, social, investment criteria that typically are not used by traditional sources of capital
- Many different crowd funding structures:
 - Donation based – no financial return expected
 - Rewards based – the reward is a form of service or product
 - Equity based – partial ownership is available



Crowd Funding Tax Consequences

- Kickstarter and Indiegogo web sites mention tax, but provide no further explanations
- The vacuum was filled by the I.R.S. in Information Letter 2016-0036
- For campaign owner, the proceeds of the funding produce taxable income unless the funds represent:
 - Loans that must be repaid
 - Capital contributed in exchange for an equity interest – this means it must be bargained for by the parties or
 - Gifts made out of detached generosity and without any quid pro quo – raising funding for charitable purposes



Debt Characterization I.R.S. Proposes Regulations

- In April, controversial proposed regulations involving related-party debt were proposed by the I.R.S.
- The regulations characterize debt issued to related parties as equity in several circumstances:
 - The debt is issued in certain tainted transactions where debt replaces equity, such as dividends in the form of a debt instrument, stock purchases in affiliates in return for a debt instrument, and debt used in certain internal reorganizations
 - The debt is not supported by contemporaneous documentation
 - The debt capacity of borrower is less than the face amount of the debt, in which case the debt is bifurcated by the I.R.S. between the part that is debt and the part that is equity



Debt Characterization Documentation

- The proposed regulations required documentation and analysis as to the credit capacity of the borrower at a time that is contemporaneous with the loan
- The documentation consists of:
 - A binding obligation to repay the loan
 - The inclusion of typical creditor terms to enforce the terms of the loan
 - An analysis demonstrating the credit capacity of the borrower, which cannot be exceeded
 - Evidence of an intent to enforce the rights of a creditor against the borrower
- The note must come into existence within the 30-day period following the loan and the credit analysis must be completed within the 120-day period following the loan



Debt Characterization I.R.S. Proposes Regulations

- Over 29,600 comments were received by the I.R.S.
 - **Congressmen and Senators** were concerned about the effect of the rules on the U.S. economy
 - **The U.S. Chamber of Commerce** was concerned on the cost for companies that are not part of a group that has participated in an “inversion”
 - **The Business Roundtable** commented that the proposed regulations exceeded the authority of the Treasury Department
 - **The American Bar Association Section on Taxation** commented that the proposed regulations depart from a century of Federal income tax law regarding debt and equity
 - **The New York State Bar Association** commented that there were too many traps as a result of the documentation and that the grant of regulatory authority by Congress was limited to factors
 - **Industry** submissions complained that group cash pooling arrangements would not meet the documentation standards
 - **Hedge fund** associations complained about the definition of “control” that triggers application of the rules



Debt Characterization I.R.S. Proposes Regulations (cont'd)

- Final regulations were adopted in October
- Many but not all provisions are scaled back
- In particular, loans to fund tainted transactions that replace equity with debt remained
- It is now estimated that only 1,200 corporations will be affected



Debt Characterization Documentation

- The final documentation rules are modified as follows:
 - The documentation rules become effective on a deferred basis – Instruments issued before January 1, 2018, are subject to the rules
 - The documentation requirements apply only if the issuer is a member of a group with at least one publicly traded corporation, a group with at least \$100 million in assets, or a group with at least \$50 million in revenue
 - Documentation is timely if prepared by the time for filing the issuer's Federal income tax return (taking into account extensions)
 - The rights of the creditor may be provided by applicable state law referred to in the instrument
 - A prohibition on subordination that existed in the proposed regulations have been removed
 - The annual credit analysis will cover all loans within the period, provided that the borrower's credit capacity is not exceeded



Debt Characterization Other Provisions in Final Regulations

- The final regulations do not apply to debt issued by non-U.S. issuers.
- Financial service entities subject to Federal regulation are generally exempt
- Short-term loans are generally excluded from the final regulations, including cash pooling arrangements and international treasury centers
- All taxpayers can exclude the first \$50 million of debt



Trump Proposals



The Trump Proposals

- Reduce number of individual tax brackets from seven to three brackets of
 - 1) 12% - taxable income less than \$75,000,
 - 2) 25% - taxable income >\$75,000 and <\$225,000
 - 3) 33% - taxable income more than \$225,000
- Increase standard deduction to \$15,000 for single filers (from \$6,300) and to \$30,000 for joint filers (from \$12,600) - indexed for inflation
- Leave personal exemptions at \$4,000 per person (indexed for inflation)



The Trump Proposals

- Cap on itemized deductions
 - \$100,000 for single filers
 - \$200,000 for married filers
- Tax dividends and capital gains at maximum rate of 20%
- Treat carried interest as ordinary business income



The Trump Proposals

- Repeal of Net Investment Income Tax (Obamacare)
- Repeal of AMT
- Repeal of estate tax BUT...
 - replace with a capital gains tax on assets held at death and valued over \$10 million
 - Contribution of appreciated assets into a private charity established by the decedent will be disallowed



The Trump Proposals

- Childcare
 - Above the line deduction for children under age 13
 - Capped at state average for age of child
 - Not available for taxpayers with total income over \$500,000 (MFJ) or \$250,000 (single)
 - Exclusion applies to families who use stay at home parents / grandparents
 - Limit of 4 children per taxpayer



The Trump Proposals

- Business
 - Reduce tax rate from 35% to 15%
 - One time 10% tax on repatriation of corporate profits held offshore
 - Repeal corporate AMT
 - Allow U.S. based manufacturers to elect full expensing of plant and equipment
 - No interest expense if election made



The Trump Proposals

- Repeal of the Estate Tax
- Replaced with a capital gains on death tax (applies to capital gains valued over \$10 million)



The Trump Proposals

Analysis – Tax Policy Center

- Reduce federal receipts by \$9.5 trillion between 2016 and 2026
- 3/4s of the reduction comes from individual tax provisions
- Business tax cuts – reduce revenues by \$3.5 trillion
- Elimination of estate tax – reduce revenue by \$224 billion



The Trump Proposals

Analysis – Tax Policy Center

- Including interest costs, the proposals would add \$11.2 trillion to the national debt by 2026 and \$34.1 trillion by 2036
- Assuming no corresponding spending cuts – national debt would rise by 39% of GDP in 2026 and to nearly 80% in 2036.



The Trump Proposals

Analysis – Tax Policy Center

- Cut taxes by an average of \$5,100 (7%)
- Highest 1% would get an average cut of over \$275,000 (17.5% of after tax income)
- Highest 0.1% would get an average tax cut of over \$1.3 million (19% of after-tax income)
- Lowest-income households would receive an average tax cut of \$128 (1% of after-tax income)
- Middle-income households would receive an average tax cut of \$2,700 (5% of after-tax income)



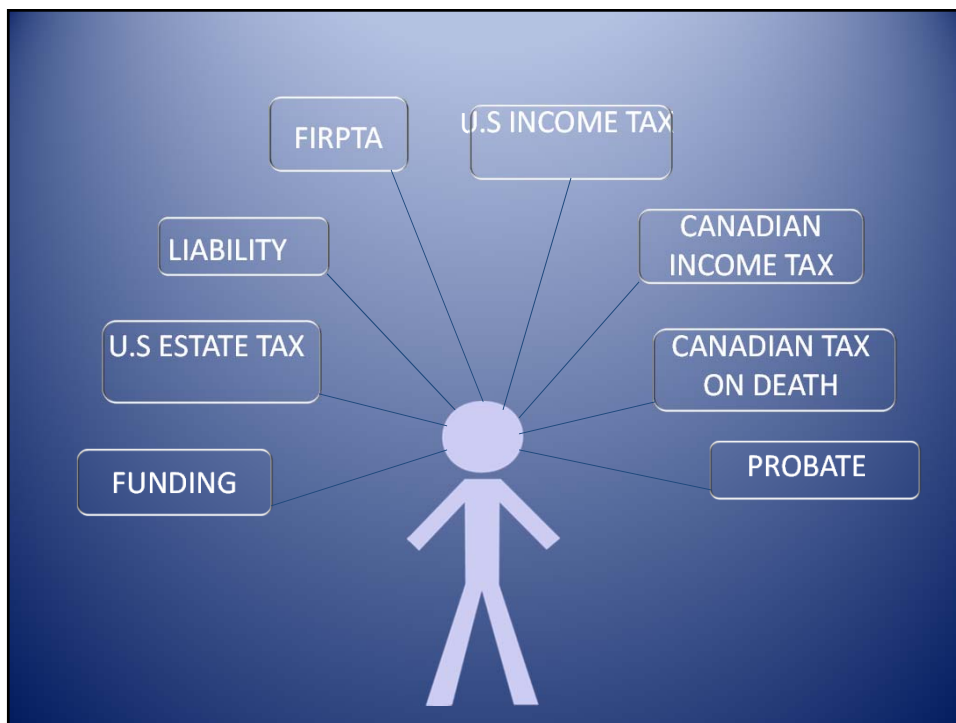
The Trump Proposals

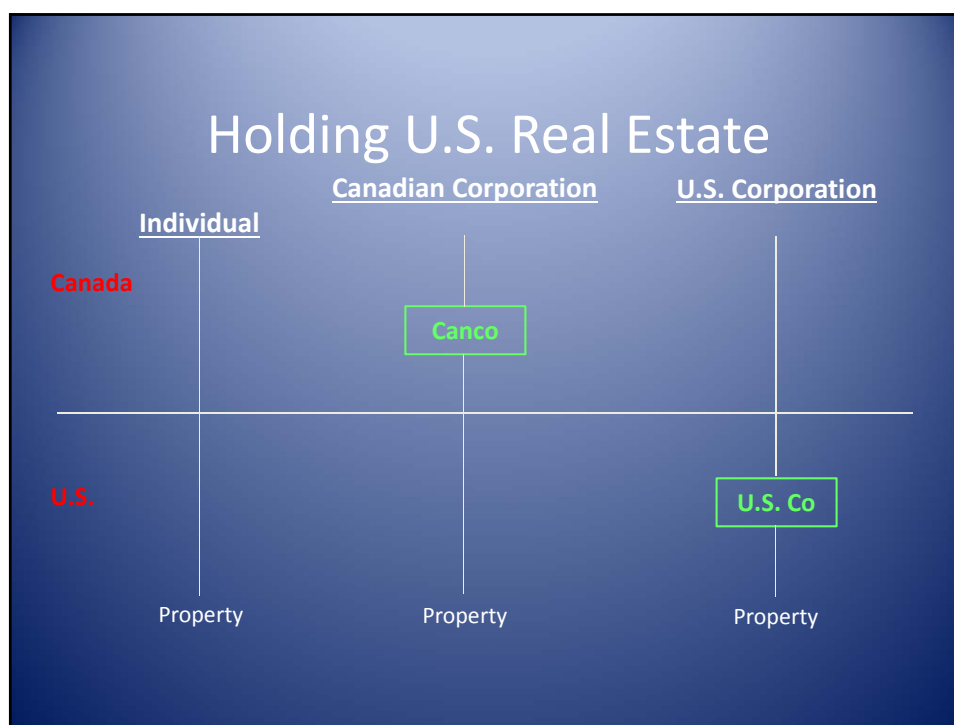
Analysis – Tax Policy Center

- The number of households that would pay no income tax would increase to 110 million (63%) from the current 77 million (44%).




U.S. Real Estate





Holding U.S. Real Estate

	Individual	Canadian Corporation	U.S. Corporation
Rental income	30% withholding or net election and U.S. tax return 1040 NR.	30% withholding or net election and U.S. tax return 1120 F.	No withholding but U.S. corporate tax on income.
Foreign tax credit in Canada	Yes	Yes	No
FAPI	No	No	Yes but likely U.S. tax high enough to negate.
U.S. tax on sale as capital gain	Maximum 20%	Maximum 35%	Maximum 35%
Double taxation	No	Yes	Yes


CADESKY TAX
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Overall Tax on Sale

	Individual	Canadian Corporation	U.S. Corporation
Capital gain	\$100	\$100	\$100
U.S. federal tax	(20)	(35)	(35)
Withholding tax on dividend	N/A	N/A	(9.75) (15%)
Capital dividend	N/A	50	N/A
Taxable dividend	N/A	15	65
Canadian personal tax	(26.5)	(6.75)	(34.8)
FTC	<u>(20)</u>	<u>-</u>	<u>(9.75)</u>
Total tax	<u>\$26.5</u>	<u>\$41.75</u>	<u>\$69.79</u>
			<u>52.23%</u> if redemption



Issues that need to be addressed

- On purchase (how and where are the funds coming from)
- During period of ownership (personal or rental use)
- On disposition – sale, gift, exchange or on death
- Issues include
 - Effect of residence status (U.S. or foreign)
 - Income tax/withholding tax on rental income,
 - Capital gains - FIRPTA and state withholding
 - Gift tax, estate tax and generation skipping transfer tax



Other Issues

- Actual usage – how often are you going to use the property – maybe better to rent instead or purchase a time share
- U.S. Federal income tax
 - Corporate vs. personal rates – i.e., long term capital gain
- State income tax (if applicable)
 - Corporate vs. personal rates – Florida for example
- Canadian income tax
 - Need to look at global tax impact not just country by country
- Ancillary probate
- Real property taxes
 - Homestead exemptions
- Transfer taxes (stamp duties, etc.)



Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)

FIRPTA withholding if owner (seller) is foreign

- 15% withholding imposed on gross amount realized
 - Exemption protects buyer
 - Exemption is only from withholding, not from FIRPTA taxation
 - This is not a final tax but is a credit that is claimed
- Purchase price up to \$300,000. There is an exemption where buyer will reside in the property 50% of time it is in use during each of the first two 12-month periods following the date of transfer.
- Purchase price between \$300,001 to \$1,000,000. Withholding can be reduced to 10% if buyer has definite plans to reside in the property.
- Purchase price over \$1,000,000 – 15% withholding applies – no residence exemption



FIRPTA (cont'd)

- Excess withholding can be avoided based on maximum tax
 - See IRS Form 8288-B and Rev. Proc. 2000-35, 2000-2 CB 211
- Without waiver, funds must be remitted to the IRS (by purchaser or their agent) within 20 days following the day the closing took place.
- If waiver applied for, funds must be remitted within 20 days of receiving the IRS withholding certificate notice.
- Many title agents DO NOT want to hold funds – will just withhold and remit to IRS
- Some states require withholding on sale by non-residents
- Form 1040NR must be filed to report the sale/income – due June 15th following year



Buying the property



Goals

- Want to take advantage of long term capital gains rate – 0%, 15% or 20% (depending on level of U.S. taxable income)
- Corporations are not entitled to long term capital gains rate – ordinary income up to 35%
- Some states (Florida, Texas) do not impose a state personal income tax but may impose a corporate tax (Florida – 5.5%)
- Liability issues



Individual Ownership

Positives

- Taxes on disposition will be lower (LTCG)
- Step-up in basis/ACB for both U.S. and Canadian tax purposes
- May qualify for principal residence exemption in Canada (though probably not in the U.S.)
- Planning opportunities
 - Doubling of U.S. unified credit
 - Use of non-recourse mortgages
 - Term life insurance
 - Cost effective (probably cheaper than corporate ownership and corporate filings)



Individual Ownership

Some potential issues

- U.S. estate and gift tax exposure
 - 2017 exemption amount – U.S. \$5,490,000
- JWROS - Joint With Right of Survivorship – eliminates probate but NOT estate tax exposure
- Who provided funds to purchase property?
- Sale subject to FIRPTA



Individual Ownership

Income tax issues

- Need to file U.S. personal tax return – Form 1040NR (if rented and/or on sale)
- Income / expenses also included on Canadian return
- U.S. taxes paid eligible for FTC in Canada
- Capital gains treatment on eventual sale
 - Long term if property held greater than 1 year
- No liability protection – need sufficient insurance



Individual Ownership

Taking title (assumed with Canadian spouse)

➤ JWROS

- Not effective for estate tax planning purposes, but simplifies transfer at death. U.S. situs asset for U.S. estate tax purposes
- Tenants in common ownership preferred versus joint tenancy
 - Joint tenancy – deemed disposition on death of first spouse unless otherwise demonstrated survivor funded purchase
 - Tenants in common – possible benefit from favourable valuation of minority interest (FMV decreased – how can you sell 50% of property?)
- Possible gift at time of purchase, then subject to U.S. gift tax.



Corporate Ownership

Positives

- Anonymity (if desired) – bare trustee arrangement? U.S. may not recognize.
- No probate on death of shareholder
- No gift tax on intangibles (if ownership gifted)
- No FIRPTA issue (if selling corporation is U.S.)
- No need to file U.S. individual personal tax returns



Corporate Ownership

- Some potential issues (U.S. corporation)
 - If U.S. corporation – Canadian controlled foreign affiliate (CFA) rules – T1134 filings
 - FAPI
 - If U.S. corporation – U.S. situs asset for U.S. estate tax purposes
 - Increased tax rate – no LTCG treatment
 - Potential shareholder benefit issues for personal use
 - Imputed income?
 - On death – no step-up in basis/ACB of underlying real property



If U.S. Company

Issues To Think About

- 50% or greater shareholder disclosed on Form 1120
- 25% or greater shareholder must be identified on Form 5472 if U.S. corporation engages in related party transactions
- Reporting extends to foreign corporation engaged in U.S. trade or business



If Canadian Company

- No U.S. estate tax
- No U.S. gift tax on gift of Canadian shares
- No probate
- Potential U.S. branch profits tax (5%) instead of withholding on dividend distributions (but exemption on up to \$500,000 of earnings)



Canadian Company - Further Details

If a Canadian corporation

- Is rent effectively connected?
- Is shareholder tenant a withholding agent?
- Trade-off of depreciation vs. potential increase of FIRPTA gains



Canco Further Details

- If rented must file Form 1120-F to report income and expenses
- Long term capital gain treatment not available
- May also be subject to state corporate tax
- U.S. taxes paid can be claimed as a foreign tax credit in Canada



Canco Ownership - Further Details

Issues on Sale or Exchange by a Foreign Corporation

- Mandatory gain recognition and taxation (Section 897)
 - 20% tax rate for capital gains of NRAs, 25% for recapture income
 - 34%/35% tax rate for corporations on net income* after reduction for net operating loss carryovers
 - Branch profits tax on gain (5%) if property is owned by foreign corporation and steps are not taken to completely terminate U.S. business (\$500,000 exemption)
 - Credit allowed for tax withheld under Section 1445
- Basis
 - If home used in trade or business, may require depreciation adjustment

* Capital gain 100% included in net income.



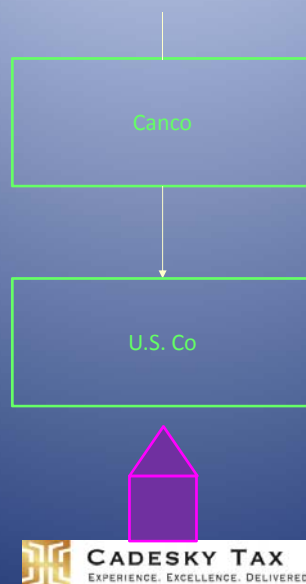
Canco Ownership - Further Details

Issues on Sale or Exchange by a Foreign Corporation (cont'd)

- Availability of net operating loss carryovers
 - Regs. §§ 1.873-1 and 1.882-4(a) deny losses and deductions if no tax returns filed during ownership period but basis may still be reduced by “allowable” depreciation
- Sale of principal residence exclusion – Section 121
 - Technically can apply to NRAs
 - But facts will often make section unavailable except for departing individuals
- Section 1031 unavailable for personal use property
- Section 1031 inapplicable to exchange for foreign real property



Two-Tier Corporate Structure



Two-Tier Corporate Structure

Benefits

- U.S. estate tax sheltering
- Dividend from U.S. Co to Canco tax-free except 5% withholding
- Can still get capital gains treatment on repatriation by share redemption



Canadian Partnership

Positives

- Maintains lower personal tax rates (on the assumption that the partners are individuals)
- Maintains LTCG rate
- Possibly no probate tax (since partnerships do not die)
- No gift tax on transfer of property interest (intangible property)
- But if purely passive holding will it be a partnership?



Canadian Partnership

Issues

- Need a GP as well as LP interest if limited liability is important – increased organizational and ongoing filing costs
- Is this partnership interest a U.S. situs asset for U.S. estate tax purposes? Probably but not certain.
- FIRPTA
- IRC 1446 withholding on ECI



Canadian Partnership

Income Tax

- Payments (rent, sale proceeds) to foreign partnership subject to withholding by payor (tenant, buyer) under Sections 1441 and 1445
- Use of home may require income to be imputed or expenses disallowed
- Transfer of U.S. real property to partnership entitled to non-recognition, but notice to IRS needed to avoid FIRPTA withholding



Canadian Partnership

Estate Tax

- Situs is the critical factor
- Rules for partnership interests unclear
 - IRS position: Partnership interest has U.S. situs if partnership engaged in U.S. trade or business
 - Apparently irrespective of relative sizes of U.S. business and other activities and assets
 - What if partnership is not actually engaged in trade or business but has income deemed effectively connected under Section 897(a) or NRA made net rental income election under Section 871(d)?
 - Other possibilities:
 - Situs based on residence of partner
 - Place of organization
 - Look-through (partnership as aggregate)



Canadian Family Trust

Positives

- No probate since trust never passes away
- Taxed at lower (U.S.) personal tax rates
- Disposition treated as LTCG
- No probate

Items to think about

- If properly structured – no U.S. estate tax



Canadian Family Trust

Some potential issues

- FIRPTA
- 21-year rule
- Ascertainable standard
- Should have non-related independent third party trustee
 - Not related or subservient



Giftting?

Issues at Time of Gift of U.S. Real Property Interest

- Gift tax applies to gifts of real property located in the United States, but not to gifts of stock in USRPHC or in partnership
- \$60,000 exemption for gift tax. Serious problem. Do not gift U.S. real estate.



Ownership Issue Rental

If rented:

- If no election made, gross rent taxed at 30%
- No return required to be filed
- Can elect to be taxed on a net income basis
- Tax depreciation is mandatory
- Return must be filed
- Consider state filings as well
- Can claim operating expenses
 - Mortgage interest, property tax, insurance, etc.



Ownership Issue Personal Use

Personal use (not rented)

- No tax returns need to be filed unless property is sold
- If net worth < US\$5,450,000 simplest way to take title is in personal name (liability issues?) due to estate tax exemption
- JTWRORS vs. Tenants in Common



Practical Issues

- Setting up entities
 - Opening bank accounts – this has become a real challenge
 - Obtaining ITINs (miserably difficult) and EINs (relatively easy)
- Managing the property
 - Filing tax returns
 - Recordkeeping
 - Local transfer taxes on “tax-free” transfers
 - Respecting structure
- Basis
- Privacy
- Home country taxation



Conclusions

Need to balance issues of

- income tax
- U.S. estate tax
- limited liability
- cheap and cheerful structure

Income tax →	personal holding
U.S. estate tax →	trust properly constructed or corporate (but bad for income tax) unless within exemption level
Limited liability →	corporate structure or insurance
Cheap and cheerful →	personal ownership



Conclusions

- Solve U.S. estate tax issue by removing other U.S. situs assets from personal name.
- Corporate ownership looks tempting but many regret this later.
- Trust must be specially drafted and carefully funded (cannot just use any old trust).



Conclusions

Value Matters

- U.S. situs assets under exemption limit US\$5.4 million
→ hold personally
- U.S. situs assets (with U.S. real estate) over US\$5.4 million
→ remove other U.S. situs assets
→ double up on marital exemption
- U.S. situs assets above US\$5.4 million after tax planning → use trust structure if property is valuable
- But watch this space
TRUMP IS COMING

