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2013 US TAX STRUCTURE: IMPACTS FOR CANADIAN RESIDENTS

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Beginning January 1, 2013 a number of new taxes and new rates took effect in the US tax system. Tax rates, on occasion, change in the US and for the most part don't affect Canadians or US citizens living in Canada. However, with this round of tax changes Canadian residents should take note.

Normally, in its simplest form, cross-border tax involves paying tax in the jurisdiction in which the income is "sourced" and receiving a credit in the home country in which the taxpayer is resident. Let's use an example throughout this newsletter for simplicity where a US citizen taxpayer is resident in Canada and receives only Canadian source income, say employment income earned while present in Canada and dividends from Canadian companies at the top rates.

This income in our example is taxed in Canada and then taxed in the US, but the US would permit a credit for the taxes paid in Canada which would exceed the rate of US tax on that same income so there would likely be no additional tax in the US under normal circumstances.

As alluded to above, this system seems to work well as a whole for US Citizen/Canadian taxpayers as long as the rate of tax in Canada exceeds the US tax on the same income in the US. Where it falls apart is when there are situations where Canadians pay less tax in Canada than the US on the same income, such as a Canadian capital dividend, or winning the lottery, or splitting pension income as examples of unique Canadian tax situations with low Canadian tax and no reductions to US rates.

The first change to the US tax structure for 2013 shouldn't affect US citizens in Canada as it will not increase the US tax rate beyond the Canadian rates. A marginal rate increase was added to the top rate of 35%, to make a 39.6% rate (to match the top rate during the Clinton administration), which starts at $400,000 of taxable income for single filers and $450,000 for joint filers. Qualified dividends and Capital gains continue to be taxed at 0% for the first $36,500 and then at a top rate of 15%, but that rate now stops when total income exceeds $400,000 (or $450,000) and now a top rate of 20% applies if taxable income exceeds that threshold. Again, a Canadian taxpayer who is paying at the regular top Canadian tax rates should have enough foreign tax paid in Canada to cover the US tax on that passive income.

The other new tax is a .9% social security tax addition. This tax will affect any taxpayer who is receiving wages that have US social security taxes withheld. Most Canadian taxpayers don't have US wages, and even if taxpayers have a salary from US companies, they generally have a "Certificate of Coverage". This is a document which is authorized by the Canada-US totalization agreement on Social Security which permits a US employer exemption from withholding social security (FICA) taxes from US wages because that employee is covered by Canadian CPP. They would have received this certificate because they are temporarily working in the United States and will be returning to Canada.

The third tax, which will cause concern, is the tax which is intended to fund the new health care system in the US. This additional tax will apply for those taxpayers with gross income that exceeds a certain threshold. For married filing jointly, the threshold is $250,000, for single taxpayers and head of household it is $200,000 and for married filing separately (which is a very common filing status for US Citizen/Canadians who are married to Canadians who are not US citizens) is $125,000. This tax does not apply to US Non-Resident Aliens.

Once a taxpayer has reached this threshold, then the additional tax of 3.8% applies to the "Net Investment Income" which is (with some exceptions and additions): interest, dividends, net capital gains, rents and royalty income reduced by interest expense, brokerage fees, rental expenses, and state and local income taxes allocable to that income.

Again, under normal circumstances a taxpayer at its face should not be concerned because even at 39.6%, an additional 3.8% tax wouldn't use all of the Canadian tax paid at that same level of income, however this is an unusual situation which involves some complex analysis.

This new tax was placed in Section 1411 of the Internal Revenue Code, which becomes very relevant in our analysis of why this will be an extreme problem for Canadians.

Section 27 of the Code gives us the Foreign Tax Credit that says that we can use foreign (i.e. Canadian taxes) to the extent permitted by other code sections like Section 901, against any taxes imposed on taxpayers by Chapter 1 of the Internal Revenue Code.

The Internal Revenue Code is actually part of the bigger set of all federal law called the United States Code (USC). The USC is broken up by area of law called Titles. The Internal Revenue Code is Title 26 of the USC, and within the titles it is broken further by chapter and then by subchapter, then by section. Chapters are referred to in everyday common language in other parts of the USC, like the bankruptcy code (which is Title 11). We hear of companies utilizing chapter 7 or 11 of the bankruptcy code all the time. In contrast, normally we don't refer to what chapter things are in Title 26, the Internal Revenue Code, as normal taxes are all in Chapter 1.

Our problem lies in the fact that Chapter 1 ends at the conclusion of Section 1400. Section 27 says we get a credit for all taxes incurred by Chapter 1 but this new tax is at Section 1411. Our normal foreign tax credit that we get for Canadian taxes paid can only be for all the normal taxes assessed from sections 1-1400. As such, this additional US 3.8% tax will be paid but foreign tax credits are not allowed to be used against the additional tax.

To provide one further example which would elicit a very punitive result for a US citizen in Canada, let's assume the taxpayer utilized their Canadian capital gains exemption on the sale of qualifying shares. For Canadian tax purposes there would be effectively no tax, but for US tax purposes there would be potentially up to 20% tax on the long term capital gain which would have no Canadian tax to offset as a foreign tax credit (unless there was any tax carryforward in the correct basket), and in addition there would be the new 3.8% tax with of course no offset by any Canadian tax.

An argument will likely be made that the Canada-US treaty was designed to discourage double-taxation, however the courts have routinely said that when a conflict between law and the treaty occurs we look to which was put into place last, and this law clearly was the last enacted.

Of course Canada won't give a credit for the additional US taxes paid on the Canadian return because the investment income that generated the US tax would be Canadian source income in our example and Canada would only give a foreign tax credit for taxes paid on foreign source income.

The best US citizens in Canada can hope for at this point would be that the Treaty be amended to reflect this new tax, or that this new law be moved to chapter 1, or that it be changed completely, or that the health care act be modified or funded in a different fashion.