Rethinking your firm’s cross-border tax strategy: The impact of Donald Trump’s business tax reform on Canadian entrepreneurs

Azadi Rajan JD, LLM (US Tax)
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It is safe to say President-elect Trump ran a presidential campaign that was bold, filled with fiery rhetoric, and sometimes knew no bounds. For example, at the first presidential debate when asked about paying no personal income tax since 1995, the former Celebrity Apprentice host unequivocally responded, “That makes me smart.” For Canadian entrepreneurs thinking about expanding their business into the US, being smart like Trump means understanding the impact an evolving US tax landscape will have on them and their business.

President-elect Trump’s tax platform calls for significant changes to the US tax system for individuals such as reducing the number of tax brackets and repealing the estate tax. On the business tax side, his plan includes reducing the US corporate tax rate from 35 per cent to 15 per cent, providing a current deduction for capital investments and eliminating many current corporate tax deductions including interest.

Admittedly, the President-elect’s tax reform plan has a lot of moving parts and will require fine-tuning as he works through reforming the 75,000-page puzzle called the US Internal Revenue Code and regulations. That being said, President-elect Trump has the benefit of a Republican-controlled House of Representatives and Senate which share his vision and thus make it much more likely that some of his proposals will be implemented.

So what do President-elect Trump’s proposals mean for Canadian entrepreneurs who are thinking about starting a new business or expanding their existing business into the US? Do the traditional cross-border tax planning techniques still make sense? Before tackling these questions, let’s start by reviewing the current US business tax landscape.

The current US business tax landscape

There are a number of ways Canadian entrepreneurs and businesses can structure their US business activities, which will determine how the business will be taxed and its net effective rate of tax. The US Treasury regulations allow certain business entities to choose a classification for tax purposes such as corporations, partnerships, or disregarded entities. There are flow-through entities, limited liability companies, and unincorporated branches. Each entity and tax classification has its own benefits, drawbacks, and complexities.

Canadian entrepreneurs dipping their toe into the US typically use a branch structure because it is relatively easy to set up in that there is no need to incorporate a separate legal entity and there is the immediate repatriation of US profits. Also, any US branch losses can be used against the Canadian home office profits, which may be a nice benefit in the start-up phase of the US operations. Conversely, if the US branch turns profitable, the Canadian company may be subject to US branch taxation on deemed withdrawals from the branch and will also be subject to Canadian tax on the US profits.[1]

The US tax reporting obligations for a Canadian corporation with a branch in the US can be quite onerous because it includes calculating not only the entity's US net income subject to tax but also income subject to branch level taxes. Importantly, Canadian companies that fail to timely file their US branch tax return run the risk of being subject to significant penalties for each taxable year in which the failure to file occurs.[2] Further, the Canadian corporation may also be precluded from claiming deductions and tax credits as a result of the failure to supply the required information to the IRS.[3] With respect to state income tax reporting, some states may require the Canadian company to determine its state taxable income based on worldwide income. The Canadian company will likely have to register in each US state where it conducts business, which may result in higher registration fees and it could open up the Canadian company to IRS or state audit.

To avoid some of the administrative burdens inherent in a US branch structure, a Canadian business could form a wholly-owned US subsidiary (USCO) to conduct its US operations. In general, under current law, USCO would be subject to tax in the US on its taxable income at a maximum US federal corporate income tax rate of 35 per cent. In addition, USCO would also be subject to US state and local taxes where it has a taxable presence. If at least 10 per cent of the voting stock of USCO is owned by the Canadian parent, then pursuant to Article X of the US-Canada Treaty, any dividend paid by USCO to the Canadian parent would be subject to US withholding tax at a rate of five per cent. From a Canadian tax point of view, USCO's business profits can be deferred from Canadian corporate income tax until dividends are paid to Canada.

Rethinking the traditional cross-border tax strategy

Cross-border tax planning is generally built around the goal of moving profits from high-tax rate jurisdictions to low-tax ones thereby minimizing the enterprise's global tax footprint. Many sophisticated tax structures used by large multinational businesses such as Apple, Amazon, Microsoft, and Pfizer are premised on this simple idea. If the President-elect's proposal to reduce the US federal corporate tax rate to 15 per cent comes to fruition, the US would have one of lowest corporate income tax rates in the OECD countries. As a result, Canadian businesses should be prepared to rethink their tax strategy when choosing to expand into the US.

Income tax deferral in a US corporation: FAPI is back in town

Currently, an Alberta-based business is taxed at the maximum corporate rate of approximately 27 per cent[4], while a US company is subject to tax at the maximum corporate rate of approximately 40 per cent.[5] The reduction of the US federal corporate tax rate to 15 per cent will require Canadian businesses with passive US activities to reconsider the application of Canada's foreign accrual property income (FAPI) rules to their business. For example, if a US subsidiary of a Canadian corporation holds passive assets—such as US real estate or portfolio assets—then Canada's FAPI rules might apply to impute income to the Canadian corporation notwithstanding such income has not been distributed by the US subsidiary to the Canadian corporation. Such FAPI income may, however, be offset by 'foreign accrual tax' (FAT) in respect of the US tax paid by the US subsidiary. Since US corporate tax rates have traditionally been higher than Canadian corporate tax rates resulting in fully offsetting FAT deductions, in many cases, FAPI has no net impact to the Canadian corporation. However, this may not be the case anymore with a significantly lower US corporate tax rate.

Less tax efficient cross-border financings

Traditional cross-border tax planning for Canadian corporations with US operating subsidiaries often involved cross-border financings to fund large asset acquisitions in the US. The reason for this is because the interest on the cross-border loan was deductible by USCO when paid and was not subject to US withholding tax pursuant to the US-Canada Treaty.[6] Tax efficient financings traditionally saved the Canadian company between 10 – 13 percentage points on taxes based on the current tax rate arbitrage between the US and Canada. If USCO used the funds to purchase new equipment, it would be able to take deductions for depreciation on those asset purchases. Under President-elect Trump's tax reform plan, US businesses will be able to immediately expense business investments rather than depreciating these costs. However, businesses that elect to expense would not be allowed to deduct interest expenses. Although President-elect Trump's plan is short on details on how this would be implemented, traditional planning that involved cross-border financings are likely not going be as tax-efficient as they once were.

The rise of the US corporation

Choosing the optimal form of organization is and will continue to be a critical element in ensuring a successful business expansion in the US. Traditional cross-border planning often involved avoiding US domestic corporations in favor of flow-through entities such as unincorporated branches or limited liability companies (read a previous blog for comments on the use of LLCs by Canadian investors). However, as a result of the President-elect's tax reform plan, US domestic corporations may now be the best choice in some circumstances. For example, profitable US branches of Canadian corporations may no longer be optimal because, unlike corporations, profits of the US branch would be deemed to be immediately earned by the Canadian company and reportable on its Canadian tax return. Such profits would be taxed at the Canadian combined rate of 27 per cent versus the new combined US tax rate of approximately 20 per cent[7] in a US corporation. Further, future incorporation of the branch into a US corporation may, in certain cases, trigger Canadian tax liability since the deferral of built-in gains is generally not possible for Canadian tax purposes on property transferred to a non-Canadian corporation. As a result of President-elect's plan, the use of corporate entities may now be the best option in certain cases, but each case will need to be reviewed carefully.

Next steps

President-elect Trump will be sworn into office on January 20, 2017, and the Trump administration will officially commence after Chief Justice Roberts administers the oath of office. The business community in the US seems to be getting comfortable with the thought of a Trump Presidency. Indeed, the capital markets appear to have already become comfortable with the change of administration because, on election night, futures on the Dow Jones Industrial Average (DJIA) plunged almost 800 points and the global economy was thought to be in jeopardy. Now the DJIA is reaching all-time highs and the global economy is poised for growth.

These are exciting times for businesses in the US but, as discussed above, the President-elect's business tax reform proposals contain many traps for unwary Canadian businesses and entrepreneurs expanding or doing business in the US. Although many people have applauded Donald Trump for overcoming all the obstacles and naysayers to become the next President of the United States, I recall the advice a smart man once gave me: "One does not applaud the tenor for clearing his throat." With President-elect Trump in the driver seat, buckle up your seatbelt because you ain't seen nothin' yet.

[1]The US branch profits tax is 30 per cent but may be reduced to 5 per cent pursuant to the US-Canada Treaty. The branch profits tax base is essentially the branch earnings for the year less amounts reinvested in the US.

[2] I.R.C. §§ 6038A(d), 6038C(c).

[3] Treas. Reg. § 1.882-4(a)(2).

[4] Assuming a Canadian federal corporate tax rate of 15 per cent plus Alberta provincial tax rate of 12 per cent.

[5] When doing business in the US it important to keep the application of various state and local taxes in mind. State corporate income tax rates vary, so a 5 per cent average is assumed.

[6] We have assumed that such interest would not qualify as portfolio interest. Interest and original issue discount that qualifies as portfolio interest is not subject to chapter 3 withholding under sections 1441 through 1443 of the Internal Revenue Code. However, such interest may be subject to withholding if it is a withholdable payment, and there is no exception under chapter 4 (sections 1471 through 1474) of the Internal Revenue Code.

[7] Assuming a state corporate income tax rate of 5 per cent.