The Trump Transition Tax's Impact on Certain Canadians: A Practical Solution for Ottawa to Consider

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Every day, it seems, Finance Minister Bill Morneau fields questions about Canada's international competitiveness considering the recently enacted US tax reforms, which became effective January 1, 2018, by the Tax Cuts and Jobs Act ("TCJA"). Indeed, the TCJA lowered US tax rates and handed out tax breaks to all kinds of entrepreneurs, businesses, and individuals. All of which tend to make Canada (and other OECD members) internationally less competitive. However, some US citizens residing in Canada were handed the opposite of a tax break: a one-time tax hike. As with Canada's overall tax competitiveness, Ottawa could provide tax relief to these individuals.

Generally, under the TCJA every US citizen individual who controls "a non-US corporation (or who owns an interest in a non-US corporation controlled by US persons) has to pay a one-time tax on the retained earnings of those corporations either as a lump-sum or in installments spread out over eight years. This one-time tax is commonly referred to as the Transition Tax, and it can leave those affected Canadian residents with a substantial (and unexpected) US tax liability.

The Transition Tax generally works as follows: US citizens and US businesses that own a controlling interest in a foreign corporation—such as Canadian corporations—are deemed to receive a dividend equal to the corporation's retained earnings. These shareholders are subject to US tax on the deemed dividends at two different rates – the retained earnings of the corporation reflected by cash assets are subject to a 15.5% effective rate and non-cash assets at an 8% effective rate. When the retained earnings are distributed to the shareholder in the future as a dividend they are not taxed again by the US (though they are subject to tax in Canada).

Let's quickly illustrate the application of the Transition Tax. Let's assume that Ms. Smith is a US citizen and resident of Canada. She owns 100% of the shares of CanadaCo and thus controls CanadaCo. The only assets of CanadaCo throughout 2017 was cash of US$1m. Ms. Smith will be deemed to have received a dividend of the US$1m and therefore will subject to a Transition Tax liability of US $155,000. Ms. Smith can choose to pay the resulting tax liability over 8 years or pay it in a lump sum.

In most cases, however, the Transition Tax will not be available as a tax credit here in Canada for two reasons: First, the Transition Tax applies to the shareholder even if the Canadian corporation has not actually declared a dividend meaning that there is no "source" of income against which to credit the Transition Tax. Second, under Canadian law, dividends received by a shareholder from a Canadian corporation are classified as Canadian source income and therefore the resulting Canadian tax liability is not eligible to be credited for the US tax paid (the general principle is that US taxes will be creditable only if the income received is US sourced).

At the 2018 Society of Trust and Estate Practitioners (STEP) conference held in Toronto, the Canada Revenue Agency (CRA) confirmed that a Canadian resident shareholder's Canadian tax liability would not be eligible for a credit to offset the Transition Tax paid (see question #12 of the CRA Roundtable Questions & Answers here). Accordingly, this can lead to double taxation for these unfortunate Canadian residents.

The media has reported that Ottawa is aware of this issue and is in discussions with the Trump administration to persuade it to provide a US solution.[1] While a diplomatic solution would be best, recent experience between Ottawa and Washington D.C. leaves little hope of success. Fortunately, Ottawa could unilaterally provide relief to these Canadian residents by a straightforward modification of Canadian domestic law.

Thinking outside the box, a potential solution would be to modify Canadian law to allow Canadian residents the ability to offset their Canadian tax by way of a credit of the Transition Tax. This would alleviate the double tax burden. This one-time credit would be allowed to individuals when income is realized in Canada, the source of which gave rise to the Transition Tax. In other words, if the Transition Tax was paid by a Canadian resident shareholder, any future dividends paid to the shareholder (which would not be taxable from a US perspective, given the fact that such amounts were already subject to the Transition Tax) would be eligible to utilize the one-time special credit to reduce the shareholder's Canadian tax payable on that dividend.

Admittedly, this modification to Canadian law would produce a drain on tax revenues. However, it may be possible to estimate the magnitude by analysis of data that is readily available from the IRS. Further, the Transition Tax may be payable over an eight-year period (without interest), so this deferral would need to be considered when determining the materiality of the impact on government revenues. We concede more analysis is required in order to quantify its economic effect.

Some may also question why Canada would offer relief like this given the fact that such a special credit would, in essence, be a Canadian subsidy of another country's tax revenue. And that is a good point. In this circumstance, however, the answer to such a question would lie in the roots of being sympathetic. The number of people in Canada affected by the Transition Tax would likely be small. However, for those people, the double taxation risks are very real and could have a significant impact on their financial well being. In addition, we believe that governments that ignore situations of double taxation will put a damper on cross-border flows of capital if investors feel that they might be exposed to double taxation in the future. Accordingly, this is an important principle to keep in mind and not ignore.

One country's limited acquiescence of its taxing authority is not unusual and, in fact, is a foundational underpinning of double taxation treaties such as the Canada-US taxation treaty (Treaty). The allowance of a domestic tax credit for foreign tax paid on domestic income is more unusual than a limited acquiescence of taxing authority, however, that result is specifically found in the Treaty. Specifically, Article XXIV of the Treaty provides similar relief by deeming the source of some types of income to be foreign, thereby enabling the use of FTCs to offset the Canadian (or US) tax otherwise payable.

The 2017 US tax reform was breathtaking in the speed of its enactment, the breadth of its international provisions, and its complexity. Canadian residents who are subject to the Transition Tax might have been unintended casualties of the new legislation or they may have been intended casualties, the record isn't clear. Regardless, however, the legislation is in place and those affected are left to contend with its consequences. Fortunately, however, Ottawa can alleviate the double-tax burden of these individuals with an elegant legislative solution.

[1] Some media are also reporting that the recent proposed Regulations continue to pile on damage to affected persons. However, our firm's

view is that the proposed Regulations are consistent with previously issued guidance and simply provide further clarity on some issues (for example, US citizens who renounce their citizenship will no longer be able to pay the Transition Tax over an 8-year period and any remaining liability would be due and payable at that time).