U.S. citizens resident in Canada and Canadian companies that do business in the United States will want to follow the progress of U.S. tax reform plans in the wake of the recent election. Although it is unclear exactly when any significant changes to the U.S. tax regime may be drafted and enacted, there are already some indications that tax-relieving measures may be on the way, including increased incentives for investment and savings, repatriation of profits currently being held overseas, and lower tax rates for both businesses and individuals.

It is now more likely that the United States will enact significant tax legislation in 2017 or 2018, since Republican Donald Trump was elected as president and Republicans also kept control of both the House of Representatives and the Senate in the next Congress. In this edition of TaxNewsFlash-Canada, we describe the existing proposals and their related areas, as well as the process and timing in which any of these proposals might become law.

To help you gain additional insights on important cross-border personal and corporate tax issues following the U.S. election, KPMG Canada is holding a webcast on December 8, 2016. At this webcast, “Will Trump’s Election Shift U.S. Tax Landscape?”, KPMG Tax professionals will provide an update on important U.S. tax and immigration issues and share our insight on how any new U.S. measures may affect Canadians. To attend this webcast, please register online.

Background
In June 2016, House Republicans released a plan for tax reform called “Tax Reform - A Better Way” that proposes to reduce the complexity of the U.S. tax laws and to move...
the U.S. tax system closer to a consumption-based tax. The Republicans are currently collecting stakeholder feedback on this plan, sometimes referred to as a blueprint, which could represent the biggest tax overhaul in the United States since 1986.

Although some tax proposals included in the House plan closely align with measures announced during President-elect Trump’s campaign, others do not. Currently, it is expected that the House will move a new tax bill that is largely based on the House plan, but which also may include measures based on President-elect Trump’s tax proposals, especially in areas which the Republicans and President-elect Trump are in consensus.

In the United States legislature, passing new tax rules can take considerably longer than in Canada. Before it can be enacted, U.S. tax legislation must generally move through the House, the Senate, and Congress as a whole before it is presented to the president for signing. At many of these stages, the bill is subject to debates and further amendments. Because the changes considered in the House plan are extensive, it could be some time until any significant new tax reform is enacted.

### Corporate tax changes

#### Corporate tax rate

While both President-elect Trump and the House plan say they intend to reduce the current corporate rate, which can be as high as 35%, they don't agree on where the rate should be set. The House plan recommends a 20% corporate tax rate, with a special 25% rate on business income earned by pass-through entities while President-elect Trump favours a rate of 15% for both corporations and pass-through entities.

#### Treatment of Capital expenditures and Interest expense

The House plan contemplates allowing businesses to fully and immediately expense the cost of investment in tangible property (i.e., buildings and equipment, but not land) and intangible assets (i.e., intellectual property) and will disallow deductions for any net interest expense. President-elect Trump, on the other hand, has said he will allow U.S. manufacturing firms the option to elect to expense capital investment and lose the deductibility of corporate interest expense.

#### Deductions and credits

Both President-elect Trump and the House plan look at eliminating various special interest deductions and business credits. Specific credits were not mentioned, however both President-elect Trump and the House plan clarify that they will not make changes to the existing R&D credit.
During the campaign, one additional tax benefit that President-elect Trump suggested is a proposed $137 billion in tax credits to investors in infrastructure projects.

**KPMG observations**

While the implementation of credits for infrastructure projects will be subject to the competing priorities of President-elect Trump and the Republican House leadership, the emphasis on repairing the U.S.’s infrastructure and the related job creation has been a consistent theme since the campaign. It seems likely that a more specific infrastructure plan will emerge and Canadians will want to watch closely for the details of the plan to identify any opportunities.

**Other House plan measures**

An additional area of potential tax reform includes eliminating the current deduction for net interest expense allowing deductions for interest expense only up to current interest income. Any disallowed interest expense could be indefinitely carried forward to offset interest income in future years. As mentioned above, President-elect Trump’s plan would continue to allow net interest deductions to corporations which elected to forego the immediate expensing of capital purchases.

Further, the House plan suggests removing the existing provision allowing for the carry-back of net operating losses while allowing them to be carried forward indefinitely (limited to 90% of the net taxable amount for the year) and indexing the losses for inflation. President-elect Trump’s plan doesn’t comment on the treatment of net operating losses.

**Personal tax changes**

**Income tax rate**

Both the House plan and President-elect Trump’s campaign proposals recommend simplifying the individual income tax system by reducing the number of brackets to three (from seven) and reducing the top marginal rate to 33% (from 39.6%).

**Standard deduction**

The standard deduction may also increase in upcoming U.S. tax legislation. Currently, the standard deduction is $12,600 for joint filers and $6,300 for single filers. President-elect Trump is looking at increasing the deduction to $30,000 for joint filers and $15,000 for singles, while the Republicans’ House plan eyes a more modest deduction—$24,000 for joint filers and $12,000 for individuals, along with a special $18,000 deduction for single parents.

**Itemized deductions**

President-elect Trump has indicated that he would cap itemized deductions at $200,000 for joint filers (and $100,000 for single filers). However, the House plan goes further in its
proposal to eliminate itemized deductions other than home mortgage interest and charitable deductions.

Capital gains, interest, and dividends

Although President-elect Trump favours retaining the 20% maximum capital gain rate, the House plan recommends a 50% deduction for capital gains, interest, and dividends, resulting in three new effective tax rates for each (i.e., 6%, 12.5%, 16.5%, respectively).

Carried interest

Under President-elect Trump’s plan, carried interest would be taxed as ordinary income, while the House plan recommends that, for pass-throughs, taxing an amount equal to “reasonable compensation” as ordinary income. Under current tax law, carried interest, or income to the general manager of alternative investment structures such as hedge funds or private equity, is taxed at the preferential capital gains rates. However, this approach has been criticized by some as unfair and market-distorting.

Other personal tax measures

Other areas of agreement for both President-elect Trump and the House plan include:

- Repealing the alternative minimum tax
- Repealing 3.8% net investment income tax as part of repealing Obamacare
- Repealing the 40% estate tax to estates worth more than $5.45 million (although, under President-elect Trump’s plan, capital gains over $10 million at death would be taxed)
- Enhancing child and dependent care measures

International tax changes

Repatriation of controlled foreign corporation income

U.S. parent companies with Canadian subsidiaries could benefit from possible changes to the taxation of repatriated foreign earnings. Currently, taxation on foreign income is deferred until it is repatriated, at which point it is taxed at the corporate tax rates which are as high as 35%. The non-partisan Joint Committee on Taxation estimates that there is roughly $2.6 trillion in deferred offshore profits currently. President-elect Trump has pledged that these earnings could be deemed repatriated at a one-time 10% rate, with the deferral eliminated and future earnings of foreign subsidiaries included in the U.S. parent company’s taxable income in the year earned, with a credit for foreign taxes paid. The House plan, in contrast, contemplates an 8.75% rate for assets held in cash or, for other
assets, 3.75% with future earnings of foreign subsidiaries largely exempt under the new territorial tax system.

**Comprehensive reform of U.S. International Tax Rules**

The House plan includes two changes that represent a fundamental change in how the U.S. taxes multi-national corporations, both domestic and foreign. First, it suggests introducing a territorial tax system rather than the current system which taxes U.S. corporations and individuals on their worldwide income. Second, the House plan recommends a destination-based U.S. international tax system, in which business income would be taxed where goods are sold or services are performed rather than the location of production (as is currently the case). This move toward a consumption-based tax approach would include a 100% exemption for dividends from foreign subsidiaries.

The Republicans also recommend “border adjustments” to exempt exports and tax imports as are commonly used in countries with VAT systems, and with Canada’s GST. This change appears to be in response to the concerns of U.S. multinationals that feel disadvantaged when trying to compete with enterprises from countries with VAT systems that have these adjustments.

**KPMG observations**

While there is no indication that the United States will adopt a national sales tax or VAT system, the House expects that the new cash flow approach to domestic corporate taxation (for instance through the expensing of capital purchases) would be sufficient for it to be classified as ‘indirect taxation’ under World Trade Organization rules. These rules allow border adjustments for indirect taxes, but not direct taxes.

Because the U.S.-Canada Income Tax Treaty does not address indirect taxes, it is unclear how it may be affected by this reform.

It is not yet clear how the United States would handle the transition to a new tax system for domestic and foreign multi-national corporations. President-elect Trump has not addressed this issue.

**KPMG observations**

Canadian enterprises may also be interested in the future of the *Foreign Investment in Real Property Act* (FIRPTA), in light of President-elect Trump’s proposal to increase infrastructure spending. At a recent event, the Chairman of the House Ways and Means Committee indicated to KPMG that he would like to see the entire Act repealed, along with other barriers to foreign investment, although whether such a change may happen remains to be seen.
We can help

Your KPMG adviser can help you assess the effect of the U.S. election and any upcoming tax reform legislation on your business or personal tax situations. For more details on potential U.S. tax reforms and their possible impact, contact your KPMG adviser.