The U.S.TAXFAX

TOPIC: RECENT DEVELOPMENTS IN U.S. AND CROSS BORDER TAXATION

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This edition of the U.S.TAXFAX will discuss a few of the current developments in U.S. and crossborder taxation that have occurred in recent months.

Changes to Taxation of Social Security:

In the tenth edition of the U.S.TAXFAX, we briefly discussed the then proposed change to the Canada-United States tax treaty with respect to social security benefits. On December 16, 1997 these changes were ratified effective for payments made after January 1, 1996.

The new rules give the country of residence the exclusive right to tax social security benefits. This means that the U.S. will no longer withhold 25.5% on U.S. social security benefits paid to Canadian residents and that 85% of the total benefits will be taxable in Canada on the Canadian resident's return. This change will benefit those low income seniors who were negatively impacted by the 25.5% withholding.

Many people have called us recently and asked when the U.S. will stop withholding taxes at source. The answer provided by the Social Security Administration is they will stop withholding tax by March of 1998 and will refund any tax withheld in 1998 with subsequent monthly benefit payments.

Another issue addressed by the two administrations is how to deal with the taxes withheld in 1996 and 1997. Revenue Canada has stated that this change will not cause recipients to pay **more** tax than that which was withheld by the U.S.. Revenue Canada's press releases imply that this may only be the case if the social security was originally reported correctly on the 1996 and 1997 returns.

Revenue Canada has obtained from the U.S. government a complete list (they think) of Canadian residents who have received social security benefits during 1996 and who had tax withheld. This information will enable them to review the recipient's 1996 returns and make a determination as to whether the new rules create on overpayment of tax. If Revenue Canada requires additional information they will contact the recipient. They have stated that they will begin issuing 1996 refunds in early 1998.

For 1997, Revenue Canada has stated that returns should be filed as they were in 1996. This means that the total benefits received should be reported as income on line 115 of the return and then deducted on line 256. Once Revenue Canada receives the information from the U.S. regarding the 1997 social security benefits paid to Canadian residents, they will process reassessments to the 1997 returns if it is beneficial. Revenue Canada hopes to begin issuing refunds of 1997 tax in late 1998.

We recommend that you advise any of your clients who are eligible for a refund from Revenue Canada of the changes to the treaty. If they do not hear from Revenue Canada sometime in 1998, it may be advisable to contact them and inquire about the status of the refund.

Taxpayer Relief Act (TRA) of 1997

#42 - 1480 Foster Street,
White Rock, B.C. (V4B 3X7)
Bus: (604)531-6207
Fax: (604)538-9713
Web: www.kvdb.com
Marc W. Kotler, CA
Wes van den Brink, BBA, CGA

This recently enacted piece of legislation makes dramatic and sweeping changes to the U.S. taxation of taxpayers on both sides of the border. As the name implies, many of the changes provided tax breaks, however, there are some revenue raising provisions which tax advisors should be aware of. We will address a few of the changes we feel will most affect taxpayers on the Canadian side of the border.

Increase in the Foreign Earned Income Exclusion: The TRA increases the foreign earned income exclusion from $70,000 to $80,000 in $2,000 increments starting in 1998. This means that in 1998, U.S. citizens living in Canada will be able to shelter $72,000 of earned income on their U.S. income tax returns.

Gains on the Disposition of a Principal Residence: Before the TRA, gain on the sale of a principal residence by a U.S. citizen living in Canada was taxable. Deferral of taxation was possible if the taxpayer reinvested in a replacement residence of equal or greater value within two years. As these gains were never taxable in Canada, this was one of the biggest costs of having U.S. citizenship. The new rules exempt from taxation up to $250,000 ($500,000 in the case of married taxpayers filing a joint return) of gain realized on the sale of a principal residence and are effective for sales which take place after May 6, 1997. It should be noted that one of the eligibility requirements for this exception is that the taxpayer must have owned and occupied the property as a principal residence for at least two years in the five year period before the date of sale. This new section should significantly reduce the tax risks associated with having a U.S. citizen own a principal residence.

Reduction in Maximum Capital Gains Rate: The TRA reduces the maximum rate of tax on an individual's net capital gain (i.e. the excess of the net **long-term** capital gain for the year over the net short-term capital loss for the year) from 28% to 20% and even to 10% in some cases. Generally speaking, a gain is classified as long term if the asset was held for longer than 18 months. These new rates apply to sales after May 6, 1997.

This change will positively impact those U.S. citizens and non-residents who have a lower capital gains rate in Canada on the sale of an asset than in the United States. This could happen if the capital gains deduction was used to increase the ACB of the asset or if capital losses are available in Canada and are not available in the United States.

Increase in Estate and Gift Tax Exclusion: Prior to the TRA, U.S. citizens could effectively exempt $600,000 of an estate's value from estate tax (this is the case if the individual did not make any taxable gifts during his/her lifetime). The TRA raises this exemption to $1,000,000 by 2006. The catch is that the exemption amount is only increased by $25,000 per year until 2004 at which time a big increase will occur. This change will help those U.S. citizens living in Canada who have to pay U.S. estate tax on the gross value of their estate and are unable to utilize the U.S. tax as a credit on their final Canadian return.

Limitation of Treaty Benefits to Limited Liability Companies (LLC): Much of the cross border tax planning of the past few years has revolved around the use of "financing LLC's" to repatriate profits into Canada at a lower rate than if the income had been earned through a U.S. subsidiary. The TRA has added a provision that denies tax treaty benefits for certain payments made through hybrid entities such as an LLC. This change effectively reduces or eliminates the usefulness of a "financing LLC". Anyone involved in this type of structure should consider whether the benefits still outweigh the costs of maintaining the LLC.

Future U.S.TAXFAXs will address many other parts of the legislation. Suffice it say that the TRA has provided some tax relief, however, it has also significantly increased the complexity of the tax legislation in the process.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained herein.