Collins Barrow
Chartered Accountants

US TAX ALERT

March 2013

U.S. Tax Changes Resulting from Fiscal Cliff Legislation

Matthew Wilson, CPA (Ohio), is a Partner in the Toronto office of Collins Barrow.

On January 1, 2013, the long-anticipated *American Taxpayer Relief Act of 2012*, commonly known as the Fiscal Cliff Legislation (FCL), was passed into law. The FCL addressed looming reversions to old tax rules that could have affected up to 98% of American taxpayers. Compromises were needed from Democrat and Republican lawmakers in order to make the bill work. Some of these compromises were expected. Others came with a few surprises. The permanent and temporary extensions are effective for tax years beginning after December 31, 2012.

Background

To understand what brought this issue and lawmakers to the so-called "cliff," it is helpful to understand the legislative history dating back to the beginning of the new millennium. Rules that were in place in 2000 were changed substantially when President Bush passed numerous tax incentives into law in 2001 and 2003, commonly referred to as the Bush tax cuts. The Bush tax cuts provided numerous relief items, most notably reduced personal and capital gains rates, and reduced rates (and increased exemptions) for estate tax purposes. They also provided certain tax-friendly business benefits, such as favorable fixed-asset expensing provisions. Additional tax incentives were added between 2003 and 2012. In recent years, for example, "bonus depreciation" rules were introduced, providing even greater fixed-asset expensing benefits and further modifications to the capital gains tax rates.

The Bush tax cuts were temporary in nature; their expiry ultimately was pushed to the end of 2012. Much of the disagreement between the Republicans and Democrats revolved around raising rates that would affect "wealthy" taxpayers in particular. Had there been no resolution on the FCL, the Bush tax cuts, along with the temporary rates and rules that had been added along the way, would have reverted back to the provisions in effect before the original Bush tax cuts were passed into law (i.e. the pre-2001 and 2003 rules). The FCL permanently extends some of these interim rules and temporarily extends others.

General extensions (mainly individuals)

Probably the most press-worthy of the rules involved the actual tax rates themselves. Tax rates on "wealthy" U.S. taxpayers were raised under the new FCL. Under the old rules prior to the Bush tax cuts, the rates ranged from 15% to 39.6%. The Bush tax cuts reduced these rates in general; the lowest rate was lowered to 10% and the top rate to 35%. The FCL has moved the top rate back to 39.6% for wealthy individuals, generally defined as married couples earning more than $450,000 and single taxpayers earning more than $400,000. The rates for all other taxpayers remain as they were under the Bush tax cuts rules.

The long-term capital gains rates also were impacted by the FCL. U.S. tax rules allow for lower, beneficial rates for long-term gains on the sale of capital property (i.e. stock & securities, land, etc.) for individuals. Generally, these rules apply to property held longer than 12 months. (Note that the favorable long-term capital gains tax rate treatment is not extended to corporations.)

Under the old rules, the top tax rates were 10% and 20%, depending on the taxpayer's level of income. Under the Bush tax cuts (and changes subsequent to those rules), the top tax rates eventually became 0% and 15%. Further, the long-term capital gain treatment was also expanded to include certain qualified dividends, subjecting them to the lower capital gains rates. Prior to the Bush tax cuts, there had been no favorable tax rate allowed for dividends.

The FCL moves the top rate back to 20% for individuals, subject to the high 39.6% rate described above, and leaves the lower 0% and 15% rates for everyone else. It also permanently extends the long-term capital gain treatment for the so-called qualified dividends.

Also affecting an individual's personal tax return is the treatment of personal exemptions and itemized deductions. U.S. taxpayers receive certain beneficial reductions in their taxable income via personal and dependent exemptions, as well as the ability to

IN THIS ISSUE

U.S. Tax Changes Resulting from Fiscal Cliff Legislation 1

U.S. Tax Treatment of Certain Canadian Tax-Deferred Accounts 4

reduce taxable income with specified deductions, such as mortgage interest, real estate taxes and medical expenses. Under the old rules, these personal exemptions and itemized deductions were subject to a phase-out. This phase-out was removed over time by the Bush tax cuts. Under the new FCL, the phase-out has returned. However, once again it only affects wealthy taxpayers – those individuals subject to the high 39.6% personal income tax rates.

Tax legislators have long struggled with temporary fixes for the Alternative Minimum Tax (AMT). The AMT is essentially a parallel tax system aimed at ensuring that taxpayers with a so-called “ability to pay” do not escape their share of the nation’s tax burden by taking advantage of too many tax preference items that reduce taxable income (i.e. certain itemized deductions, accelerated depreciation, etc.).

The AMT provisions are not designed to impact lower-income taxpayers, and thus an exemption was put in place to exclude taxable income below certain thresholds. However, as incomes rose over the years, this exemption had to be managed annually with legislative “patches,” because the original exemption amount was far too low to exclude the lower-income taxpayers. The FCL provides a permanent solution for this problem by instituting a final patch for 2012, and tying the exemption amount to the rate of inflation on a permanent, go-forward basis.

Certain additional beneficial credits against tax were either permanently or temporarily extended. These credits notably include:

- the Child Tax Credit (permanently increased from $500 to $1,000 per child);
- an adoption credit (permanently increased from $5,000 to $10,000, adjusted for inflation);
- the American Opportunity Tax Credit for tuition and expenses (temporarily extended through 2017 for up to $2,500, subject to a phase-out); and
- the Earned Income Tax Credit, with increased benefits and phase-out amounts (temporarily extended through 2017).

In addition, further extensions have been granted for certain deductions that may reduce taxable income, such as those for education expenses and for state and local sales taxes (taxpayers choose between the more beneficial of this sales tax deduction and a state and local income tax deduction).

Estate tax

Generally, persons subject to the U.S. estate tax can be subject to a tax on the fair market value of their estates upon death. As with the other FCL changes discussed thus far, these rules have been designed to affect wealthy persons primarily. Under the old rules, a person’s estate was subject to this tax only if the fair market value of the estate was more than $2 million, and the top rate was 55%, potentially resulting in a very sizeable tax bill. Under the Bush tax cuts, the exemption was raised to $5 million and the top rate was reduced to 35%, significantly mitigating the impact of the estate tax rules. Under the FCL, the $5 million exemption has been extended (the exemption will be adjusted for inflation), and the rates are raised to 40%.

This resolution came as something of a surprise, as most pundits expected the agreed-upon increase of the exemption to fall somewhere between the original $2 million exemption and the $5 million threshold provided under the Bush tax cuts. Further, the increase in the top rate from 35% to 40% represented a relatively modest rise, given the history of rates for this set of rules.

Business extensions

U.S. tax rules have long provided for the ability to currently expense a portion of fixed assets otherwise subject to capitalization and recovery over their useful lives. However, under the old rules, this benefit (commonly referred to as a “section 179 deduction,” named after the federal provision under which these rules fall) was significantly limited. An amount of eligible fixed assets up to $25,000 was allowed as an expense, and this amount was phased out, dollar for dollar, by the amount of all investment property purchased during the year that exceeded $200,000. Further, these rules only applied to tangible personal property (machinery, furniture and fixtures, etc.), not buildings and real property.

Under the Bush tax cuts, these limits were increased significantly. After reaching very high expensing and threshold levels in recent years, the section 179 deduction eventually settled at $139,000, with a phase-out beginning at $560,000 under most recent law. The Bush tax cuts also allowed for the section 179 rules to apply to certain qualified real property. The FCL increases the expensing amount temporarily to $500,000 for 2012 and 2013, with a

phase-out threshold of $2 million. The qualified real property rules have also been extended to 2012 and 2013.

In addition to the favorable increase in the section 179 deduction rules, the Bush tax cuts also introduced a new, parallel set of fixed-asset expensing rules commonly known as bonus depreciation rules. These rules allowed for the expensing of up to 50% of eligible fixed assets purchased during the year. Eligible property includes new or "original use" property (the section 179 deduction does not have this limitation), and the recovery period for otherwise-available depreciation purposes should not exceed certain thresholds. During specified years, this bonus depreciation eligibility even rose to 100% of eligible fixed assets purchased during the year, before settling back to the current 50% rules. The FCL has extended the 50% bonus depreciation eligibility through the 2013 tax year.

The FCL provided additional business extensions, including:

- a temporary extension of the research credit (similar to AMT, an issue that confronts lawmakers year after year);
- the extension of reduced recovery periods of 15 years for qualified leasehold improvements (otherwise, 39.5 years under the old rules);
- the temporary extension of favorable exclusions of gains associated with the sale of qualified small business stock (from 50% to 100%); and an extension for certain "S" Corporation benefits.

President Obama is also well known for his eco-friendly initiatives, and the FCL extends some pre-existing energy credits, including those for energy-efficient homes and appliances, for alternative energy vehicles and fuel, and others.

Summary

The FCL generally resulted in higher rates and deduction-limiting provisions for higher-income taxpayers. This result is not surprising, though the thresholds for determining who is considered a higher-income taxpayer were a surprise to some (i.e. the threshold limits for those subject to the 39.6% tax rate, the capital gains rate, and the retention of the $5 million exemption for estate purposes). Favorable tax rates and rules under the previous Bush tax cuts remain for the rest of the taxpayers. Temporary extensions for potentially very favorable business tax provisions, such as the ability to expense fixed assets, provide more opportunities to take advantage of these benefits. It will be interesting to see how the related "debt ceiling" discussion now facing lawmakers will impact future deliberations on the temporary measures, or perhaps even a revisit of the "permanent" extension rules under the FCL.

Contact your Collins Barrow advisor for more information on your U.S. filing obligations and any other U.S. tax matters. **§**

U.S. Tax Treatment of Certain Canadian Tax-Deferred Accounts

Matt MacEwen, CPA, CA, CPA (Colorado), is a Tax Manager in the Kingston office of Collins Barrow.

While many U.S. citizens living in Canada have recently become aware of the requirement to file annual U.S. individual income tax returns, they may not be aware of the specific filing requirements in regard to certain registered investment plans held in Canada.

RRSPs and RRIFs

Canadian retirement accounts held by U.S. citizens, such as Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs), require specific reporting with the Internal Revenue Service (IRS) in order to receive tax-deferred status in the U.S. RRSPs and RRIFs are not tax-deferred under the U.S. Internal Revenue Code (IRC), and thus the income generated inside these accounts technically is taxable income for U.S. tax purposes. It is only through an election in the Canada-U.S. Income Tax Convention (the Treaty) that these accounts may receive tax-deferred status in the U.S.

To make the election pursuant to Article XVIII(7) of the Treaty, U.S citizens must file IRS Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans,* for each year the account is held. A separate Form 8891 is required for each RRSP or RRIF account. The form requires certain information regarding the accounts, including the account number and the balance held in the account at the end of the tax year. Form 8891 is to be filed annually with the U.S. individual income tax return.

Failure to file the form will result in the accounts becoming taxable in the U.S., and any income generated within an account must be reported as income on the U.S. individual income tax return, even if no monies are withdrawn from the account. This can lead to U.S. tax owing depending on the amount of income generated within the account.

Under new IRS streamlined filing compliance procedures, U.S. citizens residing in Canada who have failed to file these forms may use the procedures to become compliant, even if they have previously filed their U.S. individual income tax returns. For more information regarding the new IRS streamlined procedures, please refer to our November 2012 *U.S. Tax Alert.*

RESPs

Another type of registered account commonly held by U.S. citizens living in Canada is the Registered Education Savings Plan (RESP). In Canada, an RESP allows money deposited for a child's post-secondary education to grow on a tax-deferred basis, with the income ultimately taxed in the child's hands upon withdrawal. There are also Government of Canada grants that match contributions to this plan, with certain limitations. Unfortunately, unlike RRSPs and RRIFs, the RESP is not granted the same tax-deferral election under the Treaty. Thus the income earned within the RESP is taxable to the subscriber (i.e. the parent) on their U.S. return in the year the income is earned. It is important to note that any grant received from the Government of Canada in the RESP is considered income, and is taxable in the U.S. in the year it is received.

This issue can lead to double taxation, as the income in the RESP is taxed in the hands of the subscriber for U.S. purposes and taxed again for Canadian purposes in the hands of the child when the income is withdrawn from the RESP, usually several years later.

In addition to these negative consequences, the IRS considers RESPs to be foreign trusts, requiring trust returns (Forms 3520 and 3520-A) to be filed on an annual basis in the U.S. There can be significant penalties for failure to file the forms. Form 3520 is due at the same time as the U.S. tax return of the subscriber, including extensions, while Form 3520-A is due on March 15. An extension is available for the 3520-A filing.

One practical solution to these issues is to transfer the RESP into the hands of a non-U.S.

citizen/resident subscriber. Typically, a non-U.S. parent, grandparent or other relative becomes the subscriber. This transfer does not, however, address the filing requirements of the U.S. citizen for the tax years in which they were still the subscriber.

Tax-Free Savings Accounts

Similar to RESP accounts, Tax-Free Savings Accounts (TFSAs) are not “tax free” for U.S. purposes. The income earned within a TFSA must be reported on the U.S. individual income tax return in the year earned. Depending on the structure of the TFSA, it may also be subject to the foreign trust filing requirements discussed above, although the IRS has not commented specifically on this issue.

Summary

It is important to recognize that the U.S. tax rules may treat certain items differently than they are treated under Canadian tax rules. Two specific examples presented above are the RRSP and RRIF accounts, which are only tax-deferred for U.S. purposes when the proper election is filed. Further, RESP and TFSA accounts are never treated as tax-deferred vehicles in the U.S., and may be subject to U.S. foreign trust tax filing obligations. Finally, it is important to note that all of the accounts discussed in this article must be disclosed on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR) and IRS Form 8938, *Statement of Specified Foreign Financial Assets*, if the respective filing thresholds for these two forms are met.

Contact your Collins Barrow advisor for more information on your U.S. filing obligations and any other U.S. tax matters.

Collins Barrow publishes a regular *US Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada with respect to US issues.
While *US Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

www.collinsbarrow.com
info@collinsbarrow.com

Clarity Defined.™

Editor:
Michael R. Hayward, CPA, CA, CPA (Illinois)
mihayward@collinsbarrow.com
613.768.7569