Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Karim F. Visram, CFA, CGA, CFP, FMA
Vice-President & Director, Portfolio Manager
karim.visram@rbc.com

Team line: 416-956-8888
Team email: TeamKarim@rbc.com
Team fax: 416-842-2222
Toll-free: 1-800-561-6431

How Joe Biden's U.S. presidential election win may impact Canadian taxpayers

A look at the potential tax and estate planning impact

The 2020 U.S. presidential election was held on November 3 and due to an unprecedented voter turn-out, including those who submitted their ballots early and by mail, it took several days before Joe Biden emerged as the projected winner to become the 46th President of the United States. While the Democrats will maintain control of the House of Representatives, it is not yet clear, which party will ultimately control the Senate.

When the Republicans took control of the White House and both chambers of Congress after the 2016 election, many tax policy changes were implemented, including those in the Tax Cuts and Jobs Act (TCJA) in 2017, which significantly reduced U.S. income taxes and increased the exemption thresholds for U.S. estate and gift taxes. While many provisions of the TCJA are scheduled to sunset (expire) at the end of 2025, the question is, with President-Elect Joe Biden's win, will many of the provisions in the TCJA survive until the end of 2025, or will many of the current tax laws be repealed before that time?

This article provides a comparison of the key federal income and estate tax laws that currently exist (excluding any temporary changes due to the COVID-19 pandemic) versus those that are proposed or favoured by President-Elect Joe Biden's election platform. It will also discuss the potential tax impact to Canadian residents, including those who are U.S. persons (U.S. citizens and green-card holders) living in Canada, should the proposals be successfully passed into legislation.

Individual income tax

	The current rules	Biden proposals
Individual income tax rate	• The TCJA lowered top marginal tax rate on taxable income to 37% from 39.6%. *(This change is valid until the end of 2025)*	• Increase top marginal tax rate back to 39.6%.
Long-term capital gains tax rate (also applies to qualified dividends)	• Tax rates range from 0-20% plus a 3.8% net investment income tax, actual rates are dependent upon the taxpayer's taxable income. • As such, the top long-term capital gains and qualified dividend tax rate is equal to 23.8%.	• For taxpayers with taxable income over $1 million, long-term capital gains and qualified dividends will be subject to ordinary income tax rates plus a 3.8% net investment income tax. • As such, the top long-term capital gains and qualified dividend tax rate is 43.4%.
Itemized deductions and credits	• TCJA repealed the law (Pease limitation) that limits a taxpayer's ability to claim all itemized deductions when their taxable income reaches a certain threshold. • The TCJA limited the deduction for state and local taxes (SALT) including sales and property tax deduction to US$10,000 for joint filers. • The TCJA limited mortgage interest deduction to the interest paid on qualified mortgage loans of US$750,000 (instead of US$1 million) and allows them only for loans to buy, build or substantially improve your residence. • The TCJA suspended the provision that reduces miscellaneous deductions by 2% of income. • The TCJA increased charitable contribution limitation to 60% from 50%. *(The TCJA changes are valid until the end of 2025)*	• Reinstate the repealed law (Pease limitation) but only on taxpayers that have taxable incomes that exceed US$400,000. • Cap the benefit of itemized deductions to a 28% rate but only on taxpayers that have taxable incomes that exceeds US$400,000. • Repeal the US$10,000 cap on SALT.
Alternative Minimum Tax (AMT)	• The TCJA raised exemption levels and income thresholds that basically eliminated AMT for most taxpayers. *(This change is valid until the end of 2025)*	• Reinstate the previous lower exemption levels and income thresholds, which may result in AMT for many taxpayers.
Like-kind exchanges	• The TCJA repealed like-kind exchange treatment except for transactions involving real property.	• Eliminate like-kind exchange treatment for real property transactions for taxpayers with taxable income exceeding US$400,000.

Individual income tax rate

The U.S. personal income tax system is based on a graduated tax rate system, meaning you are subject to higher tax rates as your income increases. There are currently seven personal tax brackets that apply to ordinary income with the top marginal tax rate being 37%. This top tax rate applies on ordinary income that exceeds US$524,000 for single filers and US$628,000 for married, joint filers (these thresholds are indexed to inflation annually). Biden plans to maintain the current seven brackets and change the top U.S. federal tax rate back to the pre-TCJA tax rate of 39.6%. It is uncertain whether he would favour reducing the income thresholds to have the top tax rate apply to incomes that exceed US$400,000.

These proposed changes will affect Canadian residents who are U.S. persons living in Canada and are subject to U.S. federal tax on their worldwide income. The proposed changes could also affect Canadian residents (who are non-U.S. persons) who are subject to U.S. tax on certain U.S. source income (e.g. rental income on U.S. real estate or employment income for services rendered in the U.S.)

Keep in mind, as a Canadian resident, you are generally subject to higher tax rates in Canada (combined federal and provincial tax rates) and with the ability in most cases to claim foreign tax credits to reduce your Canadian and U.S. federal income tax liability, there may be no additional tax that may result from these proposed changes. However, you should confirm with a qualified

cross-border tax advisor to determine whether you will have additional exposure.

Capital gains and qualified dividends

Long-term capital gains and qualified dividends are currently subject to tax rates of 0-20% plus a 3.8% net investment income tax. The actual rate that applies is based on your taxable income. A capital gain is considered long-term if the gain is realized on property you held for at least one year before the property is sold. Net short-term capital gains are treated as ordinary income and thus taxed at the graduated tax rates that apply to ordinary income.

Biden proposes to keep the 3.8% net investment income tax and eliminate the preferred tax rate on long-term capital gains for taxpayers with taxable income over US$1 million. For these taxpayers, their long-terms capital gains will be subject to a 39.6% tax rate plus the 3.8% net investment income tax. This change would also apply to qualified dividends.

These proposed changes will affect Canadian residents who are U.S. persons living in Canada who incur gains and have taxable income on their U.S. tax return that exceeds US$1 million. They may also be subject to a 3.8% net investment income tax. The proposed changes also apply to Canadian residents (who are non-U.S. persons) but only to the extent of capital gains triggered on the sale of U.S. real property interests (e.g. gains on the sale of U.S. real estate or shares of a U.S. corporation that owns a significant amount of U.S. real property) where their taxable income for U.S. tax purposes, exceeds US$1 million. The 3.8% net investment income tax does not apply to individuals who are not U.S. persons.

Canadian residents are only subject to Canadian tax on 50% of capital gains realized regardless of the holding period, meaning the capital gains you realize are subject to tax at half of your marginal tax rate. The effective Canadian marginal tax rate is generally higher than the maximum U.S. long-term capital gains rate under the current tax laws. However, if the proposal is enacted, the Canadian tax rate on capital gains could be lower than the U.S. rate if your income exceeds US$1 million. As a result, you may have a U.S. tax liability on the capital gains you earn on top of the Canadian taxes you have already paid on those capital gains. Further, you cannot use foreign tax credits to reduce the 3.8% net investment tax.

U.S. dividends are subject to Canadian tax based on your Canadian marginal tax rate regardless of whether they are qualified dividends for U.S. tax purposes. As Canadian personal tax rates are generally higher, the Canadian taxes you will be subject to on U.S. dividends may be higher even

> Biden proposes to keep the 3.8% net investment income tax and eliminate the preferred tax rate on long-term capital gains for taxpayers with taxable income over US$1 million.

for those dividends subject to the proposed higher U.S. tax rate. In other words, you will generally not have additional U.S. tax on top of the Canadian tax. However, the 3.8% net investment tax will still apply to dividend income and cannot be reduced with foreign tax credits.

Speak with a qualified tax advisor to determine whether you would benefit from recognizing long-term capital gains or triggering losses to offset capital gains where it becomes evident that these proposals will become law.

Itemized deductions and credits

For U.S. tax purposes, you are entitled to deduct the greater of the standard deduction provided by the U.S. tax laws, or the sum of your itemized deductions. Under the current tax laws, the TCJA repealed what is referred to as the Pease limitation, which limited a taxpayer's ability to claim all of their itemized deductions when their taxable income reached a certain threshold. At the same time the TCJA added numerous limitations on claiming itemized deductions. It also suspended all miscellaneous itemized deductions, such as a deductions for personal investment management fees, unreimbursed employment expenses, and tax preparation fees. However, it increased the charitable contribution limitation to 60% from 50%. In addition, the TCJA nearly doubled the standard deduction, which greatly reduced the number of taxpayers who claim itemized deductions. These tax changes are effective until the end of 2025.

Biden proposes two changes to itemized deductions. First, reinstate the Pease limitation but only for taxpayers with taxable incomes that exceed US$400,000. This provision will reduce a taxpayer's total itemized deductions by 3% for every dollar their taxable income exceeds US$400,000. In addition, Biden would limit the benefit of itemized deductions to a 28% rate for those with taxable incomes that exceed US$400,000. Biden also proposes to end the current SALT limitations.

These proposes changes affect Canadians residents who are U.S. persons and those who are non-U.S. persons who must file a U.S. income tax return as a result of earning certain types of U.S. source income. However, since Canadian tax rates are generally higher than the U.S. tax

rates, these proposed tax changes may have little to no effect on your net tax liability. Speak to a qualified cross-border tax advisor to confirm if these tax changes will have an impact on you.

Alternative Minimum Tax (AMT)

Under current tax laws, the TCJA made changes to AMT, which in effect eliminated AMT for most taxpayers. This change is set to expire at the end of 2025, if not repealed earlier by Biden, who proposes to revert back to pre-TCJA rules.

This proposed change may affect Canadian residents who are U.S. persons living in Canada who are subject to U.S. income tax on their worldwide income and Canadian residents (who are non-U.S. persons) who are subject to U.S. tax on employment income earned for services rendered in the U.S. and on rental income and capital gains triggered on certain types of U.S. property. Canadian residents who are subject to U.S. AMT may be subject to double taxation in certain cases. You should speak to a qualified cross-border tax advisor to determine how these rules will affect you.

Like-kind exchanges

Under current tax laws, the TCJA modified like-kind exchanges which provides you with the ability to defer the recognition of capital gains when you dispose of a property and subsequently acquire a similar property in certain circumstances. After the modification, you can only defer tax on gains from sales of real property owned for business or investment purposes by rolling the sales proceeds into a subsequent real property purchase (exchanges of vacation properties would not qualify). Biden proposes to repeal like-kind exchange treatment for real property transactions for taxpayers exceeding US$400,000 of taxable income.

These rules and the proposed change will affect U.S. persons. They may also affect non-U.S. persons who sell U.S. real property and purchase a replacement property.

These rules and the proposed change will affect U.S. persons. They may also affect non-U.S. persons who sell U.S. real property and purchase a replacement property. For Canadian residents, Canadian tax laws have a similar rules in concept, referred to as the replacement property rules. The replacement property rules do not apply in exactly the same manner as the U.S. like-kind exchange rules. Therefore, in some cases, you could have a capital gain that qualifies for a tax deferral under U.S. tax laws but not under Canadian tax rules. This may result in double taxation (i.e. you are subject to Canadian tax in the year you sold the first property and U.S. tax in a future year when the deferred gains become taxable). In effect, there may be no tax benefit or advantage for you to defer U.S. capital gains tax on like-kind exchanges for U.S. tax purposes if you will not qualify for deferral in Canada.

Social Security and Medicare

	The current rules	Biden proposals
Employed individuals	• 6.2% Social Security tax applies on wages earned up to the inflation adjusted cap for the calendar year (paid by an employer and employee). • 1.45% Medicare tax on all wages (paid by an employer and employee) with no cap. • 0.9% Medicare tax on wages in excess of $200,000, $250,000 if married filing jointly (paid by employee only) with no cap.	• Keep current system but eliminate Social Security tax exemption for wages above $400,000 (wages between the current year cap and $400,000 would still not be taxed).
Self-employed individuals	• 12.4% Social Security tax on self-employment earnings up to the inflation adjusted cap for the calendar year. • 2.9% Medicare tax on all self-employment earnings with no cap. • 0.9% Medicare tax on self-employment earnings in excess of $200,000, $250,000 if married filing jointly, with no cap.	• Keep current system but eliminate Social Security tax exemption for earnings above $400,000 (earnings between the current year cap and $400,000 would still not be taxed).

Social Security and Medicare

Currently, wages and self-employment income are subject to a 12.4% Social Security tax that is split evenly between an employer and an employee (6.2% each) and paid in full by a self-employed individual. The Social Security tax applies only on wages and self-employment income earned up to an inflation-adjusted capped amount that applies in the calendar year. Wages and self-employment income are also subject to a 1.45% Medicare tax levied to an employer and to an employee (2.9% in the case of a self-employed individual). An additional 0.9% Medicare tax applies to employees or self-employed individuals on wages and self-employment income that exceeds US$200,000 in a calendar year (US$250,000 in the case of individuals who are married filing jointly) with no cap. The employer does not fund the 0.9 % Medicare Tax.

Biden proposes to levy an additional Social Security tax for wages and self-employment earnings that exceed US$400,000. However, wages and self-employment earnings between the inflation adjusted cap for the year and US$400,000 will continue to be exempt from the tax.

Social security and Medicare tax rules generally do not apply to Canadian residents, including U.S. citizens or U.S. green-card holders living and working in Canada, unless they are temporary transferred employees from a U.S. employer with a certificate of coverage under the Canada/U.S. Social Security Agreement that keeps them in the U.S. system. Canadian residents pay into Canadian social security systems, such as the Canada Pension Plan/Quebec Pension Plan (CPP/QPP). The tax rates under these Canadian programs are lower than the U.S. Social Security and Medicare tax system, and the difference will be much more pronounced if the proposals are enacted. If you become temporarily employed in the U.S. (generally up to 5 years) by a Canadian employer, you can apply to be covered under a Canada-U.S. Social Security Agreement and remain and pay into the Canadian system only. If you are deciding whether to relocate to the U.S. or you are a sports professional who is contemplating on whether to play on a Canadian versus a U.S. team, you may want to consider the treatment of these taxes on your wages in your decision making.

Biden proposes to levy an additional Social Security tax for wages and self-employment earnings that exceed US$400,000. However, wages and self-employment earnings between the inflation adjusted cap for the year and US$400,000 will continue to be exempt from the tax.

Estate and gift tax

	The current rules	Biden proposals
Rates	• Top tax rate of 40%.	• Increase top tax rate to 45%.
Exemption thresholds	• $10 million per individual (indexed for inflation which will be $11.7 million in 2021). *(This change is valid until the end of 2025)*	• Biden has not publicized a proposal; however, there has been some expressed support for returning the exemption thresholds back to the historical norm (in 2009, the individual exemption thresholds were US$3.5 million for U.S. estate tax and US$1 million for U.S. gift tax).
Basis adjustment	• Property received by heirs have a basis equal to the fair market value on death.	• Eliminate the basis adjustment for inherited property.

Estate and gift taxes

The TCJA effectively doubled the estate tax exemption threshold that existed in 2017 from US$5 million to US$10 million (both amounts are indexed to inflation, thus the 2021 exemption is $11.7 million). Since estate tax and gift tax are unified, the U.S. gift tax exemption was also increased to $10 million (indexed to inflation). Unless Biden repeals these laws sooner, these tax laws will sunset at the end of 2025.

With the current law, you are not subject to U.S. income tax on any accrued gains on your property on your passing. Your heirs will receive your property with a basis that is equal to the property's fair market value at the time of your death. As a result, any capital gains accrued on the property at your death is not subject to U.S. income tax. Biden proposes to increase the rate to 45% for U.S. estate and gift tax and plans to eliminate the basis adjustment for inherited property.

While Biden has not publicized his plans to change the U.S. estate and gift tax exemption thresholds, under a Biden-Sanders unity task force, it has been proposed that the U.S. estate and gift tax regime be returned to its "historical norm." This could mean restoring the estate tax exemption threshold to the 2009 level of US$3.5 million and gift tax exemption to US$1 million with no annual indexed increase for the thresholds.

While Biden has not publicized his plans to change the U.S. estate and gift tax exemption thresholds, under a Biden-Sanders unity task force, it has been proposed that the U.S. estate and gift tax regime be returned to its "historical norm." This could mean restoring the estate tax exemption threshold to the 2009 level of US$3.5 million and gift tax exemption to US$1 million with no annual indexed increase for the thresholds.

These proposed measures may significantly impact Canadian residents especially those who are U.S. citizens living in Canada or U.S. green-card holders who are considered domiciled in the U.S. for U.S. estate and gift tax purposes. For Canadian residents who are not U.S. citizens and are not domiciled in the U.S., U.S. estate tax only applies to U.S. situs property and U.S. gift tax only applies to gifts of U.S. tangible property (e.g. U.S. real estate). Since Canadian residents are only subject to U.S. capital gains tax on U.S. real property interests such as U.S. real estate and shares of a company that owns significant U.S. real property, the proposed changes to the basis of inherited property will only affect Canadian residents who own or inherit such U.S. real property interests.

Keep in mind, although accrued gains on U.S. property are currently not subject to U.S. income tax upon death, there is a deemed disposition for Canadian tax purposes, which may trigger Canadian capital gains tax on property left to heirs who are not a surviving spouse or common-law partner. Given the lack of details, it remains unclear how Biden will eliminate the basis adjustment. If your heirs are required to take on your basis in the property, this could result in double tax. This is because you may be subject to Canadian tax on any gains accrued on your property on death and your heirs may be subject to U.S. income tax on the same gains if they sell the property in the future.

The proposed estate and gift tax changes may have a significant impact on your U.S. tax exposure and your ability to transfer your wealth to your heirs. You should evaluate your current exposure and your current estate planning to determine if any actions should be taken, such as possibly implementing gifting strategies to take advantage of the currently higher U.S. lifetime gift tax exemption. Be sure to speak to a qualified cross-border tax/legal professional for advice.

Business tax

	The current rules	Biden proposals
Corporate tax rates	• TCJA reduced corporate tax rate to 21% and eliminated corporate AMT.	• Increase corporate tax rate to 28% and include a 15% corporate AMT where book income exceeds US$100 million.
Global Intangible Low-Taxed Income (GILTI)	• TCJA introduced GILTI with an effective tax rate of 10.5%. *(The effective tax rate is increased to 13.125% after 2025)*	• Double GILTI effective tax rate to 21%. • Eliminate the Qualified Business Asset investment (QBAI) exemption.
Qualified business income (QBI) deduction	• TCJA created a 20% pass-through deduction for qualified business income (QBI). (This change is valid until the end of 2025)	• Keep the 20% pass-through deduction only for QBI of taxpayers with taxable income that does not exceed US$400,000.

Corporate tax rates

Prior to the TCJA, corporations were taxed on a graduated tax basis, and tax rates topped out at 35%. The TCJA introduced a flat corporate tax rate of 21% and eliminated corporate AMT. Biden proposes to increase the corporate tax rate to 28% and introduce a 15% corporate AMT on profits where a company's net book income exceeds US$100 million in the U.S.

The current rules and proposed changes will affect Canadian residents who are shareholders of a U.S. corporation (either directly or indirectly). It can also affect Canadian residents who are shareholders of Canadian corporations that conduct business in the U.S. or own U.S. real estate.

GILTI

The TCJA introduced GILTI tax measures that applied to 2018 and future years as a means to reduce the incentive for U.S.-based multinational corporations to shift profits from the U.S. to low or no tax jurisdictions. GILTI also affects U.S. individual shareholders of controlled foreign corporations. Generally, GILTI imposes a 21% tax rate on affected income that is paid by a corporate or individual shareholder. However, corporate shareholders may be able to claim a 50% deduction that would effectively reduce the GILTI tax rate to 10.5%. There is also an exemption from GILTI for amounts that are QBAI. With proper planning individual shareholders may be able to achieve the same or better tax result. Biden seeks to increase the effective tax rate to 21% and eliminate the QBAI exemption.

These rules and proposed changes will apply to Canadian residents who are U.S. citizens and U.S. green-card holders who are shareholders of non-U.S. corporations (either directly or indirectly) and U.S. corporations with operations in Canada. The GILTI tax laws are complex, please speak to a qualified U.S. tax advisor for more information.

QBI deduction

The current tax laws may allow taxpayers other than corporations such as partnerships, S corporations, trusts and estate and sole proprietorships to claim a 20% QBI deduction on their U.S. tax return. This reduces the effective top rate on QBI from 37% to 29.65%. This deduction is subject to many limitations/phaseouts depending on the type of business. Biden proposes to keep the QBI deduction for those who have taxable income that does not exceed US$400,000.

These rules and proposed change applies to Canadian residents who are U.S. citizens and U.S. green-card holders who earn QBI. Keep in mind, Canadian residents are generally subject to higher Canadian individual income tax rates, therefore, your ultimate tax liability is generally the higher of your Canadian and U.S. tax liability. As a result, this proposed change may potentially have no or little impact on your overall taxes.

It is important to note that tax legislation begins with Congress, not the White House, so any tax legislation that emerges must be agreed upon by both the House of Representatives and the Senate and then signed by the President before it becomes law.

Conclusion

It is important to note that tax legislation begins with Congress, not the White House, so any tax legislation that emerges must be agreed upon by both the House of Representatives and the Senate and then signed by the President before it becomes law. This could lead to action or inaction depending on whether either party can secure a majority in Congress and even then would require full alignment across the party voting lines to enact change. It is possible that any changes to legislation may not be exactly as proposed.

Further, as a Canadian resident, you will need to understand the Canadian tax implications of any transactions you undertake. As such, it is important to seek qualified tax advice before implementing any plans or strategies in light of Biden's proposed tax changes.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Wealth Management

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ®/™ Registered trademarks of Royal Bank of Canada. Used under licence. © 2020 Royal Bank of Canada. All rights reserved. NAV0284 (11/20)