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CANADA - U.S. INVESTMENT: CANADIAN TAX PERSPECTIVE

The Evolution of U.S. Tax Rates and Related Matters Since 2017 — in a Canadian Context


By Nathan Boidman, Esq. and Heath Martin, Esq.[*]
Davies Ward Phillips & Vineberg LLP
Montréal and New York

[*] Nathan Boidman and Heath Martin are with Davies Ward Phillips & Vineberg LLP in Montréal and New York, respectively.

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OVERVIEW

Trump-era legislation, Biden-era proposed legislation, and pre-existing significant differences between corporate and personal tax rates of various states have resulted in widely divergent combined/integrated U.S. federal and state tax rates and burdens (and related factors/matters) across the United States.

This commentary examines the underlying elements/parameters and specific instances of this phenomena — and does so in a comparative Canadian context with the assistance of two charts.

BACKGROUND STATE/CITY MATTERS

U.S. Corporations

For U.S. corporations,[1] there can be about a 16-percentage-point difference between the highest and lowest state/city corporate tax rates.

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[1] Corporations for the purposes of this commentary are those entities that are (or have elected to be) treated as corporations under both U.S. and Canadian tax laws and does not apply to hybrid entities.

The lowest is zero, in six states: Ohio, Nevada, South Dakota, Texas, Washington, and Wyoming. Note, however, that four of these states levy tax on gross revenue.

For example, in Ohio, where there is no corporate income tax, the tax on $5M of gross revenue is $2, 600 plus 0.26 of 1% of the $5M ($13K) for a total of $15,600. If the corporation's net profit were 10% of sales or $500K and instead of the gross revenue tax there were an income tax of $15,600, that would be approximately 3% corporate tax. So it is misleading to say — in the latter assumed circumstances — that there is no tax in Ohio on corporate profits.

But if the net-profit-to-sales ratio were 90%, then the equivalent corporate tax rate ($15,600 over $4.5M) would be roughly a third of 1%, which is negligible, and it would not be misleading to say there is basically no corporate tax in Ohio.

At the other extreme, there are two places that vie for the highest state/city corporate tax rate. A corporation taxable in Philadelphia pays city tax of 6.21% and (Pennsylvania) state tax of 9.99% for a total of 16.2%. Just slightly less is the corporate tax burden of 15.35% in New York City (6.85% to the state and 8.50% to the city).

The other 42 states fall in between the two extremes. The discussion and the chart below focus on California at 8.84% and Florida at 5.5%.

The foregoing are integrated with the four-phase federal situation (pre-Trump, Trump, Biden, and House Ways and Means) in "The Evolving Integrated Corporate Tax Rate Scene," below.

U.S. Individuals

There can also be a difference of almost 15 percentage points between the highest state/city taxes for individuals and the lowest.

The latter, including Florida, consists of states with no individual income tax. The former includes California at 13.3% and combined New York State (10.9%) and New York City (3.876%) of 14.776%.

BACKGROUND CANADIAN MATTERS

Canadian Corporations

A corporation resident in Canada[2] that is controlled by nonresidents and/or publicly traded corporations or is resident by reason of mind and management generally pays a combined federal/provincial tax rate in most parts of Canada (including Canada's two largest provinces, Ontario and Québec) of 26–27% — although in Alberta it will go down to 23% in 2022. Fifteen percent goes to the federal government and the balance to the relevant provincial government. Note that in Canada, provincial tax is not deductible in computing the federal taxable income base. Note also that in Canada only half of capital gains (of any type of taxpayer) are subject to tax.

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[2] A corporation is resident in Canada for income tax purposes if: (1) it is formed under federal corporate law or that of a province or other subdivision and has not been continued (re-domiciled) under the corporate laws of a foreign jurisdiction; (2) it has been formed under the laws of a foreign jurisdiction and has been continued under the corporate laws of a Canadian jurisdiction, unless in either case it is a treaty dual resident that under a tie-breaker has been assigned to the other treaty country and as a result is exempted from Canadian tax on non-Canadian-source income; or (3) its central mind and management is exercised in Canada. See section 250(4) et seq. of the Canadian *Income Tax Act*.

If the corporation is not controlled by nonresidents and/or publicly traded corporations and its Canadian residence does not arise because of mind and management, so that the corporation is a "Canadian-controlled private corporation," the foregoing rates may be reduced on up to $500,000 of active business profits per year and may be increased on certain passive/investment income.

For purposes of the comparative comments below, the 26–27% number will be used.

Canadian Individuals

An individual (or trust) who or that is resident in Canada for tax purposes[3] will pay, depending upon the province involved, aggregate federal and provincial taxes of up to 54%, with the rate in Ontario and Québec being roughly 53.5%.

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[3] Such residence will arise for an individual who either ordinarily lives in Canada or spends 183 days or more "sojourning" (which may require more than simply being present) in Canada. Again, a treaty tie-breaker rule may change that. See section 250(1) to (3) and (6). Such residence will arise for a trust if it is managed and controlled

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in Canada and a modified version for certain trusts with Canadian settlers or beneficiaries. See section 94.

As noted, capital gains are only half taxable so that those effective rates are 27% and 26.7%.

The rate on dividends from Canadian resident corporations is reduced down to 40–48%, the precise amount depending on a number of factors.

Finally, it should be noted that Canada abolished conventional estate and inheritance taxes in 1972, substituting at death a deemed disposition at fair market value for income tax purposes. This will be discussed further below in relation to the Biden deemed disposition proposal.

THE EVOLVING INTEGRATED CORPORATE TAX RATE SCENE

Overview

We will now consider, with the assistance of the chart below, the integrated results of pairing the four federal corporate tax phases with the state/city rates discussed above. This will reflect the deduction permitted corporations for state and local taxes in computing the taxable income base for federal purposes.

CORPORATE TAXES[4]					
(Combined totals account for SALT deduction)					
	PRE-TRUMP	**TRUMP**	**BIDEN**	**HOUSE**	**CANADA**
U.S. JURISDICTION[5]	**FED: 35%**	**FED: 21%**	**FED: 28%**	**FED: 26.5% for $5M INCOME 18% for <$400k 21% for <$5M (Totals based on 26.5% rate)**	**NON CCPC**
PHILADELPHIA					
- CITY 6.39%					
- STATE + 9.99%					
= 16.38%	45.64%	33.94%	39.79%	38.54%	26/27%
NYC					
- CITY 6.50%					
- STATE + 8.85%					
= 15.35%	44.52%	33.12%	39%	37.78%	26/27%
CALIFORNIA					
8.84%	40.7%	27.98%	34%	32.56%	26/27%
FLORIDA					
5.50%	38.57%	25.34%	31.96%	30.54%	26/27%

OHIO, NEVADA, SOUTH DAKOTA, TEXAS, WASHINGTON, WYOMING					
0%	35%	21%	28%	26.5%	26/27%

[4] Prepared for TMIJ.

[5] The state and city rates are from 2018 but have changed little since.

By way of overview, the chart shows that the lowest effective tax rate (21%) is in the Trump era in the six states that impose no corporate tax, and the highest (45.36%) was in Philadelphia in the pre-Trump era. The Canadian results (26–27%) are closer to the low than the high.

The Pre-Trump Era

Here, the federal rate had been 34% and then 35% since the 1986 *Tax Reform Act* (and before that an even heftier 46%). By 2017, it was one of the world's highest even without reference to state rates. When combined with the 16.38% rate in 2018 for Philadelphia (not the current 16.20% rate explained above) as seen in the chart, it produces the highest rate on the chart, 45.64%.

Even in the six non-taxing states, the 35% overall rate is materially higher than the Canadian comparable of 26–27%. Overall it is evident why the election of a Republican Administration and Congress in fall 2016 would lead to Trump-era legislation, as described below.

The chart shows that the effective rate in New York City of 44.52% was not far from the top (Philadelphia) rate. The California and Florida rates shown on the chart are more than 10 percentage points higher than the main Canadian rates.

The Trump Era

The 2017 Tax Cuts and Jobs Act, responding to the calls for deep corporate tax rate cuts, slashed the federal rate from 35% to 21% and maintained for corporations (but not individuals) full deductibility of state and local taxes (SALT). This caused the lowest integrated rate (for the six non-taxing states) to fall from 35% to 21% and the highest integrated rate (for Philadelphia) to fall from 45.64% to 33.94%. The rates in California and Florida fell, respectively, to 27.98% and 25.34%.

The chart shows that the Canadian advantage disappeared *vis-à-vis* all states considered other than the state/city combinations of Philadelphia and New York City. This is the existing situation that the Democrats said they would change once elected. The next two sections discuss their proposals.

The Biden Proposals

President Biden would raise the corporate rate to 28% and maintain deductibility of SALT for corporations.

The chart shows this would bring the integrated rate for all states considered above the Canadian rate, although only marginally so for the six non-taxing states. Canada (at 26–27%) would have a daunting advantage *vis-à-vis* Philadelphia and New York City (at 39.76% and 39% respectively) and a lesser but still material advantage *vis-à-vis* California and Florida (at 34% and 31.96% respectively).

The House Ways and Means Committee Proposals

The Ways and Means Committee proposals of September 13 would raise the corporate rate to 26.5%, and maintain deductibility of SALT for corporations. As this is about 80% along the Biden (rate increase) road one would expect the integration chart to show results/effects similar to those for Biden.

And they do. Canada and the six non-taxing states are at parity. But the chart shows that Canada remains materially preferable to Philadelphia, New York City, and California, and at least somewhat preferable to Florida.

THE EVOLVING SITUATION FOR INDIVIDUALS

Overview

We now turn to three aspects of the evolving landscape for U.S. individuals having regard to the background discussion in "U.S. Individuals," above. They are tax rates on ordinary income, taxation of capital gains, and taxation at death — viewed with a Canadian comparative.

INDIVIDUALS[6]					
ORDINARY					
	PRE-TRUMP	**TRUMP**	**BIDEN**	**HOUSE**	**CANADA**
	39.6% SALT ALLOWED	**37% SALT DISALLOWED**	**39.6% SALT DISALLOWED**	**39.6% SALT DISALLOWED[7]**	
	+ OBAMA 3.8% (not included in totals below)				
FLORIDA					
0%	39.6%	37%	39.6%	39.6%	53%
CALIFORNIA					
13.3%	47.7%	50.3%	52.9%	52.9%	53%
NYC					
- CITY 3.876%					
- STATE + 10.9%					
= 14.776%	48.525%	51.776%	54.376%	54.376%	53%
CAPITAL GAINS					
FED ONLY	20%	20%	39.6%[8]	25%	26.5%

AT DEATH					
	ESTATE TAX	ESTATE TAX W/DOUBLE EXEMPTION ($10M)	BOTH ESTATE TAX DEEMED DISP (CAN BE >70%)	ESTATE TAX BUT DROP EXEMPTION TO $5M	D.D. 26.5%

[6] Prepared for TMIJ.

[7] Plus 3% for income over $5M.

[8] Biden would also have billionaires mark to market.

Tax Rates on Ordinary Income

U.S. federal individual tax rates have been on a rollercoaster over the last 50 years, going from above 70% in the early 1970s to a low of 28% — brought about by the 1986 *Tax Reform Act* — and creeping back up to 39.6% by 2017.

The chart shows the highest integrated rate in 2017 — when SALT was deductible for individuals — was in New York City at 48.525%, compared to the lowest — in a non-taxing state such as Florida — of 39.6%. Either rate compared favourably with the 53% in Canada's two largest provinces.

The TCJA nominally reduced the rate to 37%, but with a repeal of the SALT deduction in excess of a $10,000 cap, the effective New York City rate increased to 51.776% — still lower than Canadian rate (without regard to the 3.8% Affordable Care Act (Obamacare) tax).

But then both Biden and the House Ways and Means Committee proposed to restore the 39.6% rate *without* restoring full deductibility of SALT, increasing as seen in the chart the highest rate (in New York City) to 54.376% (and possibly higher with Obamacare). That would outdo Canada even before considering an additional three-percentage-point add-on for income exceeding $5M. The chart shows that the burden for California individuals would not be much less than for those in New York City.

Tax on Capital Gains

The tax treatment of capital gains (and the bottom-line tax burden) has and may continue to be quite different in the United States than in Canada.

As noted earlier (in "Background Canadian Matters"), since 1972, Canada only taxes half of a capital gain, at ordinary rates, producing currently, as the chart shows, a maximum effective tax rate on the entire gain of around 26.5%. In contrast, the United States taxes the full gain but has traditionally provided individuals with a reduced rate — which was before TCJA and continues after TCJA to be 20% (aside from state/city taxes and Obamacare tax).

Biden has proposed to radically increase that 20% rate to 39.6% for individuals with income exceeding $1,000,000. For an individual with high SALT, the effective rates would go above 50% — presumably doubling in some cases the Canadian 26.5% rate. The House, however, would only increase the rate from 20% to 25%, in line with the Canadian rate where there are no material state taxes.

Finally, there is some support arising for a mark-to-market regime respecting capital property of billionaires.

Tax at Death

The United States has long had an estate tax and a tax-free step-up in tax basis for a decedent. For example, if a person owned, at death, a property with a fair market value of $100 but a tax basis of zero, and the applicable estate tax rate was 40%, the decedent's estate would pay $40 and the heir would have a basis of $100 so that there would be no tax on a subsequent sale at $100 and overall tax of $40.

Canada, on the other hand, as noted above, abolished estate tax decades ago and substituted a deemed disposition at death, which means that for capital property the maximum tax at death is the 26.5% capital gain rate.

But now Biden proposes to adopt Canada's deemed disposition without abolishing the estate tax so that if he also got a 39.6% tax rate on capital gains, the overall result in the above example — assuming the deemed disposition tax reduced the value for estate tax purposes and without regard to SALT or Obamacare tax — would be as follows: 39.6% times $100 plus 40% times ($100 – $39.6) equals $63.76 or 63.76% of the value of the property. State and city taxes could push that rate to the low 80s.

However, Ways and Means does not support Biden's plan, and only recommended a repeal of the TCJA's doubling of the estate tax exemption from $5M to $10M.

CONCLUDING COMMENTS

The foregoing shows both the wide range of tax results in different locations in the United States and Canada and the speed at which they change, or may change, particularly in the United States.

And that (is seen) even without reference to special regimes in the United States (for example, GILTI or FDII), the recent Canadian election-driven pledge to increase the tax rate of large banks and insurance companies by three percentage points, recent election-driven threats in both countries to impose wealth taxes, or the 136-country agreement on October 8 to raise billions of taxes from the world's leading multinationals.

POSTSCRIPT

After this article was complete, the theme — the role that frequent actual or proposed tax rate changes plays in establishing the wide range of related tax burdens in the United States — was confirmed by the October 23 Bloomberg/Daily Tax Report headline: *Biden Says He Doesn't See Votes To Raise Tax Rates in Deal*. The report in the second paragraph refers to both corporate and personal tax rates (as not receiving enough voting support), but in the third paragraph cites a White House source as saying "Biden was referring only to corporate tax rate increases. . . ."