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President Obama's 2010 Tax Proposals

On February 1, 2010, President Obama released his FY 2011 budget as a follow up to his recent State of the Union Address. The budget included a significant volume of tax provisions.

Obama's proposals must be approved by both houses of the U.S. Congress before becoming law. As noted with the President's much publicized Health Care Reform legislation, such approval is far from certain for some (if not all) of the provisions in the bill.

The difference between the proposed health care legislation and the proposed budget is that some form of the latter must be passed in order for the government to function, or dysfunction in the mind of many a cynic. With mid-term elections coming in November coupled with recent Republican wins in two gubernatorial contests as well as the Massachusetts Senate race, it is unclear as to what the Congressional appetite for those proposals will be.

The following are some selected highlights that would likely impact Canadian-based multinationals doing business in or investing in the U.S. It is not a comprehensive review of the bill.

- [Worker Classification Rules](#)
- [Income Treatment for Receipt of Carried Interests in Partnerships](#)
- [Increased Tax Rates and Impact of Canadian Individuals Investing in U.S. Business](#)
- [Broader Requirement to Electronically File Tax Returns and enhanced Penalties for Noncompliance](#)
- [Additional Form 1099 Reporting Requirements](#)
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Worker Classification Rules

Often Canadian corporations, doing business in the U.S., hire workers in the U.S. Rather than dealing with U.S. payroll tax issues, the Canadian company treats each worker as an “independent contractor.”

Whether a worker is treated as an employee or independent contractor has been an area of significant tax controversy between taxpayers and the IRS. In order to mitigate this controversy, the bill permits the IRS to issue worker classification guidance in a neutral manner.

Once the IRS issues the guidance, taxpayers would be required to prospectively reclassify employees who are currently misclassified as independent contractors. Those taxpayers who voluntarily reclassify their workers and file the required information returns with the IRS before being contacted by the IRS would be eligible for either reduced or no penalties for the misclassification.

Treatment of Carried Interests in Partnerships

The budget repeats the proposal from last year's budget to tax carried interests in a partnership as ordinary income subject to self-employment taxes. A carried interest is one which is held by a person who provides service to the partnership but contributes a disproportionately low amount of capital to the entity relative to his or her profits interest.

This proposal would impact Canadian entities which enter into joint venture type arrangements with local U.S. operators where the former contributes capital either in the form of cash and/or inventory and the latter provides services. Under this fact pattern, it would appear as though a "work around" to any prospective legislation, could exist by simply changing the arrangement, eliminate the equity component and replace it with a profit sharing incentive to the local operator.

Increased Tax Rates

The proposals, if enacted, would in 2011 reinstate the highest individual tax rate to 39.6% for married couples with at least \$373,650 in taxable income.

The proposed increase would have an impact on Canadian individuals investing in a U.S. business in partnership form. Partnerships are required to withhold on a quarterly basis at the highest U.S. rate on a foreign partner's share of income which is effectively connected with the conduct of a U.S. trade or business. Though withholding will increase if the proposed tax increase passes, the Canadian investor still maintains the opportunity to get said amounts refunded by filing a Form 1040NR for the year.

Electronic Filing of Returns

Under current rules, a corporation which has over \$10 million in assets and files 250 or more returns (e.g. W-2's etc.) in a calendar year is required to file its U.S. federal return electronically. Under the proposed legislation, all partnerships and corporations with at least \$10 million in assets would be required to file if a new, reduced threshold of other returns (from the current threshold of 250) is satisfied. The new threshold will be determined by the IRS.

The electronic filing requirements increase the preparer hours and resulting cost in preparing U.S. tax returns. However, as Obama has proposed a \$25,000 penalty for corporations for noncompliance with said requirements for returns filed after 2011, the incremental cost of filing electronically is worthwhile.

Additional 1099 Reporting Requirements

Under current legislation, Form 1099 (i.e. the U.S. equivalent of form T4A) must only be filed for payments of at least \$600 to non-corporate recipients. Under the proposed legislation, Form 1099 would be required to be filed for corporate recipients.

Recipients of real estate rental income that make payments of \$600 or more to a service provider such as a handyman or a plumber, will also be required to file Forms 1099 for said amounts. Exceptions will be made for recipients of small amounts of rental income.

Extension of Bonus Depreciation Provisions

The proposal would extend the \$250,000 asset expensing and \$800,000 annual investment limits through 2010. Additionally, the election to increase first year bonus depreciation of 50% would be extended through 2010. It should be noted that the rules do not apply to real estate property purchases or leasehold improvements.

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