Impact of US policy reforms on Canadian companies
Board and C-suite strategic considerations
Canadian businesses today face unparalleled uncertainty as the public policy landscape is shifting dramatically, both at home and abroad. Here in Canada, the tax and spending priorities and parameters of Prime Minister Justin Trudeau’s government are markedly different than those developing in the United States at the present time.

On the international stage, due in part to the rise of populist movements, the policy landscape is changing even more significantly, both in magnitude and direction, away from globalization and trade liberalization toward more isolationist and protectionist taxation and trade policies.
The policy ground is shifting at home and abroad

A common thread that underlies the phenomenon of populist movements is coalescence around a policy position that rejects conventional wisdom and the status quo, thereby increasing uncertainty and unpredictability. The vehicle by which a new populist position is adopted is often a campaign leading up to a trigger event, such as a referendum or general election.

Brexit, the outcome of the United Kingdom’s referendum on whether to remain a member of the European Union, was a forerunner of this trend. Shifts towards populism influenced the election of Donald J. Trump as the 45th president of the United States and are influencing upcoming elections in France, Germany and Italy.

These policy shifts and their attendant disruptive effects have created a climate of uncertainty and may have potentially serious competitive implications for Canadian businesses.

Because of our strong bilateral trading relationship, and the integrated nature of the Canadian and US economies, the most significant developments for Canadian companies have been the changes in US policy direction in many key areas.

Prime Minister Trudeau and President Obama were developing a good relationship during the brief overlap of their respective administrations. And the Canadian and US governments were aligned on most major policy areas. The new US administration has charted a different course in a number of areas affecting the bilateral relationship, including:

- **Tax policy**
  - Fundamental reform of the current system with lower business and individual tax rates
  - A possible border adjustment tax (BAT) component

- **Regulatory policy**
  - Environmental deregulation (rejection of the Paris Climate Agreement setting out carbon reduction commitments and related measures)
  - Financial sector deregulation (review and possible dismantling of some Dodd-Frank regulations)
  - Manufacturing sector deregulation

- **Immigration and border security policy**
  - A US/Mexico border “wall,” additional security measures and possible tariffs
  - US border and immigration controls and travel bans
  - Possible Canada/US “border thickening” measures that could impact cross-border movement of goods and services

- **International trade policy**
  - Renegotiation of the North American Free Trade Agreement (NAFTA)
  - Withdrawal from the Trans-Pacific Partnership (TPP)
International trade

Of most immediate concern to Canada, and Canadian exporters in particular, is President Trump’s strong protectionist stance and his demand to reopen existing multilateral trade agreements and oppose new ones. Successive Canadian governments, both Conservative and Liberal, have been strong proponents of free trade, including NAFTA and the proposed but now defunct TPP. Canada also recently signed the Canada-European Union Comprehensive Economic and Trade Agreement (CETA) after seven years of negotiations.

On 24 January 2017, President Trump signed a Presidential Memorandum withdrawing the United States from the Trans-Pacific Partnership Negotiations and Agreement, signalling instead that the United States would “begin pursuing, wherever possible, bilateral trade negotiations to promote American industry, protect American workers, and raise American wages”. As a consequence, Canada might pursue regional or bilateral treaties with some Asian countries that would be of interest to many Canadian companies.

Early signs from the Trump Administration are that Mexico is the main target in renegotiating NAFTA and that the existing terms and balance of trade with Canada less of a concern. This may be somewhat reassuring to Canada, but the signals have been mixed, and the United States has challenged softwood lumber, agriculture (supply management), intellectual property and broadcasting limitations in the past.

Hints at the Trump Administration’s NAFTA renegotiation priorities were contained in a draft letter to members of Congress from the Office of the United States Trade Representative that was leaked to the media on 30 March 2017. Areas identified where change should be sought include agriculture, telecommunications, financial services, government procurement and tax policies, rules of origin and dispute resolution.

Regardless of whether these early signals are cause for concern or optimism, experience has taught that when it comes to trade negotiations, the details are critically important. And, at minimum, reopening NAFTA risks creating uncertainty that can adversely affect bilateral trade and business investment.

“We have a very outstanding trade relationship with Canada. We’ll be tweaking it. It’s a much less severe situation than what’s taking place on the southern border.”

Remarks by President Trump in a joint press conference with Prime Minister Trudeau 13 February 2017
Tax

US tax reform is a clear policy priority for both Congress and President Trump. Republican control of both houses of Congress and the White House has dramatically increased the likelihood of achieving this objective. In addition, public expectation that tax reform will happen would translate into a high political cost in the event that these expectations are not met.

However, as seen with the withdrawal of the House of Representatives’ plan for health care reform, nothing is certain with respect to the legislative process in the United States. The twists and turns leading up to the last major US tax reform in 1986 provide a good reminder (Showdown at Gucci Gulch: Lawyers, Lobbyists and the Unlikely Triumph of Tax Reform).\(^1\)

To date, the tax reform debate has been driven by the US House of Representatives’ tax reform Blueprint, a comprehensive plan released by Republican leaders in June 2016. However, the timing and content of the final legislative package is likely to change, perhaps fairly significantly, given the number of compromises typically necessary to gain sufficiently broad support to pass legislation.

If enacted, a number of the Blueprint’s provisions may affect multinational companies. These include:

- Lowering the statutory corporate tax rate from 35% to 20% and introducing a non-corporate business tax rate of 25%.
- Moving the US business tax regime toward a “consumption-based tax” paid by business, elements of which include:
  - Immediate expensing of all capital expenditures (other than for land)
  - Eliminating deductibility of net interest expense and most targeted tax incentives
- Imposing a territorial international tax system (with a one-time tax on accumulated foreign earnings as a transition mechanism)
- Implementing a border adjustment tax (BAT) mechanism.

The BAT has been the most controversial element of the Blueprint. It would generally exempt revenues from exports and disallow the deduction of import costs from the corporate cash flow tax base. The BAT is similar to border adjustments under any destination-based value added tax (VAT) in that it imposes a tax on imports and exempts exports to make the tax into a consumption tax. However, unlike a VAT (such as Canada’s GST), wages are deducted from the proposed US corporate tax base. Given wage deductibility, there are differences of opinion as to whether the BAT would be WTO compatible if challenged.

It is expected that a shift from corporate income tax to a cash flow corporate tax on a destination-basis would cause the US dollar to rise. Whether it would increase by the cash flow tax rate of 20% is debatable, but some appreciation should be expected.

“My economic team is developing historic tax reform that will reduce the tax rate on our companies so they can compete and thrive anywhere and with anyone. It will be a big, big cut.”

President Trump’s joint address to Congress 28 February 2017

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For a number of years now, Canada has enjoyed a comparative advantage relative to the United States in terms of corporate tax competitiveness as measured by the effective corporate tax rate on new investments, taking into account corporate income tax and provisions, sales taxes on capital purchases and other capital-related taxes. Canada’s G7 and OECD rankings in that regard improved over a number of years, but have recently declined, largely due to tax increases in some recent provincial budgets and rate reductions in other countries.

It’s too early to tell what proposals might prevail in a final US tax reform package. If the US tax on capital investments drops dramatically, it will affect production, supply chains and investment decisions for many North American businesses. If the House Blueprint were adopted, Canada would lose its business tax advantage relative to the United States, built up during the reform years 2000-12.

Impact of House Blueprint on corporate effective tax rates on new investments by industry for 2017 and in comparison to Canada (as of February 2017)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Canada</th>
<th>United States: current</th>
<th>House Blueprint**</th>
<th>Trump***</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Forestry</td>
<td>9.0</td>
<td>21.7</td>
<td>8.4</td>
<td>17.1</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>12.4</td>
<td>24.5</td>
<td>11.1</td>
<td>8.1</td>
</tr>
<tr>
<td>Construction</td>
<td>25.0</td>
<td>27.8</td>
<td>17.6</td>
<td>24.3</td>
</tr>
<tr>
<td>Utilities</td>
<td>19.6</td>
<td>16.7</td>
<td>9.7</td>
<td>16.2</td>
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<tr>
<td>Transportation</td>
<td>20.1</td>
<td>16.7</td>
<td>14.4</td>
<td>18.5</td>
</tr>
<tr>
<td>Communications</td>
<td>24.2</td>
<td>27.6</td>
<td>24.5</td>
<td>29.7</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>23.4</td>
<td>32.2</td>
<td>15.9</td>
<td>24.5</td>
</tr>
<tr>
<td>Retail trade</td>
<td>23.8</td>
<td>33.7</td>
<td>14.5</td>
<td>23.5</td>
</tr>
<tr>
<td>Other services</td>
<td>25.2</td>
<td>35.5</td>
<td>22.0</td>
<td>28.8</td>
</tr>
<tr>
<td>All industries</td>
<td>20.7</td>
<td>27.3</td>
<td>16.1</td>
<td>20.8</td>
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</tbody>
</table>

* Assumes bonus depreciation under the current system. Without bonus depreciation, the all-industry effective tax rate on new investments is 34.6% in the United States.

** Assumes 20% corporate tax rate and proposed expensing for capital with no interest deductibility.

*** Assumes a version of the Trump election proposal with a corporate income tax rate of 15%, expensing for manufacturing (no interest deductions if expensing is elected).

Source: School Of Public Policy, University Of Calgary and P. Bazel and J. Mintz, Tax Foundation, Washington D.C.¹

Canada and the US both signed the Paris Agreement under the United Nations Framework Convention on Climate Change on 12 December 2015, thereby committing to achieve nationally determined reductions in greenhouse gas emissions. Canada has since taken steps to establish a national price on carbon in consultation with the provinces (either through a carbon tax or a cap and trade regime) and agreed with the United States to introduce methane regulations.

Alberta and British Columbia have carbon taxes, while Quebec and Ontario have introduced cap and trade systems. Provinces have also pursued various regulations such as renewable energy standards. Meanwhile, the Trump administration is expected to reverse various climate change regulations affecting the coal and oil and gas sectors.

This policy difference on the application of environmental taxes, combined with improved prospects for tax reform in the United States that will likely include a significant reduction in corporate tax rates may erode competitive advantage for Canadian firms.

The direction and speed with which President Trump is prepared to act on deregulation is perhaps best signalled by the number of announcements of executive decisions coming from the White House in the early months of his Administration:

- On 24 January 2017, President Trump signed an Executive Order (“Expediting Environmental Reviews and Approvals For High Priority Infrastructure Projects”) stating that infrastructure projects have been routinely and excessively delayed by agency processes and procedures, and committing to expediting environmental reviews and approvals.

- On 24 January 2017, President Trump signed a Presidential Memorandum (“Streamlining Permitting and Reducing Regulatory Burdens for Domestic Manufacturing”) directing departments and agencies to support the expansion of manufacturing in the US through expedited approval for proposals to reduce regulatory burdens affecting domestic manufacturing.

- On 30 January 2017, President Trump signed an Executive Order (“Reducing Regulation and Controlling Regulatory Costs”) requiring, among other things, that for every one new regulation issued, at least two prior regulations be identified for elimination.

- On 3 February 2017, President Trump signed an Executive Order setting out “Core Principles for Regulating the United States Financial System” and directing the Secretary of the Treasury report back within 120 days and periodically thereafter on what actions are being taken to promote them.

- On 28 March 2017, President Trump signed an Executive Order to review regulations with respect to old and new power plants to reduce carbon emissions as well as methane regulations. The moratorium on coal developments on federal lands is reversed.

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2 US presidents can use their executive powers to issue legally binding orders that declare government policy. These orders are often used to reverse executive orders issued by prior administrations and to direct government agencies - they are not able to reverse laws passed by Congress. Both the US legislative and judicial branches can reverse an executive order, but that power is typically used sparingly.” [http://www.cnn.com/2017/01/23/politics/donald-trump-executive-orders-executive-actions/]
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While both Canada and the US have historically supported immigration, the Trump Administration has announced restrictions on immigration and the admission of refugees. For more, see EY’s Tax News Update dated 9 March 2017.³

On 25 January 2017, President Trump signed an Executive Order (“Border Security and Immigration Enforcement Improvements”) to, among other things, “secure the southern border of the United States through the immediate construction of a physical wall on the southern border, monitored and supported by adequate personnel so as to prevent illegal immigration, drug and human trafficking, and acts of terrorism.”

No one anticipates that a wall will be built along the northern border with Canada, but “the longest undefended border in the world” could be “thickened” by other means, which raises concerns over the impact this could have on trade and commercial relations.

Impact of US policy reforms on Canadian companies

Board and C-suite strategic considerations

Uncertainty surrounding final outcomes of these policy changes (in terms of both content and timing) means that the impact on particular sectors and individual businesses in Canada is not possible to predict. But change is definitely coming.

Corporate boards and C-suite members should therefore be thinking strategically and proactively to:

1. Incorporate these developments in their enterprise risk calculations and perform strengths, weaknesses, opportunities and threats (SWOT) analyses of likely scenarios.

2. Re-examine their global value chains.

3. Re-evaluate their business plans and pressure-test their ability to withstand a range of policy shocks in terms of supply chains, export strategies and pricing policies, credit and currency risks.

4. Consider export diversification and risk mitigation strategies, as appropriate.

5. Pressure-test assumptions, perform sensitivity analyses around key variables and examine feasible alternative positions in situations where business outcomes depend on a given tax position under existing Canadian and US tax regimes that may be affected by different US tax policy outcomes.

Five key considerations for Canadian companies

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