How US tax reform will affect Canada's competitiveness

Since the *Unified Framework for Fixing our Broken Tax Code* was released by the Trump Administration and Congressional Republican negotiators on 27 September, US tax reform advanced with remarkable speed and is now nearly concluded.

Parallel tax reform bills, the *Tax Cuts and Jobs Act*, were released in November by the US House of Representatives and US Senate. Although some significant changes were made in both House and Senate, the tax reform legislation that was passed in the House on 16 November, and the legislation passed by the Senate on 2 December, both reflected the main elements of the framework – lower business and individual tax rates, base broadening through limitations on deductions and credits, and a shift to a territorial system for US multinationals with anti-abuse provisions and a "toll charge" on previously untaxed accumulated foreign earnings.

The next procedural step was for the House and Senate to go to conference to resolve differences between their respective versions of the legislation. The conferees released a Conference Agreement on 15 December that reflected compromises in a number of areas, but once again, retained the main elements of the original framework proposals. Legislation based on the Conference Agreement was passed by the House and the Senate on 20 December and was signed by the President on 22 December, the final step in the enactment process. The legislation will go into effect for 1 January 2018.

It is useful to understand the implications of the US tax reform provisions on Canadian competitiveness. Here, we focus on tax competitiveness of large corporations that fund their investments in international capital markets.

Key US business tax reform provisions that may affect Canadian competitiveness

- *Corporate income tax rate*: Under the final *Tax Cuts and Jobs Act*, the federal corporate income tax rate will be reduced from 35% to 21% effective 1 January 2018.

- *Rates for pass-through entities*: The final legislation provides a 20% deduction for qualified business income of non-corporate pass-through entities, which results in an effective rate of 29.6% for high income business owners (at the highest individual income tax rate of 37%). For taxpayers with income above certain thresholds, the deduction is generally limited to the greater of 50% of W-2 wages, or the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of all qualified property. Specified service business income above a certain threshold is not eligible for the deduction. For most individuals, the top federal rate on non-corporate business income 29.6%.

- *Expensing*: The final legislation allows for 100% expensing by increasing bonus depreciation from 50% to 100% for qualified property with a phase-down starting in 2023 by 20 percentage points for each of the following five years.

- *Net interest expense deduction*: The deductibility of net interest expense incurred by C corporations will be partially limited. The *Act* limits until 1 January 2022 the deduction of net interest expense to 30% of the business's adjusted taxable income not taking into account interest, depreciation, amortization, depletion or net operating losses (NOLs) (disallowed amounts may be carried forward five tax years). After 2022, the limit will be based on 30% of the business's adjusted taxable income not taking into account any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, business interest expense or income, the deduction for certain pass-through income, and NOLs (disallowed amounts may be carried forward indefinitely).

Unlike the House and Senate bills, the final legislation dropped the additional interest expense limitation that would have been imposed through a worldwide debt cap for large corporations.

- *Net operating losses (NOLs)*: The NOL deduction will be limited to 80% of taxable income for losses arising in tax years beginning after 2017.
- *Research credit*: The final legislation retains the research and development credit, but R&E expenditures paid or incurred in tax years after 2025 will be capitalized and amortized over a 5-year period (15 years for expenditures attributable to research conducted outside the United States).
- *Corporate Alternative Minimum Tax (AMT)*: The corporate AMT is repealed.
- *Territorial tax system*: The US will adopt a "territorial" system, whereby foreign-source dividends paid from affiliates with a minimum 10% ownership will be exempt from US tax when repatriated to the United States. New anti-tax abuse measures are included.
- *Transition tax*: As a transitional measure, existing foreign earnings accumulated abroad since 1986 would be subject to a mandatory toll (transitional tax) payable over 8 years — 15.5% for earnings held in cash and 8% for the remainder.

Impact on Canada's competitiveness

These US tax reforms are expected to have a mixed but generally negative overall economic impact on Canada. On the plus side, with lower taxes on capital and labour, and anticipated resultant economic growth in the United States, Canada stands to benefit by exporting more goods and services to a healthier US market, assuming that the current NAFTA negotiations either continue or can be successfully concluded.

On the negative side, a more tax-competitive environment south of the border, and potentially rising trade protectionism in the United States, may draw capital and skilled labour from Canada to the larger US market.

The most significant impact, however, will be on Canada's tax competitiveness. Taking into account state income tax rates, the new combined US federal-state corporate income tax rate will fall significantly from 39.1% to 26% and will be slightly lower than the Canadian federal-provincial corporate income tax rate of about 26.7% (weighted by GDP for subnational jurisdictions). This significant relative rate shift may create new opportunities for tax planning for both Canadian- and US-based corporations with cross-border operations, as US corporate rates have been substantially higher than Canadian rates over the past decade.

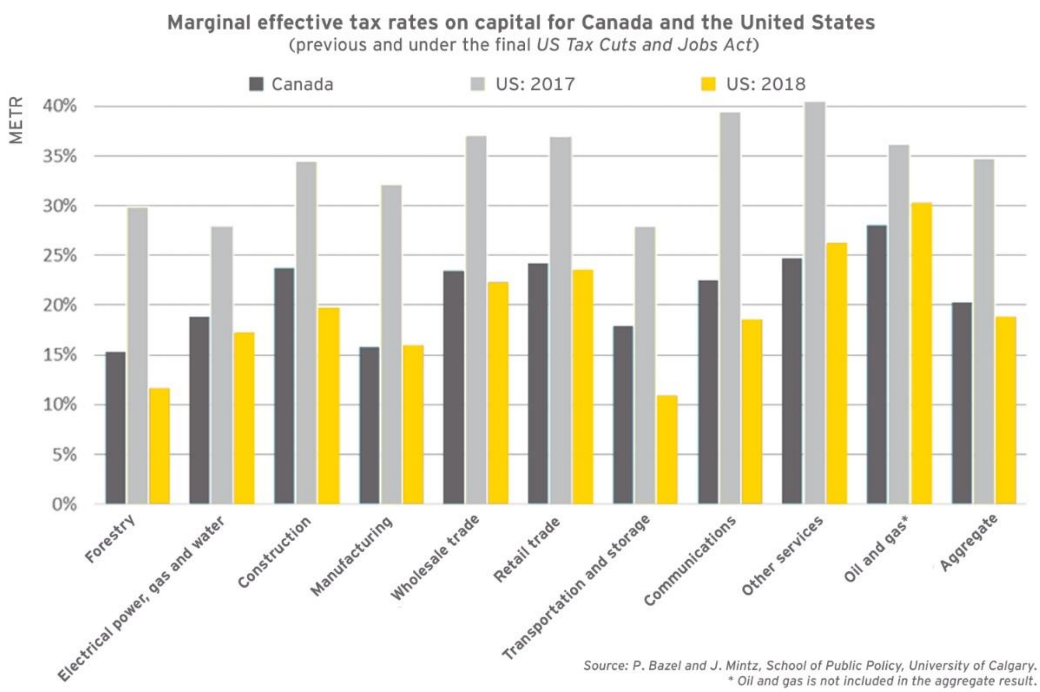
Furthermore, for a period of time, US businesses will be able to fully write off machinery and equipment investment costs from profits rather than depreciating them until 2022 (and partial expensing until 2027), although net interest expense associated with these investments may not be deductible for more levered companies.

While Canadian companies will be taxed at a higher rate than companies in the United States, Canada provides other important advantages for investment. With the adoption of the GST/HST in provinces excluding British Columbia, Saskatchewan and Manitoba, sales taxes on capital purchases by businesses have largely been removed. In the United States, retail sales taxes are levied on similar capital purchases and have a substantial impact on tax competitiveness.

We have examined the differences between the corporate taxation of investment in the United States and Canada for large companies, taking into account corporate income tax rates and deductions, sales taxes on capital purchases and other capital-related taxes such as transaction taxes.

As the chart shows, when implemented on 1 January 2018, US tax reform will result in a sharp reduction in the US marginal effective tax rate on investment (METR) in a wide variety of industries, and the US aggregate METR will drop significantly from the current 34.6% to only 18.8%. Compared to Canada's current aggregate METR of 20.3%, this will completely eliminate the relative tax advantage that Canada has enjoyed over the United States for more than a decade, marking the first time since 2006 that the US METR will be lower than Canada's.

In the rank order of the 34 OECD countries, the United States will fall from the 3rd highest to the 14th highest rate, placing it below Canada, which will have the 12th highest rate. However, both Canada and the United States will be above the simple average OECD METR rate of only 17.3%.



Considerations for Canadian businesses and policymakers

Canadian businesses and government policymakers alike need to carefully consider these tax reform developments in the United States. These significant personal and business tax changes affect the relative prices of labour and capital in both countries and returns on business investment. Tax competitiveness is only one factor among many that businesses consider when making investment decisions. But eliminating the tax competitiveness that Canada has enjoyed over the US for the last number of years could affect the outcome of many companies' tax planning and investment location decisions.

Not only will investment be affected, but businesses will need to rethink financing structures, including whether to place more cash into the United States for business expansion or other purposes.

Accordingly, due to the closely integrated nature of the countries' respective economies, tax reform in the United States merits an appropriate policy rethink and response by tax authorities in Canada, where for a number of other reasons there are already growing calls for a comprehensive tax policy review.

As a closing cautionary note, trade protectionism could also make cross-border trade in both business inputs and final outputs more difficult, thereby putting pressure on companies to re-examine their existing supply chain relationships and possibly shift production to satisfy demand in the protected US market.

With lower corporate taxes on business investment, the United States will be more attractive for investment in the future. Competitive considerations make US tax reform, now a reality, an important development to respond to and potential changes in NAFTA an important development to watch.

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