Canada's response to US tax reform

EY Policy brief
EY Policy Brief is a new thought leadership series by EY Canada on public policy issues of economic and strategic significance to Canadian business and government, and accordingly, of general interest to the public. The Brief is designed to inform and stimulate public interest and debate. *Canada's response to US tax reform* is the first in the series.

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Two recent events in the United States have combined to provide a strong stimulus to the US economy: the tax reform measures that came into effect in 2018 as part of the 2017 *Tax Cuts and Jobs Act* and ongoing selective deregulation.

These developments have also moved Canadian competitiveness to the front burner as a pressing public policy issue in this country. Why does competitiveness matter? Has Canadian competitiveness fallen behind? If so, what are the economic and fiscal implications? What should Canadian policymakers be doing about it?

Here we focus on these four questions in the context of Canada's tax competitiveness. We recognize that taxation is but one important element of the overall competitiveness agenda. The skill level of our workforce, the quality of our education and health systems, the availability of public and private infrastructure, as well as a host of other factors also impact our ability to compete and attract new business investment. However, we argue that with the *Tax Cuts and Jobs Act* now in place in the US, tax competitiveness needs to be addressed through both immediate and longer-term policy measures.
Why does competitiveness matter?

A competitive economy puts its resources to their best economic use, lowering the cost of producing goods and services, increasing returns on capital investment and creating a more innovative and dynamic economy. With innovation and investment that enhances competitiveness, Canadians enjoy growing incomes to pay for goods and services. In addition, governments generate tax revenues to fund public services and redistribute income as appropriate so that everyone shares fairly in the benefits that flow from being competitive.

Businesses invest in products that Canada can export at a comparative advantage, and import goods and services that can be produced more cheaply elsewhere. To the extent that competitiveness increases our net exports of goods and services and balance of payments, it pushes up the external value of the Canadian dollar, but it also means Canadians have higher salaries denominated in foreign currencies, resulting in greater purchasing power to travel or buy goods and services from abroad. Overall, competitiveness leads to a higher standard of living for Canadians.

In other words, competitiveness is not about cheap labour or low costs. It’s about productivity – making more with what we have so businesses can pay their people well but still compete with lower-unit labour costs of production in other countries.

Federal and provincial governments have made innovation an important focal point for policy development, with funding for superclusters, infrastructure, education, and research and development. While these policies are certainly welcome, are they sufficient in themselves to create a competitive ecosystem to ensure that Canada's standard of living will not fall behind the US? And will these initiatives succeed if other public policies, including tax policy, are not aligned with them instead of working at cross purposes?
Has Canadian competitiveness fallen behind?

Until recently, Canada’s business tax system was judged to be quite competitive by international standards. In the early 2000s, Canadian federal and provincial governments embarked on a program of gradually reducing business taxes to attract investment. They accomplished this by implementing staged reductions in corporate tax rates, eliminating taxes on capital and reducing taxes on business inputs. A good measure of the effectiveness of this strategy is that, in spite of the rate reductions over this period, corporate tax revenues continued to increase and the ratio of corporate taxes to gross domestic product (GDP) remained stable.¹

The US tax system, meanwhile, was in dire need of significant reform. But because of the highly partisan nature of US politics in recent years, most pundits thought US tax reform would not happen quickly. However, the election of President Donald Trump and Republican control of both the House and Senate combined to create the winning conditions needed for it to succeed.

As of 1 January 2018, these reform measures have taken effect (although some regulations still must be developed by the end of this year). Not all may agree with various aspects of the reforms, and there is concern about undesirable fiscal effects accompanied by spending increases in the US. But without doubt, their impact is far reaching, with lower rates, broader tax bases and an exemption for foreign-source dividends paid from post-2017 profits and earnings of US multinationals.

Specifically, as of 1 January 2018, the US federal corporate income tax rate dropped from 35% to 21%, and machinery and equipment may be written off fully rather than at 50% in 2017 (it was to have been 40% in 2018 and phased out by 2020). Including state taxes, the US corporate income tax rate varies from a low of 21% in Texas, Washington and Ohio to a high of 30.48% in Iowa. Lower tax rates now apply to certain types of income, as we discuss below.

By comparison, the Canadian combined federal-provincial corporate income tax rate on general income varies from a low of 26.5% in Ontario to a high of 31% in Nova Scotia and Prince Edward Island. With expensing, Canada’s effective tax rate on new investment (the marginal effective tax rate)² is now higher than the US rate. Other taxes on energy, including carbon taxes and labour inputs, put Canadian business at an additional competitive disadvantage (taxes on these other inputs are not included in the calculations below).

Figure 1: Marginal effective tax rates on capital for the United States before and after US tax reform compared to Canada 2018

Source: Bazel and Mintz, School of Public Policy, University of Calgary 2018. * Oil and gas sector is not included in the aggregate result.


2. The marginal effective tax rate on capital provides a measure of corporate-level taxes paid as a share of income paid to equity and debt owners of capital. Taxes include corporate income taxes (accounting for the tax rate and treatment of costs), sales taxes on capital purchases, real estate transfer taxes and other capital-related taxes (except property taxes). See P. Bazel, J. Mintz and A. Thompson, 2017 Tax Competitiveness Report: The Calm Before the Storm, SPP Research Papers, 11(7), The School of Public Policy, University of Calgary, February 2018.
What are the economic and fiscal implications?

**Will investment be drawn to the United States?**

Mobile capital moves to the jurisdiction with the highest after-tax rate of return. Although many factors influence investment decisions, a jurisdiction with a higher tax burden on new investments will lose capital investment to others, all other things being equal. So US tax reform has completely eliminated Canada’s significant corporate tax advantage to attract investment.

An EY Canada-sponsored survey asked 165 Canadian C-suite executives to gauge the impact these policy shifts are either already having, or could have, on their business operations and future capital allocation plans.3 Asked what best describes the likely impact, half say they will likely increase investment in the US, another 29% said they will shift investment from Canada to the US, and 22% said decisions will be deferred due to uncertainty – at least for the time being. Among businesses currently operating in the US, 33% foresee cutting investment in Canada and increasing it in the US, and another 53% anticipate increasing their investment in the US.

**Will skilled labour be attracted to move to the United States?**

To the extent that after-tax salaries are higher in the United States, skilled workers will be more incented to work and reside in the United States.

US tax reform reduced the federal top tax rate to 37%, but state and local income taxes are now only deductible up to $10,000. Overall, we calculate the average top federal-state personal marginal tax rate to be 44.2%, although there is considerable variation among states; seven states, including Florida, Texas and Washington, don’t tax personal income at all, while California imposes the highest top tax rate at 13.3% on income over US$1 million (for individuals) and US$1,074,996 (for married filers).

Given that Canada’s top rate averages 52% – varying from 47.5% in Saskatchewan to 54% in Nova Scotia – for incomes roughly above CDN$220,000, US personal taxes are considerably less for more skilled income.

**How about entrepreneurs?**

For entrepreneurs, lower corporate and personal income taxes on equity income in the US as a result of tax reform may encourage entrepreneurs to move to the United States or sell out Canadian business to US corporations. US tax reform provides a special deduction of 20% of qualifying income accruing to owners of “pass-throughs” (partnerships, sole proprietorships and S-corporations), which is especially important at the small business level. With a pass-through, the business does not pay corporate tax (except in a few US states like California), but the income is fully attributed to the owner and taxed as personal income.

Certain restrictions apply to ensure wages are not converted into pass-through income. The maximum business owner’s income threshold for the 20% deduction is US$157,000 for individuals and US$315,000 for married taxpayers. If income is above the threshold, the small business owner is restricted to the lesser of 20% of income and 50% of wages paid. The deduction is also phased out for certain service businesses when income is above the threshold.

Figure 2 shows the marginal effective corporate tax rate comparisons for small businesses in the US and Canada after US tax reform (calculations are similar to Figure 1 in methodology). Despite the 9% corporate income tax rate on business income earned in small Canadian-controlled private corporations (CCPCs) of less than $10 million in asset size, small Canadian firms are at a disadvantage compared to US S-chapter corporations (the majority of small US businesses). The same is the case for larger CCPCs at $20 million in asset size (neither the small business tax rate in Canada nor the special deduction for pass-through income in the US are relevant for these firms of these sizes).

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Will businesses pare down certain activities in Canada or move them to the US?

US tax reform deeply cuts the tax rate on “intangible income” — intellectual property income, marketing and services — to a federal rate of 13.25%. Some companies find it now beneficial to move intellectual property held in Canada to the US. When US corporate tax rates were higher, some companies located their sales forces in Canada. That incentive is now reversed. Some will shift certain other business services to the US from Canada. These decisions are already in the process of either happening or being considered in the context of overall business tax planning and transfer pricing.

What will happen to Canadian Government revenues?

US tax reform is a mixed blessing for Canadian Government coffers. To the extent that US reform buoys the US economy, which has so far been the case in 2018, Canadian businesses benefit from stronger export sales to the US, which improves growth in Canada. On the other hand, both spending increases and tax reductions have blown up the US federal deficit and put upward pressure on interest rates due to this fiscal stimulus.

More important, US reform potentially erodes Canadian government revenues, since US companies or Canadian companies with US operations find it better to leave profits in the United States rather than keep them in Canada as they did when we had a much lower corporate income tax rate.

As of 2018, US corporations can now return dividends back to the parent tax free and, by keeping profits in the United States, avoid new limitations with respect to interest and loss deductions. Canadian firms with little or no taxable income in the United States will be taxed more heavily under the Tax Cuts and Jobs Act’s base erosion and anti-avoidance tax provision, a minimum tax on profits disregarding certain payments to the Canadian parent.

More than half (54%) of senior executives surveyed by EY anticipate that US tax reform will result in a shift of corporate revenues out of Canada and into the US, resulting in lower tax liabilities in Canada and higher ones in the US. This proportion rose to 60% for firms with revenues above CDN$500 million, and 64% for companies with more than 500 employees.
How should Canada respond to US reform?

The federal government has promised to provide a first response to US reform in Finance Minister Bill Morneau’s annual fall economic statement, scheduled to be released on 21 November 2018. It’s not clear at the time of writing what measures are being contemplated, but there’s some speculation that immediate expensing of capital investments, similar to the new US expensing provisions, or other forms of accelerated capital depreciation, are under consideration, rather than rate reductions.

While immediate actions to address tax competitiveness are welcome, piecemeal measures such as these could have other undesirable effects on an existing tax system that is already in need of a comprehensive overhaul. For example, immediate expensing would not be neutral in its impact across industries, and it could encourage tax planning opportunities to effectively utilize tax losses that would inevitably be created. The effect would be to restore a lower marginal effective tax rate in Canada than in the US once again. But it could also distort investment decisions, and accordingly optimal resource allocation, even more than under the current system by increasing the variance in effective tax rates on capital across industries.

It would also do nothing to address a number of the other competitive issues that arise from US tax reform: for example, personal tax rates on skilled labour and entrepreneurial investments that are higher in Canada than in the United States, and after-tax returns on intellectual property that are lower here than in the US.

It would be preferable from both the tax neutrality and competitive perspectives to lower the Canadian corporate tax rate and broaden its base by eliminating some of the existing, ineffective tax expenditure programs in a way that is revenue neutral. Those who would characterize this as “a race to the bottom” should note that Canada’s corporate income tax rate at present is in the middle of the pack with respect to other G20 and OECD countries, and there is considerable scope for a further reduction or staged reductions.
If anything, all this goes to show that an effective response to competitive pressures from US tax reform requires a combination of both short-term measures and a longer-term, comprehensive approach to tax reform that addresses competitiveness issues under both the corporate and personal tax systems.

We're far from alone in this view. Fully 90% of the senior business executives in EY’s survey believe that Canada needs a comprehensive tax policy review, with many respondents citing the US tax reforms as a significant new impetus for such a review. An overwhelming majority of respondents (80%) prefer this review to be done at arm’s length by an outside commission of tax experts appointed by the government, rather than done in-house by the Department of Finance (20%).

Nor are business groups alone in this view. The federal government’s own Advisory Council on Economic Growth has recommended an “overdue” targeted review led by an independent panel. A key recommendation of the OECD in its June 2018 Economic Report on Canada was to “review the tax system to ensure that it remains efficient ... equitable and supports the competitiveness of the Canadian economy.” In June 2018, the International Monetary Fund also concluded that Canada should undertake a comprehensive review of its corporate tax system.

6. “It is time for a careful rethink of corporate taxation to improve efficiency and preserve Canada’s position in a rapidly changing international tax environment. Given its centrality to the architecture of the tax system as a whole, this requires a holistic review, which Canada has not had for some time. The US tax reform increases the urgency of moving ahead with the review. Its impact remains highly uncertain, but the potential effects, through both real activity and profit shifting, could be substantial. The review should weigh the pros and cons of incremental approaches to change, such as more generous capital cost allowance, against more radical options, such as moving to some form of rent tax at the corporate level.” https://www.imf.org/en/News/Articles/2018/06/04/ms060418-canada-staff-concluding-statement-of-the-2018-article-iv-mission
Canada’s response to US tax reform

CPA Canada has long called for a comprehensive tax review, and in October 2018 released the first in a series of three reports on Canada’s current tax system, documenting how Canada is falling behind other jurisdictions such as the United States, the United Kingdom, New Zealand and Japan where efforts are being taken to keep their tax systems competitive.7

Finally, among the key recommendations in the 16 October 2018 Report of the Standing Senate Committee on Banking, Trade and Commerce, Canada: Still open for business?, are that “the federal government act immediately to implement measures that would encourage companies to continue to invest in Canada” and that it “establish a Royal Commission on Taxation to examine Canada’s tax system with the goal of improving the efficiency, simplicity and international competitiveness of the system.”8

As stated at the outset, we’ve focused here on Canada’s tax competitiveness. The federal and provincial governments could also bolster Canada’s economic competitiveness by collaborating together in other key complementary areas for example, by eliminating interprovincial trade barriers that balkanize an already small and geographically dispersed domestic market, and by streamlining costly, slow and inefficient regulatory approval processes for major infrastructure and natural resource development projects.9

Canada has demonstrated a proven track record on how to become highly competitive on the global stage in recent decades. The lessons learned then can inform the way the federal government innovates our tax system to vie with the US in this new and highly competitive era.

The challenge for Canada’s governments is to recalibrate and realign our public policies and programs to regain and then retain our lost competitive advantage in a fast-paced and disruptive global policy environment. The challenge for Canada’s businesses is to exploit this advantage to outperform the competition and win new markets.

9. See for example, Canadian Chamber of Commerce’s Report, Death by 130,000 Cuts: Improving Canada’s Regulatory Competitiveness, May 2018.
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