

TAX POLICY TRENDS

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CANADIAN POLICY MAKERS RESPOND TO U.S. TAX OVERHAUL

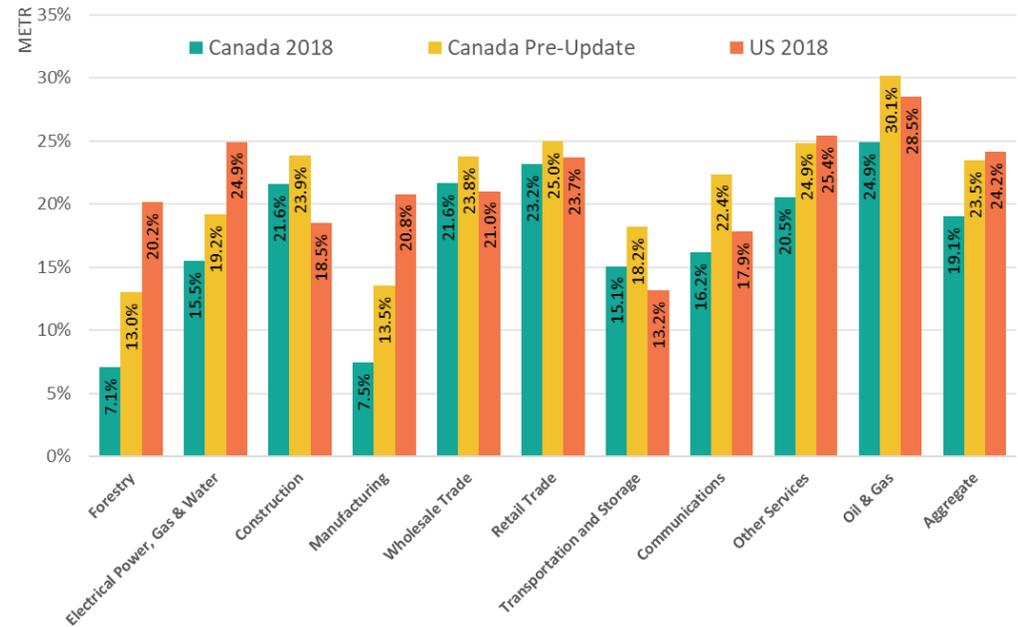
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Following the 2017 overhaul of the U.S. corporate and personal tax system, 2018 has seen much discussion regarding Canada's diminished tax advantage and its attractiveness as an investment destination in comparison to the U.S. In the November 21st 2018 *Economic Update*, the federal government's response was finally unveiled. The central policy included a generous temporary accelerated capital cost allowance. This strategy largely follows a plan of action championed by the Canadian business community and emulates features of the U.S. corporate tax reform. However, as we point out below, tinkering with depreciation schedules distorts further the corporate tax system and fails to deal with other competitive issues that can only be addressed by changes to the statutory corporate income tax rates.

The U.S. tax reform, known as the Tax Cuts and Jobs Act centered on two major corporate tax changes that dramatically reduced the marginal effective tax rate faced by large U.S. corporations.

The drop is primarily due to a major federal rate reduction from 35% to 21%, and expensing (100% write-off) for newly acquired machinery and equipment. The adopted U.S. expensing regime was introduced as a temporary five-year incentive and not extended to the utility sector.

Corporate Marginal Effective Tax and Royalty Rates on Capital for 2018 Post-Update



Various other proposals were adopted including interest expense limitations, which also impacts the U.S. METR, though to little degree at this time.

This translated to a reduction in the large corporate U.S. marginal effective tax rate (METR) from 34.6% to 21.8%¹, resulting in the U.S. METR dropping below that of Canada for the first time in nearly a decade, wiping out a roughly 14.2% advantage for Canada.

¹ *** The METR quoted here replaces our previous 2017/2018 estimate of 18.9%, based on older capital distribution data. This revision, and the difference in result, is based entirely on the inclusion of new up to data for capital distribution. In addition, this figure does not include the updated aggregate we are presenting above, which now includes the Oil and Gas sector. We are including this point for comparability with our previous work, which did not include the Oil and Gas sector in the Aggregate Canadian METR.

This *Tax Policy Trends* models the impact of the accelerated capital cost allowances and expensing regime adopted in the Fall Economic Statement. This newly introduced policy effectively triples the previous half-year convention CCA rate applied to new investments. This means that newly acquired capital—other than machinery—will now be depreciated at 1.5 times the CCA rate in the first year, as opposed to the previous ½ rate. Clean energy and manufacturing and processing machinery will be fully expensed in the first year. These measures will remain in full force until 2024, after which they will be gradually phased out, providing no benefit after 2027.

The result of expensing for machinery and equipment is a dramatic reduction in the aggregate Canadian METR from 23.5%² in 2018 to 19.1%³.

Looking at the estimates, we see that wholesale and retail trade receive the smallest benefit – the METR drops from 23.8% & 25.0% to 21.6% & 23.2% respectively. This is largely due to the low level of heavy machinery employed in the trade sector, along with a higher emphasis on buildings and structures, which continue to have significantly lower CCA rates and longer life spans, even with the new accelerated allowance. Industries more intensive with long-lived assets also benefit less including construction, utilities, and transportation. Manufacturing, which was already low-taxed due to previous accelerated depreciation benefits very little.

These distortions create an incentive to invest in technologies and industries that rely more heavily on machinery and equipment rather than land and structures, or potentially labour that is replaced by automation.

While accelerated depreciation and expensing for short-lived capital encourages more investment, it creates significant distortions in capital allocation. The dispersion index, measured as the variance in METRs across industries and asset classes over the average, climbs from 2.93% to 7.9% in Canada.

Since 1985, Canada has adopted corporate tax reforms intended to achieve more neutrality among businesses and to remove distortions resulting from many companies not paying taxes. Favouring machinery and equipment further contributes to a non-level playing field. It also results in many profitable corporations becoming non-taxpaying companies, adopting complicated tax planning structures to shift losses to taxpaying companies like banks

The impact of Canada's 2018 tax reform is enough to restore a competitive tax advantage with the U.S. in aggregate only with respect to tax depreciation. However, in a broader analysis this is only one aspect, which influences investment decisions and the flow of capital. Projects with high rates of return on capital are discouraged particularly by high statutory corporate income tax rates. These differences in corporate income tax rates also create incentives to push financing and general administrative costs into Canada, leading to corporate tax base erosion. Further, the 13.125% U.S. federal tax rate on intangible income – intellectual property, marketing, services and mining – creates an incentive to draw intangible activities to the United States. Other competitive factors, such as regulations, labour taxes and energy taxes, not included in these calculations, will determine whether Canada is sufficiently competitive to attract international investment.

² This includes Quebec's 2018 March to December 60% additional bonus accelerated depreciation, which reduced Canada's aggregate METR from our previous estimate of 20.4% to 19.8%. Following the Nov 21st economic update Quebec reduced its bonus from 60% to 30%, while making the bonus permanent whereas it had previously been a temporary two-year measure.

³ Here, our Aggregate results also include the oil and gas sector.