

TAX POLICY TRENDS

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WHETHER IT IS THE U.S. HOUSE OR SENATE TAX CUT PLAN – IT'S TROUBLE FOR CANADIAN COMPETITIVENESS

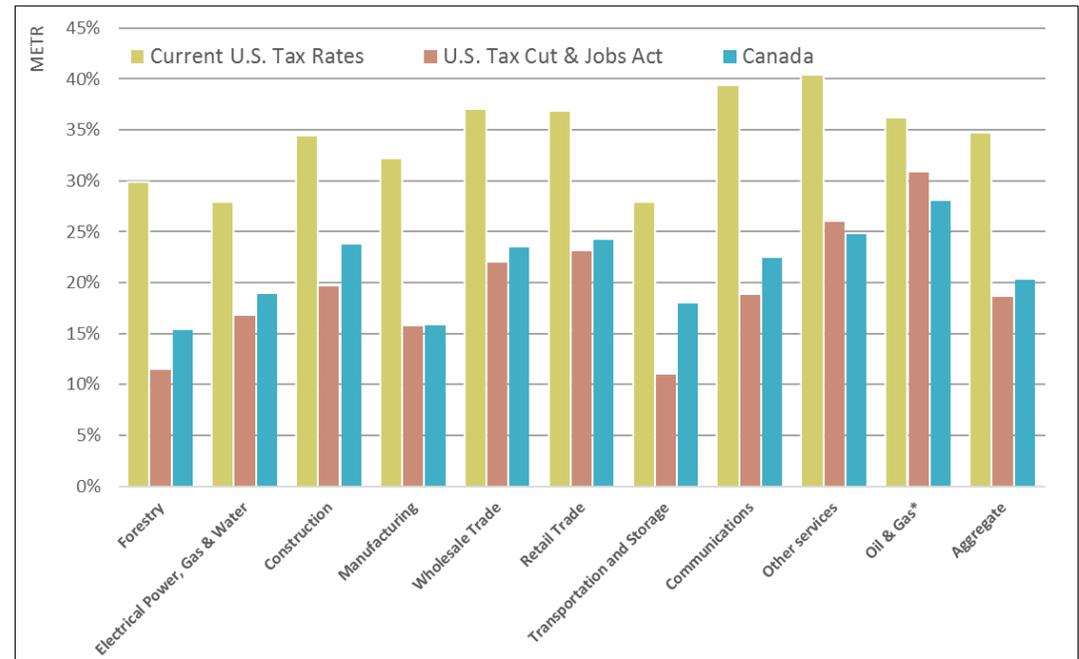
By P. Bazel and J. Mintz

In the past two weeks, Senate and House Republicans have put forward parallel mark-up bills in a step toward reform of the U.S. personal and corporate tax systems. The respective bills titled, "TAX CUTS AND JOBS ACT" (TCJA) are based on previous proposals put forward by Congressional Republicans, most notably their recent "UNIFIED FRAMEWORK FOR FIXING OUR BROKEN TAX CODE" released in September.

Most relevant to U.S. competitiveness, large corporations would see a substantial reduction in the federal tax rate under both bills, with a drop from 35% to 20%.

However, while the House bill would implement the rate reduction in 2018, the Senate bill delays the drop until 2019. Both bills also propose a dividend exemption system for foreign profits similar to most OECD countries.

Effective Tax Rates on New Investment: Current for Canada and U.S. and Proposed



* Oil & gas is not included in the aggregate result.

**The METR is calculated as federal and subnational corporate income taxes, sales taxes on capital purchases and other related taxes as a share of gross profits.

Both Senate and House proposals include a generous five-year measure intended to stimulate investment with full capital expensing for machinery.

The TCJA would benefit some industries (e.g. manufacturing) more than others. This can be attributed to the proposed changes to capital depreciation, in the form of full expensing for machinery, but not for land, inventories or structures. Firms which are investing more heavily in machinery will see a greater tax reduction over the five years the measure applies.

A significant departure from earlier proposals (both the House “Blueprint” & “Unified Framework”) occurs with regard to the treatment of interest deductibility. Whereas federal interest deductibility was previously eliminated for asset classes benefiting from the new expensing regime under earlier proposals, both bills introduce a general earnings stripping rule, which limits but does not eliminate interest deductions. Under the House plan interest deductibility would be limited to 30% of earnings before the deduction of interest, taxes, depreciation, depletion and amortization (EBITDA), with unused interest deductions carried forward, and some sectors such as utilities exempt. Under the Senate plan interest deductibility would be limited to 30% of earnings only before the deduction of interest, taxes and certain unallocated costs (EBIT). This gives the Senate plan a tighter base for the interest limitation and by extension a smaller tax cost.

The earning stripping rule under both marked-up bills would only impact more highly leveraged companies thus enabling greater use of interest deductions compared to earlier reform proposals.

Taken together the tax rate reduction, expensing for machinery, and the limited earning stripping rule, both the House and Senate bills will result in a substantial reduction in the large corporate Marginal Effective Tax Rate (METR) on capital for U.S. corporations.

As the figure above illustrates under either bill the U.S. aggregate METR would drop from the current 34.6% (27.4% taking into account 2017 50% bonus depreciation for machinery) to 18.6%, bringing the U.S. below the current G7 simple average of 26.2%

and the simple OECD average of 17.3%. The proposed changes would see the U.S. fall from the third to the 14th highest METR among the 34 OECD nations. This would also see the U.S. fall below Canada which would take the position of 12th highest METR among the OECD countries. This would be the first time in more than a decade (2006) that the U.S. METR would fall below that of Canada.

Arguably, both the House and Senate bills would create a business tax disadvantage for Canada with its METR of 20.3% vs. the U.S. rate of 18.6%.

The House and Senate bills also reduce taxes on small business income although using different approaches. Both mark-ups will require reconciliation once the House and Senate pass their own tax bills.

The Trump administration and Republican Congressional leadership have stated a clear intention for tax reform before the new year. With the passing of the budget, the tax reform bill will be part of budget reconciliation, thereby only requiring a 50 plus one majority of Senators to approve legislation and a majority in the House of Representatives. Whether the Republicans can deliver on this significant tax reform will be a closely followed development in this fall.

The U.S., like much of the rest of the world, understands that corporate taxation hurts growth and ultimately worker incomes. The world is moving to reduce corporate taxation – Canada is moving in the other direction. Canada will lose investment as a result. Canadian policy makers need to prepare now for what could be a significant challenge to Canadian competitiveness. Money can move very easily across the U.S./Canadian border

References

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