

TAX POLICY TRENDS

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CANADIAN POLICY MAKERS CONSIDER RESPONSE TO U.S. TAX OVERHAUL

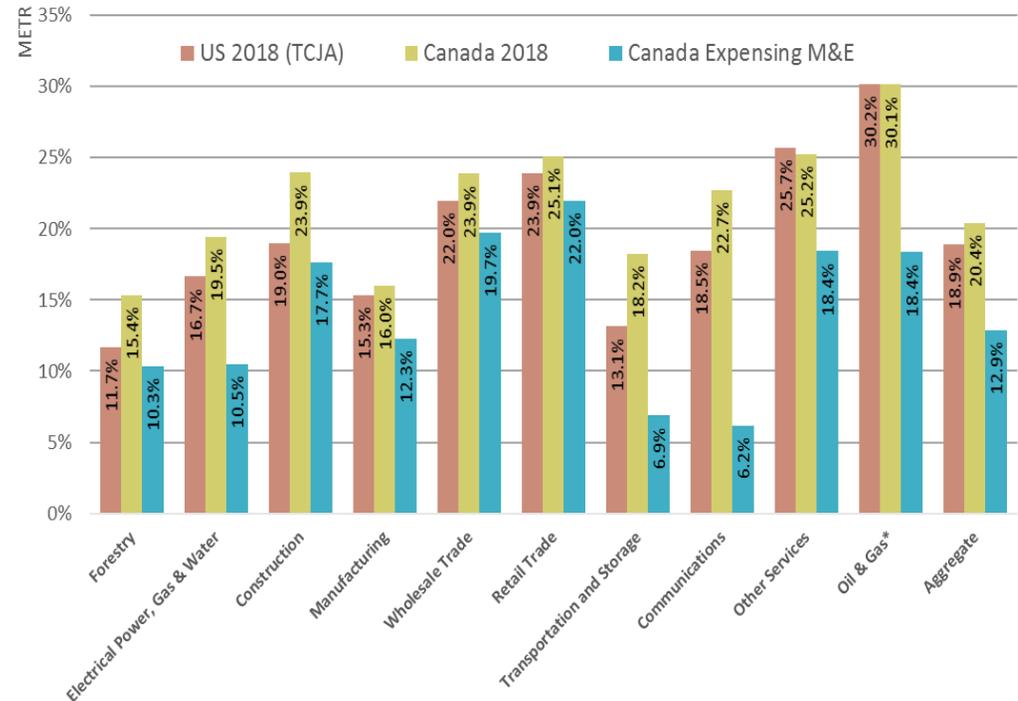
By P. Bazel and J. Mintz

Following a recent major overhaul of the U.S. corporate and personal tax system, there has been much concern expressed regarding Canada's diminished tax advantage and its attractiveness as an investment destination in comparison to the U.S. Among the proposed tax policy responses, some in the business community have called for Canada to adopt accelerated depreciation for machinery, a central component of the U.S. corporate tax reform.

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. Various

Corporate Marginal Effective Tax Rates on Capital for Selected Industries for 2018 and Expensing in Canada



*Aggregate does not include oil and gas.

other proposals were adopted including interest expense limitations, which also impact the U.S. METR, though to a lesser degree at this time. This translated to a reduction in the large corporate U.S. marginal effective tax rate (METR) from 34.6% to 18.9%, 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.**

This *Tax Trends* models the impact of expensing adopted in Canada, similar to the United States. However, given the broad nature of the discussion regarding the possibility of expensing in Canada and the current ambiguity surrounding its implementation we have included expensing for Canadian utility sector in our estimates. Instead of the current weighted average CCA rate of 19.2%, qualifying assets would be fully written off in the first year. The result of expensing for machinery and equipment would be a dramatic reduction in the aggregate Canadian METR from 20.4% in 2018 to 12.9%.

Looking at the estimates it is immediately apparent that manufacturing receives the smallest benefit--the METR drops from 16% to 12.3% since manufacturing equipment already benefits from a two-year write-off. Industries less intensive with short-lived assets also benefit less including construction, utilities, wholesale trade and retail trade.

While expensing for short-lived capital encourages more investment, it creates much larger distortions in capital allocation. The dispersion index, measured as the variance of METRs across industries and asset classes divided by the average, rises from 2.93% to 13.82%. 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.

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. Introducing expensing for machinery and equipment further contributes to a non-level playing field. It results in many profitable corporations becoming non-taxpaying companies, adopting complicated tax planning structures to shift losses to taxpaying companies like banks. Incentives become less effective as tax losses pile up. How steep of decline in corporate taxes is a matter for debate but clearly expensing would lead to a dramatic reduction in taxation, perhaps going too far.

The drop that would occur in Canada's METR under an expensing scheme (12.9%) could be better achieved by other proposals in terms of neutrality across provinces, industries and assets.

To illustrate, a drop in the federal-provincial corporate tax rate from 27% to 17% (similar to the UK by 2020) would achieve a similar aggregate METR (13.3%) for Canada, and a more neutral treatment between asset classes.

Distortions also fall, with the dispersion index dropping from 2.93% to 2.88%. The reduction in tax rates would also maintain attractiveness and help to keep profits in Canada, especially in light of the U.S. adopting a federal 13.125% tax rate on intangible income (including intellectual property, marketing and service income), which is already moving jobs to the United States.

Corporate income tax reductions results in fewer revenues collected from old investments but staging corporate rate reductions over time and/or a one-time transition-tax on past earnings and profits could easily deal with this issue. We believe that this policy would be a far better course to follow.