Intelligence MEMOS

From: Nick Pantaleo and Alex Laurin

To: The Honourable Bill Morneau, Minister of Finance

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Re: **US Tax Reform Requires Immediate Action**

The Republican Party's major tax overhaul became effective, for the most part, on January 1. It promises to spur US investments and economic growth, change cross-border tax planning while potentially damaging the competitive landscape for corporate investments in Canada.

While we wait for impact studies and fundamental reforms, two easy temporary fixes to our tax depreciation system could provide the immediate help needed to restore some of our lost competitiveness for new investment.

Even though Canadian exports stand to benefit from a stronger US economy in the short term, subject to the ongoing NAFTA renegotiation, the negative impact on domestic investments relative to the US could severely hurt Canadian jobs and Canada's relative productivity in the longer term. Immediate policy action is needed to curtail potential longer term economic damage, because changes in investment levels take time to fully materialize.

The drastic US corporate tax rate reduction from 35 percent to 21 percent, combined with immediate tax write off for many capital expenses (albeit with restrictions on interest deductibility), considerably raise the attractiveness of the US for new business investment. Combined with the adoption of a territorial system for the taxation of foreign affiliates' profits, mimicking Canada's and many other advanced nations, and the new US tax system may very well discourage the influx of foreign investment in Canada destined to serve the North American and world markets, to the benefit of the United States.

Domestically, large US companies have already started to react. Apple's pledge to invest over $30 billion in new capital expenditures in the US and create 20,000 jobs over the next five years is a case in point.

Fundamental reforms to Canada`s tax system will be needed to protect Canada`s competitiveness. Some are more deserving than others. Adopting an allowance for corporate equity, which could be paid for by broadening the base, would improve long-run investment incentives. Replacing the small business deduction with a more contained immediate expensing provision is another growth-oriented reform that deserves consideration. But fundamental reforms can take years of study before they are implemented.

In the meantime, two easy-to-implement temporary fixes to our depreciation system could substantially improve the investment climate and competitiveness in the short run:

Eliminating the half-year rule would enable businesses to claim in the first year the maximum depreciation deduction otherwise available, as opposed to only one-half; and

Eliminating the available-for-use requirement would mean that a multi-year project could start to be written off as cash investments are made, as opposed to when the entire project becomes available for use.

Both changes would primarily affect the timing of write offs. Assuming that tax rates remain constant and the investment remains profitable, the overall fiscal cost for these temporary investment incentives would likely be small. In any event, the long-run cost of doing nothing immediately certainly outweighs their immediate fiscal cost.

Nick Pantaleo is Senior Vice President, Corporate Finance, Rogers Communications and Alex Laurin is Director of Research, C.D. Howe Institute.

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