How to not respond in a non-knee-jerk fashion to US tax reform

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Eleven months since the US released and effectuated historical tax reform (and eleven months of listening to the Canadian Department of Finance's standard speaking point stating that they will not respond to US tax reform in a knee-jerk fashion), the government of Canada today provided a non-response. We believe it's fair to say, mission accomplished; **the Government didn't react at all and certainly there was no actual knee-jerk**.

The non-response

The non-response "accomplishes" three things:

1. Provides a full deduction for new purchases of Manufacturing and Processing ("**M&P**") equipment and certain new "Green" technology equipment;
2. Increases the first-year deduction for other new depreciable property purchases; and
3. Provides no corporate or personal tax rate reductions.

Outside the M&P and "Green" technology deductions, the changes essentially provide a slight increase to the amount that corporations may deduct from taxable income for the purchase of new depreciable property. The deduction, known as Capital Cost Allowance ("**CCA**") will be enhanced, for the first year only (for property acquired after November 20, 2018), and for a limited time only (the property must be available for use prior to 2024 [1]). A similar "enhancement" will be available for the Canadian Development Expenses and Canadian Oil and Gas Property Expenses of oil and gas companies.

CCA is a longstanding method for Canadian corporations (and other persons) to deduct the cost of depreciable capital property. The Income Tax Act specifies the rate of which depreciable property may be deducted. Furthermore, most depreciable property is currently subject to the "half-year rule" which reduces the first-year CCA deduction to 50% of what it would otherwise be. For example, if an asset is purchased for $100,000 and its CCA rate is 20% (computed on a declining balance basis) then the CCA deduction would be $10,000 in year 1. In year 2, the remaining un-depreciated amount of $90,000 would be subjected to a 20% rate and allowable deduction of $18,000 and so on until the asset is ultimately disposed of or is virtually fully depreciated.

The new, temporary, "accelerated investment incentive" ("**AII**") is calculated by the following formula:

A(J-K)+C(L-M)+E(N-O)+G(P-Q)-0.5(R-S) !!!!

Boiled down, all this really does, for non-M&P and Green investments, is to negate the half-year rule and provide an additional 50% deduction in year one. Keeping the same figures in the example above, the first-year deduction would become $30,000 ($100,000*20%*1.5). This is a one-time deduction boost for new depreciable property purchases. For a CCA class that is subject to a declining balance depreciation

rate of 20%, the net difference — after owning the asset for seven years — is an additional 5.2% of CCA deductions. For depreciable property that has straight-line CCA rate over six years, the change has no impact at all. Note that depreciable property transferred on a “rollover“ basis (such as property transferred pursuant to subsection 85(1)) or property transferred between non-arm’s length persons will not be eligible for the “enhanced“ CCA treatment.

Difference on Straight-line CCA over 6 years	AII	Regular CCA Regime
Year 1	$30,000	$10,000
Year 2	$20,000	$20,000
Year 3	$20,000	$20,000
Year 4	$20,000	$20,000
Year 5	$10,000	$30,000
Year 6	–	$10,000
Total CCA	**$100,000**	**$100,000**

Zero, no impact!

Let’s contrast with the new (as of 11 months ago) US policy for similar depreciable property: under US tax reform, most capital investments made in the US, other than those with more than 20 years recovery period, is entitled to 100% depreciation, in the year of “placed in service.” That is a drastically more powerful incentive than what came out today from the Canadian Department of Finance.

The new Canadian accelerated CCA regime will also provide virtually no benefit to industries that are not capital intensive, such as the service industry. This is another addition to a series of disadvantages that the Government has injected into the Income Tax Act against service businesses over the last two years (other examples: changes to the work-in-progress rules, the explicit exclusion of service business from a key exemption inside the “tax on split income” rules). Compared to capital intensive businesses, many services and other non-capital-intensive businesses can easily be uprooted and moved outside of Canada, and we have unfortunately seen a lot of this in our practice over the last two years.

Missed Opportunities

Presumably, the idea behind Canada’s “non-knee-jerk” response was to carefully study how US tax changes have significantly increased the US global competitiveness for investment, and to craft a measured response that would allow Canada to be competitive on a global scale, both for investment and for attracting global talent. In today’s global economy, Canada must be competitive in order to obtain and attract investment, and to maintain Canadians’ quality of life.

Personal Tax Rates

Economic studies and recent data releases have shown that increases in the top personal income tax rate discourage entrepreneurship as measured by the business entry rate. A well formulated “response” to US tax changes should have found ways to incentivize new investment in Canada; and reducing the top personal tax rate is a critical way in which this should have been addressed. Furthermore, let’s not forget that a number of our provinces have their highest marginal tax rates above 50%. At over 50%

taxation, Canada is severely disadvantaged in cultivating entrepreneurship or in attracting skilled human capital. What our Finance Minister failed to mention in today's economic update is that the combined personal income tax rate in Canada is amongst the highest in the G7, and our top marginal rate applies at a much lower income level compared to other G7 countries.

As previously mentioned, today's economic update did not propose any reduction in personal tax rates in Canada. This is alarming. For example, an employee with a non-working spouse that earns approximately $250,000 in Canada could be subject to almost $60,000 in additional personal tax compared to working in the US [2]. This is a result of higher marginal tax rates that apply at much lower income levels relative to the US tax rates and does not even take into account various other tax incentives that Americans are entitled to. This differential is certainly a cause for concern. A real "response" would have addressed this; and found a solution that would allow Canada to attract global talent.

The impact of this rate differential is compounded further with the "tax on split income" changes implemented earlier this year.

Corporate Tax Rates

Until US tax reform, Canada was competitive on corporate tax rates in comparison with the US. The reform eliminated any competitive advantage Canada had, and a well formulated response would have addressed these drastic changes. The decrease in corporate tax rates in the US significantly increased the after-tax returns on investment income in the US relative to Canada.

While US tax reform reduced corporate tax rates from 35% to 21%, today's fall economic update provided no reduction in corporate tax rates in Canada. Where Canada once was more competitive than the US, the pendulum has now swung heavily in the direction of the US. When foreign investors are choosing a jurisdiction to invest in, one of the first things they will look at is the corporate tax rates. The lack of changes in this area is not a response to US tax reform. It is an excellent non-response.

Despite all of this, the government trumpets that the "Marginal Effective Tax Rate" on New Investments dropped to 13.8% from 17%, showing that we are now leading the G7 by a wide margin. We are not economists, but these calculations appear misleading given that there are no corporate tax rate changes, and any savings from the accelerated CCA regime is mere timing.

Now What?

With no real response, the issue of competitiveness has not been adequately dealt with. In our home province of Alberta, concerns about competitiveness and the overall economic environment are at the forefront. We are very concerned that today's update will do nothing to incentivize investors to Canada (or for that matter Alberta).

Today's update also contained a shocking announcement regarding not-for-profit media. It will provide the ability for non-profit media to apply for charitable status and thus enable them to issue donation tax receipts to donors. We will have lots to say on this particular announcement in the future but suffice it to say that such comments are not favourable. In the meantime, let's just say that we need to take our time to respond to such a proposal to ensure that our response is not made in a knee-jerk fashion.

[1] The draft legislation includes a "sunset" provision, that reduces the enhancement of the CCA deductions beginning after 2023 and will be eliminated after 2027.

[2] Assumes the US individual is in a state with no State income tax, e.g. Florida.