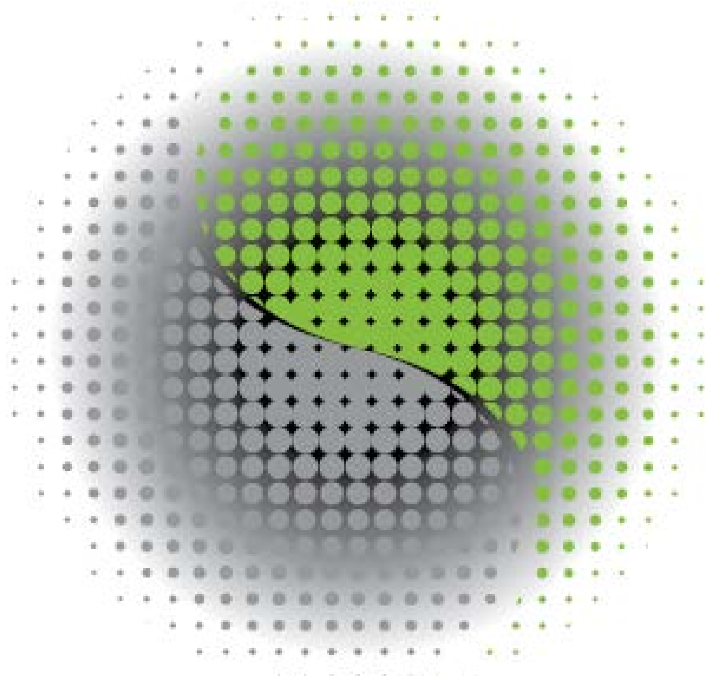

Canadian Tax Alert

US tax reform - be prepared

December 28, 2017

US tax reform will have a significant impact on Canadian companies doing business in the United States. The bill was passed strictly along party lines by the Republican majority in both the House of Representatives and the Senate, and on December 22, 2017 was signed into law by President Trump.

With these rule changes now imminent, Canadian companies must consider the impact on their businesses, including current organizational structures, supply chains, leverage, intellectual property (IP) ownership, etc., as well as planning opportunities that may result. This Alert will discuss the most salient topics for Canadian businesses to consider.

Contacts:

Fatima Laher
Tax Clients & Industry Leader
Tel: 416-601-6570

Jim McDonald
National US Tax Leader
Tel: 416-874-3139

Quebec
Daniel Tremblay
Tel: 514-390-4578

The new rules reduce the corporate and individual tax rates, allow for greater business capital acquisition expensing, limit the use of net operating losses (NOLs), eliminate the alternative minimum tax (AMT), add interest expense limitations and move the US closer to an international territorial tax system from its current worldwide taxing regime. The enactment of this major tax reform will naturally have an impact on financial statement reporting and disclosure. Time is of the essence for businesses to get ahead of these changes.

Corporate income tax

The new legislation decreases the corporate income tax rate from 35% to 21% beginning January 1, 2018. Fiscal year taxpayers will have a blended tax rate as full implementation of the full effect of the rate reduction will be effective for years beginning January 1, 2018. The lower rate creates an incentive to accelerate deductions to the current tax year and defer income until the lower-rate year takes effect. Cross-border businesses should consider the fundamental impact that the lower rate, in conjunction with other provisions, will have on their operations and any changes that may be necessitated, resulting in changes to existing transfer pricing policies. In addition, a lower US rate will make foreign accrual property income and surplus computations more relevant, as the gap between US corporate tax rates and Canadian corporate tax rates narrows.

Corporate AMT

The tax reform legislation eliminates the AMT for corporations. The repeal of the AMT would benefit those corporations traditionally subject to the tax, including many energy and natural resource companies. However, the limitations to newly generated net operating loss carryforward amounts will effectively serve as a "minimum tax" replacement.

Current asset expensing

Businesses will be allowed 100% immediate expensing for capital spending. Importantly, to qualify for expensing, an asset's original use does not need to begin with the taxpayer — used property acquired could also be expensed as long as other requirements are met. This provision creates a significant incentive to make capital investments and eliminates the previous requirement for bonus depreciation that the original use of the property must begin with the taxpayer. These changes should be considered for those currently assessing large capital outlays, as well as how they may apply to contemplated merger and acquisition transactions. The ability to immediately expense 100% of capital expenditures begins to be phased out after 2022.

NOLs

The use of NOLs is limited by the new legislation. The deduction for NOLs arising in taxable years beginning after December 31, 2017 is limited to 80% of taxable income. The two-year carryback for NOLs is repealed although NOLs created in taxable years beginning after December 31, 2017 for most business taxpayers will not expire. NOLs existing at December 31, 2017 still expire in 20 years and are not limited by the 80% reduction. These changes create a cash tax cost for taxpayers traditionally sheltered by NOLs.

Eastern Region
Michael Van Severen
Tel: 905-315-5762

Toronto
Dennis Metzler
Tel: 416-601-6144

Jackie Naish
Tel: 416-601-6292

Rob Medves
Tel: 416-601-5986

Western Region
Terri Scott
Tel: 204-926-7660

Colin Erb
Tel: 604-640-3348

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Repeal of manufacturing deduction and elimination of expenses

The manufacturing deduction resulting in a lower tax rate for activity directly related to manufacturing activity has been eliminated (the so-called section 199 rules). Other business deductions have been restricted, such as state and local lobbying expenses, business interest (discussed later), fines and penalties and like-kind exchanges for property other than real property.

Interest limitation

The ability of most taxpayers to deduct business interest will be restricted under the new legislation. Interest deductions for all taxpayers would be limited to 30% of adjusted income (ATI) but any interest disallowed may be carried forward indefinitely. In addition, the restrictions on interest, unlike the prior section 163(j) rules, are also applicable to partnerships and should be computed at that level. The 30% limitation applies to all net interest expense, not just interest paid to, or guaranteed by, a foreign-related party. The definition of ATI is nuanced, but is closely linked to earnings before interest, taxes, depreciation and amortization (EBITDA) until the year 2022, at which point ATI resembles earnings before interest and taxes (EBIT). In other words, after 2022 any deductions for depreciation, amortization, and depletion are taken into account when calculating ATI, further restricting taxpayers with large depreciation-like deductions. Despite these limitations, cross-border debt may still be beneficial as an interest expense is generally deductible when calculating the portion of shareholder distribution that is subject to withholding tax, and cross-border interest payments to a Canadian corporation often qualify for a 0% withholding tax rate.

Excise/base erosion tax

The tax reform legislation provides for a "minimum tax" that offsets the benefit of payments to foreign related parties (base erosion payments) and ensures that the US payor is subject to at least a 10% liability (5% for 2018 under certain transition rules) on taxable income, computed without regard to the related party payment. A base erosion payment generally means any payment to a foreign related party to which a deduction is allowed excluding items without a mark-up and that are considered in cost of goods sold. Both a minimum revenue threshold and base erosion threshold — tested at the corporate group level ($500 million of revenue) — must be reached before the minimum tax is applicable. Multinational taxpayers must scrutinize the impact of this new provision on their supply chain and transfer pricing policies. For example, this may force some taxpayers to reconsider the use of US limited risk distributor models. Cross-border interest and royalties would also be subject to these provisions.

Offshore intangibles

The US tax reform introduces new and complicated provisions designed to result in a minimum tax rate on certain income of controlled foreign corporations (CFCs). Although this global intangible low-taxed income (GILTI) tax targets CFCs that earn income from IP, the definition of "income" in the tax reform bill may be broad enough to capture other types of income. However, the GILTI would also create an opportunity for repatriation of IP to the United States. Combined with a deduction for foreign-derived intangible income (FDII) that results in an effective tax rate of

12.5%, the prospect of IP being moved to the United States should now be considered.

Hybrid structures

The tax reform introduces a special provision that denies a deduction for interest or royalties paid or accrued pursuant to a hybrid transaction or to a related hybrid entity. For example, a hybrid transaction occurs when a payment to a related party is treated as interest or a royalty for US purposes but not under the tax law of the country where the recipient is subject to tax. In general, a hybrid entity is one treated as fiscally transparent in either the United States or the foreign country where it is taxable, but not both. Careful consideration should be given to existing financing arrangements and the potential applicability of these provisions. Although certain cross-border financing structures are negatively impacted by this provision, disqualified payments may still reduce the amount of future distributions subject to withholding tax and reduce earnings and profits of the payor.

Transition tax

Consistent with the House and Senate bills, a US shareholder of a foreign corporation must include in income, the shareholder’s pro rata share of undistributed and previously untaxed post-1986 foreign earnings and profits (E&P) for the subsidiary’s last tax year beginning before January 1, 2017. These rules contain a number of nuanced provisions that must be carefully considered, including the possibility of a foreign tax credit offsetting a portion of any tax owed. The provisions will generally result in a tax of 15.5% of E&P comprising cash or cash equivalents, while any remaining E&P is taxed at a reduced rate of 8%. Any tax owed can generally be paid in eight annual installments.

Financial statement implications

As the President has signed the tax reform legislation in 2017, it is considered substantively enacted and its effects will have to be incorporated into an entity’s December 31, 2017 financial statements. Key areas that taxpayers will need to consider include whether to revalue deferred tax items and the impact on the value of foreign tax credits. Taxpayers will need to evaluate the earnings and profits of CFCs to determine whether the transition tax should be recorded and assess any impact on the position that earnings of subsidiaries were considered permanently reinvested. In addition, many other tax reform provisions will impact a taxpayer’s financial statements in subsequent periods.

Passthrough taxation

The tax reform legislation provides for a 20% deduction from the ordinary income tax rates for domestic qualified business income from a passthrough entity. This provision is designed to place an individual in a similar position as a corporation conducting business. However, careful modeling should be undertaken to confirm the optimal structure taking into account a range of considerations, both tax and non-tax. Certain thresholds and limitations must also be considered.

Estate tax

The tax reform legislation increases the exemption levels from $5 million to $10 million for individuals and from $10 million to $20 million for married couples. The estate or generation-skipping transfer tax is not eliminated and the gift tax rate is not reduced. The increased exemptions sunset in 2025.

Multi-state implications of US tax reform

One of the most vexing aspects of the proposed US tax reform is how the various states will react to the final legislation. The states have the potential to either decouple from select provisions or they can set their conformity date for the Internal Revenue Code to a date preceding the new legislation. Likewise, states may piggyback on some proposals such as the proposed base erosion tax to create new tax revenues.

Some of the items that may have immediate impact on state taxable income are the modifications to NOLs and immediate expensing provisions. Many states do not conform to federal NOL carryback or carry forward provisions and have already decoupled from bonus depreciation, so different add back provisions may be required with the tax reform. Another area of concern is how different revenue recognition proposals, especially regarding foreign operations, will affect the computation of apportionment factors for determining state taxable income.

States are expected to begin legislative responses to address the federal changes early in 2018 and should be carefully monitored.

	Current law	Tax Cuts and Jobs Act (H.R. 1)	Notes & observations
Corporate AMT	20% on alternative minimum taxable income	Repealed	Repeal under the bill would impact traditional AMT taxpayers, such as certain energy and resource companies.
NOL deduction	2-year carryback and 20-year carryforward allowed to offset taxable income	Limited to 80%; carryforward period made indefinite; carryback eliminated	Cash tax cost for NOL users; in some ways work may similarly to current AMT rules.
Business interest payments	Generally deductible	Limited to business interest income + 30% of EBITDA (EBIT after 2022) • Indefinite carryforward for disallowed amounts • Small businesses and real estate companies exempt	Exemption for real estate or certain public utilities. Exemption for small business: <$25M Applies to both third party and intercompany debt.
"Base-erosion prevention" measures	Subpart F rules for passive income	21% tax on GILTI with 50% deduction for FDII through 2025, then 37.5%; and 21% tax on FDII with 37.5% deduction through 2025, then 21.875% • Opens path to tax-free repatriation of IP	Complex provisions that effectively result in a minimum tax rate of at least 10% on income of all CFCs. Marketed as a tax on "intangibles" but could apply to taxpayers in many industries. Modeling and careful planning will be required.

Next steps

The Tax Cuts and Jobs Act represents the most significant change to the US tax system in over 30 years. Canadian companies must carefully consider how these changes may impact their businesses, as well as the planning opportunities that may result. Contact your Deloitte advisor or any of the individuals listed on this Alert to discuss the impact of these potential changes on your business, and how you can prepare for them.

Deloitte LLP
Bay Adelaide Centre, East Tower
8 Adelaide Street West, Suite 200
Toronto ON M5H 0A9
Canada