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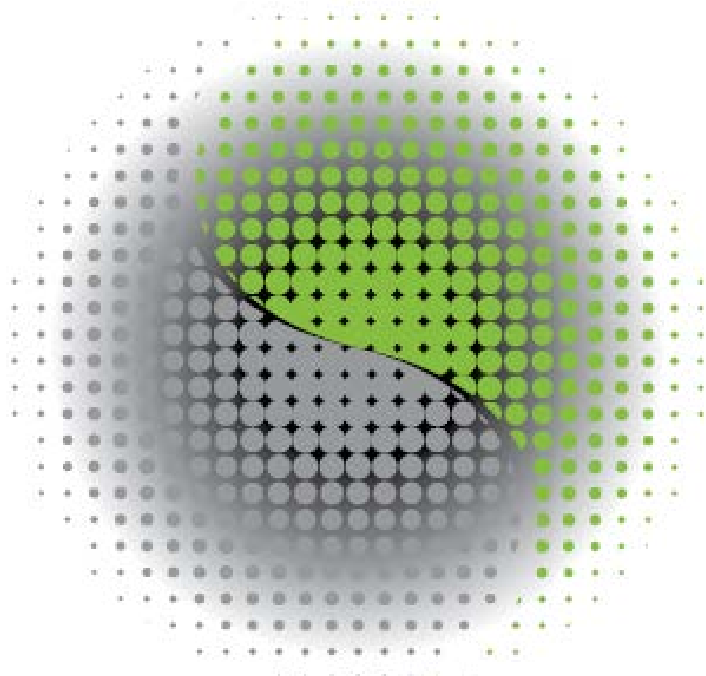

Canadian Tax Alert

US tax reform on the horizon

December 19, 2017

US tax reform is almost here, bringing changes that will affect the tax implications of doing business in the United States. The US House of Representatives and Senate have each passed separate tax reform bills that have much in common but also differ in key respects. Both houses of Congress must pass identical versions of a bill before it can be presented to the president and become law. On December 4, 2017 the House of Representatives voted to conference with the Senate to negotiate and resolve the differences. The conference teams have been set and deliberation has begun.

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A unified bill is expected to be presented to the full Congress before the Christmas recess. This Canadian Tax Alert provides a summary of the most significant proposed changes, with a comparison of the bills and a discussion of the implications to Canadian companies doing business in the US market.

Corporate income tax

The House and Senate bills both decrease the corporate income tax rate from 35% to 20%. The effective dates differ in the two bills (2017 versus 2018). The lower rate will create 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 existing transfer pricing policies. In addition, a lower US rate will make foreign accrual property income and surplus computations more relevant.

Corporate alternative minimum tax (AMT)

The House bill repealed the AMT; however, the AMT remains in effect per the Senate bill. Observers expect that the final legislation will repeal or modify the AMT in order to avoid its adverse effects on other tax reform measures. The repeal of the AMT would benefit those corporations traditionally subject to the tax, including many energy and natural resource companies. Should the AMT remain in effect, careful scrutiny will be needed to determine its impact on taxpayers, given the numerous other tax changes that may affect the calculation as well as the rate of AMT.

Current asset expensing

Both the House and Senate bills include 100% immediate expensing for capital spending, and the House version does not require the original use of the asset to begin with the taxpayer – this would mean that used property acquired could also be expensed. This provision creates a significant incentive to make capital investments, and should be considered for those currently assessing large capital outlays. However, 100% expensing may limit a corporation's ability to claim interest deductions under new limitations.

Net operating losses (NOLs)

The House and Senate bills both include provisions to limit the deductibility of NOLs. The House bill would limit NOL use to 90% of taxable income. The Senate bill would limit NOL use to 90% until 2022 when the limit would be reduced to 80%. These changes create a cash tax cost for taxpayers traditionally sheltered by NOLs.

Interest limitation

The House and Senate bills each include provisions that significantly restrict the ability of most taxpayers to deduct business interest. Interest deductions for all taxpayers would be limited to 30% of adjusted income, the definition of which has significant differences in the two bills as well as excess limitation carryforward of foregone interest. Interest for cross-border taxpayers is further limited to a pro-rata share of global interest expense. Despite these limitations, cross-border debt may

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still be beneficial as 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. Certain anti-hybrid rules in the Senate bill must also be considered for companies' current financing arrangements.

Excise/base erosion tax

The House bill includes a 20% excise tax on payments made by US corporations to foreign related parties - including cost of goods sold. The Senate bill has a "minimum tax" that offsets the benefit of payments to foreign related parties and ensures that the US payor is subject to at least a 10% liability on taxable income as computed without regard to the related party payment. Both the House and Senate versions have minimum revenue thresholds for these provisions to be applicable. While both provisions should be duly considered, early speculation from some commentators is that the Senate base erosion tax is more likely to survive the conferencing process. However, in either scenario, multinational taxpayers must scrutinize the impact on their supply chain and transfer pricing policies. This may force some taxpayers to reconsider the use of US limited risk distributor models, for instance.

Offshore intangibles

Both the Senate and House bills include complicated provisions designed to result in a 10% minimum tax rate on certain income of controlled foreign corporations. The House bill would apply a 20% tax on 50% of "foreign high return amounts" – income earned from assets with low or no tax basis. The Senate provision - called the global intangible low-taxed income (GILTI) tax - would work similarly, but would create an opportunity for tax-free repatriation of intellectual property (IP) to the United States. Combined with a deduction for "foreign-derived intangible income" that results in an effective tax rate of 12.5%, the prospect of IP being moved to the United States must now be considered.

Pass-through taxation

Perhaps where the House and Senate differ most significantly is in the taxation of income from pass-through entities. The House bill provides for a 25% tax rate on qualified business income for partnerships, limited liability companies, and other pass-through businesses. The House plan would allow taxpayers to elect whether to take 70% of their income as wages and 30% at a 25% pass-through rate or would allow owners to take a higher percentage of income at the preferential rate using a prescribed formula broadly based on their level of capital investment. More generously, the Senate bill provides a 23% deduction from the ordinary income tax rates for domestic qualified business income from a pass-through entity, set to expire in 2026. Certain thresholds for the various rates must also be considered.

Estate tax

Under both the House and Senate bills, the exemption levels are increased from $5M to $10M for individuals and from $10M to $20M for married couples. The House bill eliminates the estate and generation-skipping transfer tax entirely after 2023 and lowers the gift tax to 35%. The Senate bill does not repeal the estate or generation-skipping transfer tax or reduce the gift tax rate. Instead, it sunsets the increased exemptions in 2025.

Financial statement Impact

Pursuant to US GAAP and IFRS, the tax effects of new tax legislation is accounted for in the period in which a new tax law becomes enacted or substantively enacted, respectively. For US Ffederal tax laws, the date of substantive enactment is generally the date a bill is signed into law by the president, effectively aligning US GAAP and IFRS on this matter.

These new rules may have many implications for the financial statements, tax accounts and disclosures of a business, especially with respect to deferred tax items.

	Current law	House bill 2017 (HR 1)	Senate bill 2017	Notes & observations
Corporate AMT	20% on alternative minimum taxable income	Repealed	Retained	Repeal under House 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	NOL use limited to 90% of taxable income deductible; carryforward period made indefinite; NOLs increased by interest factor	Limited to 90% of taxable income deductible through 2022, then 80%; carryforward period made indefinite	Cash tax cost for NOL users; Would in some ways work similarly to current AMT rules
Business interest payments	Generally deductible	Limited to business interest income + 30% of EBITDA • 5-year carryforward for disallowed amounts • Exemption for retail floor planning indebtedness	Limited to business interest income + 30% of EBIT • 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 in House <$15M in Senate Applies to both third party and intercompany debt
"Base-erosion prevention" measures	Subpart F rules for passive income	20% tax on 50% of foreign high return amounts	20% tax on GILTI with 50% deduction for foreign-derived intangible income (FDII) through 2025, then 37.5%; and 20% 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 controlled foreign corporations Marketed as a tax on "intangibles" but could apply to taxpayers in many industries Modeling and careful planning will be required.
		Both bills provide additional limits on deductions by US corporations of interest paid on related-party debt		
		N/A	End special rules for domestic international sales corporations	Effective 1/1/19

Next steps

With both the House and Senate bills passed, the prospect of US tax reform becomes more real, and with it will be 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.

In the interim, it may be prudent to consider certain strategies in advance of 2018, particularly in light of the fact that some provisions are proposed to take effect on January 1, 2018. 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.

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