

Canada Less Attractive to Investors After TCJA, Report Says

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The OECD has joined the growing contingent of stakeholders urging Canada to assess the competitiveness of its corporate tax regime following the passage of the U.S. Tax Cuts and Jobs Act.

The TCJA has reduced the attractiveness of investing in Canada, and the country's corporate tax rate advantage over the United States has effectively disappeared, according to the OECD's economic survey of Canada, issued July 23. "Finance Canada estimates that the post-reform U.S. marginal effective tax rate (including sales taxes) is 19.2 percent — slightly above the Canadian rate of 17.6 percent," the report says.

The Bank of Canada estimates that the U.S. tax cut will reduce business investment in Canada by 0.9 percent by the end of 2020, the report says. Although actions have been taken over the years to improve the competitiveness of the Canadian corporate tax system, a comprehensive review of the system could help the country determine how to attract more investment, according to the executive summary. A review of the tax system should also ensure that it raises sufficient revenue without imposing excessive costs on the economy and supports Canada's competitiveness, the report says.

Specific recommendations for tax reform include relying less on taxes with high efficiency costs, like corporate and personal income taxes, and more on those with low efficiency costs, like VAT and environmental taxes. The report also recommends phasing out tax expenditures that aren't justified by market failures or equity objectives, like the preferential small business corporate tax rate.

"It is unfortunate that the federal government chose to reduce further the preferential income tax rate for small companies," since the reduction isn't likely to address a clear market failure facing small businesses, the report says. The enhanced research and development credit for small companies and heavy reliance on indirect R&D subsidies should be evaluated for efficiency and possibly adjusted, it adds.

The report recommends a progressive increase of the carbon price to meet Canada's greenhouse gas abatement objectives and the rollback of redundant abatement measures. Canada's emissions are among the highest in the OECD, and its goal is to [cut them to 30 percent below 2005 levels by 2030](#). "Meeting Canada's climate change commitments will be challenging," the report says.

Canadian Prime Minister Justin Trudeau announced in 2016 that Canada would impose a nationwide carbon tax starting in 2018 to comply with the Paris Agreement on climate change,

but [several provinces have since joined in opposing the tax.](#)

The greatest economic uncertainty concerns increased global trade restrictions, according to the OECD survey. While much depends on political decisions, "notably in the United States," associated uncertainty may already be dampening Canadian investment, it says. The Bank of Canada has estimated that trade policy uncertainty could reduce the amount of business investment and exports by 2.1 percent and 1 percent, respectively, by the end of 2020.

Canada has one of the most competitive corporate tax systems in the G-7 and its government is committed to ensuring that the country continues to have a competitive economy that fosters innovation, attracts investment, and creates jobs, a spokesman for Finance Canada told Tax Analysts. The TCJA is a complex package and "the government will not react in a knee-jerk fashion," the spokesman said. The department is carefully analyzing the effects of the changes in the United States on firms in different sectors, but can't speculate on possible policy responses, he said.

The OECD survey follows conclusions from the [IMF Executive Board's 2018 Article IV consultation with Canada](#), published July 16, which say the effect of the TCJA on Canada's medium-term competitiveness poses a risk to Canada's economic outlook. The new legislation "threatens to erode Canada's relative tax advantage," it says. The IMF report also names uncertainty related to North American Free Trade Agreement negotiations and the potential for further escalation of trade tensions among external risks.

The IMF directors said a review of Canada's tax system could assess the scope for improving efficiency while maintaining competitiveness, but stressed the need to avoid a hasty reaction to the TCJA. The Canadian government was "prudent in resisting industry pressure to cut taxes in the 2018 Federal Budget to match the U.S. tax cuts," the report says. Canada's long-standing problems of low labor productivity growth, an aging population, and weak trade competitiveness need solutions that go beyond tax cuts, it says.

Canadians for Tax Fairness recently [cautioned the government against engaging in a corporate tax rate race to the bottom](#), arguing that a competition would leave all jurisdictions worse off and that evidence of capital flight post-TCJA is merely anecdotal.

"We don't agree with all the OECD recommendations," including increasing carbon taxes, said Aaron Wudrick, federal director of the Canadian Taxpayers Federation. Wudrick said he would like to see something like an accelerated capital gains allowance, but added that generally speaking, tax reform in Canada is needed.

Rising interest rates and the U.S. corporate tax cuts will both affect investment in Canada, with the latter making the United States a more competitive destination for investment and having a greater effect than interest rates, Wudrick said.

There is no question that rising interest rates and U.S. tax reform have negatively affected capital attraction in Canada relative to the United States, said Kim Moody of Moodys Gartner Tax Law LLP. The OECD report acknowledges competitiveness challenges posed by the TCJA but doesn't provide sufficiently detailed recommendations, Moody said.