TaxNewsFlash Canada

Canadian Multinationals — Prepare for U.S. Tax Changes

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Canadian companies that do business in the United States should prepare to determine the effect of new U.S. tax changes. The United States is expected to soon pass tax legislation that will have a significant effect on domestic and multinational corporations. These amendments, which are expected to be effective January 1, 2018, substantially modify the U.S. tax Code, including introducing changes that will significantly impact both U.S. domestic and cross-border taxation.

Now that the House and Senate have voted on the final bill, it is expected to be presented to President Trump to sign into law by the end of 2017. The amendments, some of which are effective January 1, 2018 or have retroactive effect to earlier periods, represent the biggest tax overhaul to the United States tax Code since 1986. Some of the more significant changes are described below.

This edition of *TaxNewsFlash-Canada* is based on the U.S. tax bill drafted by the U.S. House-Senate conference committee. While it is not expected that the bill will significantly change before it is signed into law, some minor modifications are still possible.

Background
The current U.S. tax bill was drafted by a formal House-Senate conference committee which was instituted to bridge some of the differences in the distinct House and Senate bills that were approved earlier this year (see *TaxNewsFlash-Canada* 2017-51, "U.S. Releases Proposed Tax Reform Changes" and *TaxNewsFlash-Canada* 2017-61, "U.S. Readying Final Tax Bill").

Many measures in the U.S. tax bill will also affect U.S. individuals living in Canada. For details of these changes, see *TaxNewsFlash-Canada* 2017-63, "Highlights of New U.S. Personal Tax Changes".

Corporate tax changes

Corporate tax rates

The U.S. bill decreases the corporate income tax rate to 21% (from 35%), effective January 1, 2018. Fiscal year-end taxpayers will be subject to a blended income tax rate for their fiscal 2018 tax years, calculated by prorating based on the number of days before and after the January 1, 2018 effective date. For example, taxpayers with June 30 tax years will be subject to an effective income tax rate of approximately 28% for their 2018 fiscal years.

Corporate alternative minimum tax

The U.S. bill repeals the corporate alternative minimum tax (AMT) for tax years beginning after 2017. Existing AMT credits do not expire. Any AMT credit carryovers to tax years beginning after 2017 generally can be utilized to the extent of the taxpayer's regular tax liability (reduced for certain other credits). Additionally, for tax years beginning in 2018, 2019, and 2020, 50% of the excess AMT credit carryovers are refundable to the extent that the AMT credit carryovers exceed the regular tax liability (as reduced by certain other credits). Any remaining AMT credits are fully refundable in 2021.

Expensing of new investment purchases

The U.S. bill allows businesses to immediately write off investments in certain tangible property placed in service after September 27, 2017 and before 2023. The new provisions include a phase-down of the "bonus" depreciation percentage for property acquired after 2022. The new provisions allow businesses to expense 80%, 60%, 40% and 20% of the cost of property placed in service in 2023, 2024, 2025 and 2026, respectively. Bonus depreciation is completely phased out in 2027. The remaining cost of the property is subject to ordinary depreciation. However, the new rules follow the current-law phase-down of the bonus depreciation percentage for property acquired on or before September 27, 2017 but placed in service after that date (50%, 40%, 30%, and 0% for 2017, 2018, 2019 and 2020 and thereafter, respectively). The new rules apply to tangible property that is "new" to the taxpayer, which includes both original-use property and used property. However, the new rules generally exclude any property used by a public utility.

Limitations on net operating losses

The U.S. bill generally eliminates the carryback of net operating losses (NOLs) and limits carryovers of NOLs to 80% of taxable income. The 20-year limit on the utilization of NOLs carried forward is eliminated and they are available indefinitely.

This measure applies to NOLs arising in tax years beginning after 2017. NOLs that exist on December 31, 2017 are able to fully offset future taxable income without the 80% cap applying.

Domestic interest expense limitations

The U.S. bill substantially amends the existing earnings stripping rules that currently apply to interest paid to foreign related parties. The bill essentially replaces the existing rules with a new rule that applies to *all* business taxpayers and to *all* net business interest. Thus, the deduction for interest paid to both third parties and related parties generally will now be subject to limitation.

Subject to certain exceptions, the U.S. bill makes all businesses subject to a disallowance for net business interest expense that exceeds 30% of the relevant business' adjusted taxable income (ATI). For taxation years beginning after 2017 and before 2022, ATI is computed without deductions for depreciation and amortization. However, for taxation years beginning after 2022, ATI takes these deductions into account, making the net business interest expense deduction limitation more restrictive. The amount of disallowed net business interest is determined at the level of the applicable business (e.g., at the partnership level rather than at the partner level).

Interest expense deductions denied under this rule may be carried forward indefinitely. Once this new rule comes into force, it is unclear whether interest that was deferred and carried forward under the current earnings stripping rules will continue be available.

Small businesses are exempt from the new interest expense deduction limitation rule (i.e., businesses with average annual gross receipts of US$25 million or less). Additionally, the U.S. bill allows real estate businesses to elect out of these rules in certain circumstances (see *TaxNewsFlash-Canada* 2017-67, "Real Estate Businesses — Important U.S. Tax Changes"). Finally, the interest expense deduction limitation does not apply to certain public utilities.

This measure is effective for tax years beginning after 2017.

International tax changes

Limitations on interest expense deductions

Although both the House and Senate had previously proposed additional interest expense limitations in the international context, these provisions are not included in the final U.S. bill.

KPMG observation
The change is welcome news, particularly for multinational companies with leveraged U.S. operations who may have been adversely affected by these rules.

Hybrid limitations

The U.S. bill includes a provision targeting payments of interest and royalties involving certain hybrid transactions and hybrid entities. Specifically, the provision denies a deduction for related-party interest or royalties paid or accrued in connection with certain hybrid transactions or by/to hybrid entities, to the extent that the related party does not have a corresponding inclusion, or is allowed a deduction, under foreign tax law with respect to the amount paid. The U.S. tax bill also authorizes the U.S. Treasury to issue regulations or other guidance that may bring certain other entities within the ambit of these rules (even though they may not meet the statutory definition of a hybrid entity).

The new provision applies to tax years beginning after 2017.

KPMG observation
The new provision will eliminate the tax benefit of some structures commonly used by Canadian multinationals to finance their U.S. operations.

Base erosion anti-abuse tax

The U.S. bill introduces a “base erosion anti-abuse tax” (BEAT) that targets certain deductible cross-border payments made by U.S. corporations to related parties and operates as a minimum tax if it applies.

Deductible payments for this purpose include, among others, payments for interest, royalties, or depreciable assets. In addition, cross-border payments for services (other than those provided at cost) are caught by these rules. However, deductible cost of goods sold payments are not taxable under the BEAT.

The BEAT applies to U.S. corporations:

- That are not taxed on a flow-through basis
- That are part of a group of U.S. persons (and certain foreign persons earning effectively connected income) that averages at least US$500 million of annual gross receipts, and
- For which the total amount of deductible payments made to foreign related parties (Base Erosion Payments or BEPs) exceeds 3% of all deductible payments by the

relevant corporation (or 2% for certain taxpayers that are banks or a registered securities dealers).

The BEAT operates as a minimum tax so that modified taxable income is computed without deduction for BEPs and a tax rate of 10% generally is applied (after a one-year 5% transition rate that applies in tax years beginning in calendar year 2018). The taxpayer generally pays the higher of the resulting BEAT tax or the tax computed under the regular rules. The 10% rate increases to 12.5% for tax years beginning after December 31, 2025.

The BEAT is effective for amounts paid or incurred after 2017.

KPMG observation
Like most other countries, Canada's transfer pricing rules generally require a mark-up on services and, as a result, the exception from the BEAT for services provided at cost may have limited practical effect.

Treatment of gain on sale of U.S. partnerships by foreign partners

The U.S. bill treats a gain or loss on the sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that a foreign corporation or foreign individual that owns an interest, directly or indirectly, in the partnership would have had effectively connected gain or loss had the partnership sold its underlying assets. The U.S. bill authorizes the Treasury to provide regulations or other guidance regarding the treatment of exchanges that would generally be tax-deferred under the Internal Revenue Code. The new provision requires the transferee to withhold and remit 10% of the amount realized on the sale.

The new provision is generally effective for sales or exchanges after November 27, 2017. However, the withholding provisions apply to sales or exchanges after December 31, 2017.

KPMG observation
The IRS issued a revenue ruling in 1991 which, much like this new provision, held that a foreign partner's capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that the sale of the underlying assets by the partnership would have resulted in effectively connected income (ECI) (Rev. Rul. 91-32). Earlier this year, the U.S. Tax Court declined to follow the revenue ruling and determined that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests).

The court decision, overturning the ruling, was a surprise to many in the tax community. This U.S. bill codifies Rev. Rul. 91-32 and effectively returns the rules to the status quo, where foreign investors use blocker corporations so that income is not treated as ECI.

U.S.-owned multinationals — Participation exemption

The U.S. bill makes fundamental changes to the taxation of U.S. parented multinational companies. The rules generally shift the United States from a system of worldwide taxation (with deferral) to a participation exemption system. However, the existing "Subpart F" regime generally remains intact, whereby the U.S. parent continues to be taxed currently on certain foreign income. The U.S. bill adds other new complex provisions, including a rule to subject certain low-taxed foreign income to a minimum tax.

To move to a participation exemption system, the U.S. bill includes the following provisions:

- A 100% deduction for dividends received from 10%-owned foreign corporations
- A mandatory tax on a deemed repatriation of previously untaxed earnings of 10%-owned foreign corporations for the last tax year beginning prior to January 1, 2018. A 15.5% rate applies to earnings attributable to liquid assets and an 8% rate applies to earnings attributable to illiquid assets. The earnings are based upon the greater of earnings measured at November 2, 2017 or December 31, 2017.
- A minimum tax on "global intangible low-taxed income" (GILTI), which is generally intended to apply a minimum tax on the excess of a U.S. shareholder's foreign subsidiary's net income over the subsidiary's routine or ordinary return. A partial foreign tax credit is allowed.
- A preferential tax rate on certain intangible income earned by a U.S. corporation.

We can help

The U.S. bill presents various planning opportunities. Given the decreased corporate tax rate and the cap on NOL carryfowards equal to 80% of taxable income, where possible, U.S. subsidiaries or branches of Canadian corporations should take steps to:

- Accelerate deductions and defer income (if in a taxable position)
- Accelerate income and defer deductions (if in a loss position)
- Utilize NOLs to the greatest extent possible.

In addition, Canadian multinationals should revisit their financing structures in light of the new hybrid limitations. Also, Canadian corporations should consider the impact of the U.S. bill on their 2017 financial statement income tax provisions.

Your KPMG adviser can help you assess the effect of the U.S. tax reform legislation on your business and personal tax situations. For more details on U.S. tax reforms and their possible impact, contact your KPMG adviser.