TAXTALK

2018 YEAR-END TAX PLANNING FOR CANADIAN BUSINESSES DOING BUSINESS IN THE U.S.

This summary addresses common year-end 2018 federal tax issues for Canadian businesses with U.S. operations.

The 2017 U.S. Tax Reform brought many changes for businesses. Highlighted below are five changes to U.S. corporate tax law that will impact businesses with cross-border interests.

U.S. Corporate Tax Rate

The U.S. federal corporate tax rate has been permanently reduced from 35 percent to 21 percent and the corporate alternative minimum tax (AMT) has been eliminated. The slashing to 21 percent means every company is paying the same rate, neither the size of the company nor the type of organization matters.

Fiscal year corporations with a tax year spanning both 2017 and 2018 calendar years will pay tax using a blended tax rate calculated pro rata, based on days in the tax year before and after the effective date of the tax rate change on January 1, 2018.

A lower U.S. federal tax rate is favourable to Canadian businesses, as it allows for greater activity to be conducted in the U.S. without attracting additional federal taxes.

Entity Choice: C Corporation or Pass-Through

The corporate tax rate reduction under tax reform to 21 percent brings into question whether there is an incentive to convert from a pass-through entity or branch to a U.S. C corporation.

While such a move may be advantageous for some taxpayers, the decision is a complex one and must take into consideration your particular business activities. For example, there is double taxation with ownership in a C Corporation in the U.S. This is because the company will pay corporate tax at 21 percent on its taxable income. Then, the shareholders pay taxes on dividend income from the corporation. On the other hand, Partnership and S Corporations are flow through entities for tax purposes. As such, income or losses from these entities flow through to its members or shareholders.

Asset Acquisitions & Tax Depreciation

Beginning January 1, 2018, the tax deduction allowed under Internal Revenue Code Section 179, which provides for immediate expensing was increased from U.S. $ 500,000 to $1 million.

Qualified asset purchases (generally tangible property) made after September 27, 2017, may qualify for 100 percent bonus tax depreciation.

There are specific rules for both Section 179 deduction and bonus depreciation that should be considered during tax planning. For example, the immediate expensing of qualified assets may create current year tax savings, but as part of tax planning, taxpayers should determine if immediate expensing is the right answer, especially considering the effects of other tax reform changes.

The allowable Section 179 deduction begins to phase out, dollar for dollar, once total asset purchases for the year reach $2.5 million. However, any allowable Section 179 expense in excess of federal taxable income is carried forward only for one year to the succeeding tax year to reduce taxable income. This increased expense amount and limitation threshold could prove valuable to small business taxpayers looking to expand in the U.S.

In general, asset acquisitions whether new or used are qualifying property for purposes of bonus depreciation. This is a significant change from prior bonus depreciation rules where used property did not qualify for bonus depreciation. Also, most assets with recovery periods (useful life) of 20 years or less are now eligible for bonus depreciation. Note that unlike the Section 179 deduction, bonus depreciation can create a net operating loss (NOL) and, therefore, does have an indefinite carryforward period.

The immediate expensing and bonus depreciation changes are intended to increase business expansion in the U.S. These changes will also provide an incentive to Canadian businesses that want to expand their activities in the U.S., or enter the U.S. market for the first time.

Interest Deductibility

Effective for tax years starting on or after January 1, 2018 business interest deductions are now limited to 30 percent of adjusted taxable income, down from 50 percent in 2017 and prior years, without any debt-equity safe harbor.

Adjusted taxable income is computed using a formula that is similar to EBITDA and is generally a business's taxable income computed without regard to any item of income or expense for interest, NOLs, depreciation and amortization. Unlike in prior years, the new interest limitations apply to all business interest and not just related party interest. Interest disallowed as a deduction in the current year is carried forward indefinitely.

The new limitation does not apply to some small businesses. Corporations with average annual gross sales of $25 million or less, with the exception of tax shelters, are not subject to the interest deduction limitation.

In addition, some taxpayers (such as real estate businesses) can elect not to have the interest expense limitation apply regardless of revenues.

However, businesses making this election are required to use the alternative depreciation system (generally increases the number of years over which the property is depreciated) to depreciate certain property.

All taxpayers with business interest in the U.S. will need to discuss the new interest deductibility rules (Section 163(j)) with their tax advisors to review planning opportunities.

Net Operating Loss (NOL) Limitation

Prior to December 31, 2017, NOLs could be carried back two years and forward 20 to eliminate 100 percent of a taxpayer's regular taxable income in a single year.

NOLs generated in 2018 and beyond, when carried forward to a subsequent year, are limited to 80 percent of taxable income. NOLs generated in 2018 and beyond may no longer be carried back and may be carried forward indefinitely. NOLs generated prior to December 31, 2017, may fully offset 100 percent of future taxable income.

Taxpayers with NOLs at December 31, 2017 and who are projecting taxable income in 2018 and beyond should consult their tax advisor for assistance with applying NOL deductions and carryover rules.

Summary

Year-end tax planning for businesses differs from prior years where the primary goal was to defer income (taxed at a lower rate) and accelerate expenses because of the higher benefit of the deduction. Current planning should focus on clarification and analysis of the U.S. Tax Reform provisions and application of the new tax law to your specific situation.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices:

First Canadian Place
100 King Street West, Suite 5700
Toronto, Ontario M5J 2N8
Phone: 416-362-0515

1900 Minnesota Court, Suite 116
Mississauga, Ontario L5N 3C9
Phone: 905-451-4788
Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com). Please visit our web site at www.mgca.com.

McCarney Group LLP is an independent member of Morison KSi