TD Wealth

Straight Forward

Spring 2017

How U.S. tax changes may impact Canadians

Wealth Advisory Services, TD Wealth

For this edition of Straight Forward, we spoke to our regular contributors about the changes that may occur as a result of the recent U.S. election. More importantly, we discuss some of the more topical issues which may be of interest to you and which may affect your wealth and business planning.

Will the U.S. tax reforms under the Trump administration benefit or hinder Canadians?

This spring, change is in the air. In the wake of the election of Donald J. Trump as the 45th president of the United States on November 6, 2016 and the continued control of Congress by Republicans, it is widely anticipated that significant changes to the U.S. tax regime are imminent. What these tax reforms may turn out to be and when these changes may be enacted is anybody's guess. New tax measures may be based on the blueprint, "Tax Reform – A Better Way", released by House Republicans in June 2016 (House Plan), or on proposals announced during President Trump's campaign (Trump Proposals). The passage of a new tax bill may take considerable time as it has to move through the House of Representatives and the Senate to become law. Stay tuned. In the meantime, for Canadians, it would be prudent to assess our own circumstances, proactively plan to identify any opportunities, and to avoid any fallout from upcoming tax reforms south of the border.

Should we be concerned?

The tax reforms envisaged by the House Plan and the Trump Proposals may have a significant impact on, among others, U.S. citizens living in Canada (including dual Canadian-U.S. citizens), U.S. expatriates working in Canada, Canadian residents owning U.S. situs assets, Canadian parents with family members living in the U.S., as well as Canadian business owners. Canadian residents with no current U.S. connections but planning to emigrate to the U.S. should also be wary of any new tax legislation in the pipeline.

How may the repeal of the U.S. estate tax affect my family and me?

U.S. estate tax is currently levied at a top rate of 40% on the value of worldwide assets held by a U.S. citizen, or on the value of U.S. situs assets held by a Canadian resident, at the time of death. A decedent may be entitled to various credits and deductions to reduce any U.S. estate tax liability. U.S. citizens living in Canada and Canadian residents with a U.S. connection traditionally put in place various planning strategies to minimize their U.S. estate tax and potential U.S. estate tax on bequests to a U.S. citizen spouse and to U.S. resident family members for estate tax purposes.

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In this issue

TD Economics

In conversation with Beata Caranci

Beata Caranci, Vice President and Chief Economist, TD Economics

What's in store for Canada and NAFTA?

The stakes in renegotiating the North American Free Trade Agreement (NAFTA) are undeniably high. About 20% of Canadian Gross Domestic Product (GDP) is generated by exports to the U.S. and many Canadian companies benefit from continent-wide supply chains, direct investment within the U.S. and the flow of high-skilled workers between borders.

Fortunately, there is reason for cautious optimism. The U.S. administration has indicated they will be seeking only modest changes to the US-Canada trade relationship, however, they are expected to come to the table armed with demands that could have significant impacts at the industry level.

The U.S. administration has highlighted improved energy trade and singled out the Keystone XL pipeline as an important energy infrastructure project. In negotiations, Canada would likely look to increase supplier access to U.S. infrastructure projects, while seeking the benefits of modernizing non-immigrant visa programs and making NAFTA more inclusive of e-commerce.

Time will tell to what extent Canada's trade relationship with the U.S. will be altered. Realistically, NAFTA renegotiations could be drawn out into next year due to its complexity and differing bargaining positions. In the meantime, any deterioration in U.S. trade relations with countries such as China and Mexico could lead to Canadian "collateral damage" through global economic and financial market channels.

What is a U.S. border adjustment tax?

We believe the greater risk facing Canada is not from NAFTA negotiations, but rather from potential reforms to U.S. corporate tax policy. A proposal backed largely by House Republicans advocates for a "destination-based cash flow tax". Under this system, businesses would no longer be able to deduct the cost of imports when calculating taxes on their profits. In contrast, revenues generated by exports would be exempt from U.S. income taxes. Simply put, this tax system would raise the cost of U.S. imports and lower that of exports, if there was not a substantial rise in the U.S. dollar to offset the competitive advantage. The border adjustment proposal is part of a larger reform that would cut the U.S. corporate income tax rate from 35% to 20%. This would place it below that of Canada, further impeding trade competitiveness and potentially the ability to attract foreign direct investment.

Industries in Canada that could be most affected are those that rely heavily on the U.S. market for export revenues. These include transportation equipment, chemical, machinery and computers. The oil industry would also be heavily impacted, but much would depend on whether recent rhetoric by the Trump Administration around the importance of Canada's oil patch to U.S. energy security would see Canadian oil imports exempted from the U.S. border adjustment tax.

The ultimate impact on Canada and other jurisdictions depends significantly on changes in the value of currencies. Advocates of the border adjustment tax argue that it would not necessarily distort trade, since the U.S. dollar would immediately strengthen (and Canadian dollar weaken) to fully offset the price impacts. This would require a sharp 20-25% appreciation of the U.S. dollar, which is unlikely to occur in practice. Currencies are heavily influenced by a number of variables, such as sentiment, international portfolio holdings, and monetary policy to name a few.

Importantly, this proposal is likely to face an uphill battle in Congress, where majority support will be required to turn it into legislation. Opposition has been evident among corporate leaders in U.S. sectors that would be subject to higher import costs—notably in retail and refining—as well as consumers, who could see higher costs on store shelves. In addition, although this border adjustment tax system has been likened to value-added taxes ("VAT"), such as Canada's GST, strictly speaking it does not fit the bill since it allows for the deduction of U.S. wages associated with exports. This is why some have argued that it could be challenged under the World Trade Organization (WTO) rules, adding to the reluctance of some members of Congress.

What could be the reaction from the Bank of Canada and the Canadian dollar?

The uncertainty surrounding trade policy stateside is squarely on the Bank of Canada's radar screen. The central bank has warned about "material consequences for Canadian exports and investment" from U.S. protectionist trade measures. In January, Governor Stephen Poloz repeated his warning to markets that "a rate cut remains on the table".

We believe the bar for an interest rate reduction remains high and would require one of the following:

- A significant miss on the economic data relative to the Bank of Canada's already-conservative forecast
- A dramatic souring in U.S.-Canada trade relations, and by extension, business confidence
- A tightening in monetary conditions through currency strength or higher longer-term bond yields that are divorced from Canadian domestic fundamentals

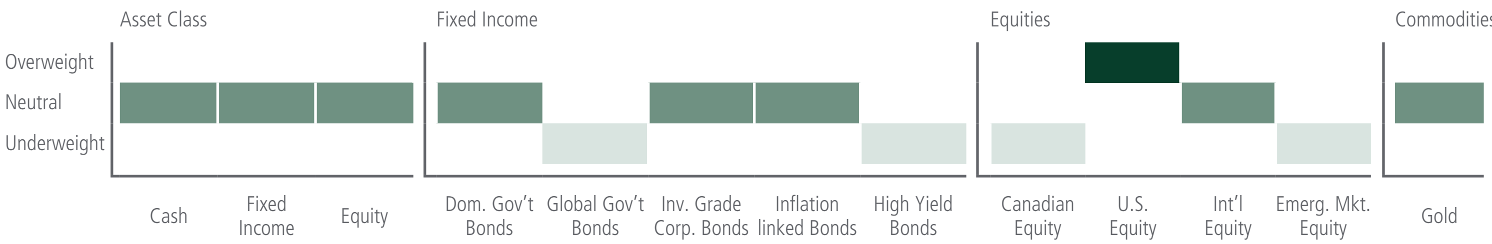
The loonie went as high as US$0.77 earlier this year and has been among the top performers against the greenback since the U.S. election outcome was known last year. This suggests that market participants are not placing high odds on U.S. policies negatively impacting Canada. However, it's early days on the policy front, and there is a high likelihood that U.S.-Canada short-term interest spreads will widen further from where they are today. The risks to the loonie appear tilted to the downside, with a value in a US$0.73-75 range in 2017 within reason.

TD Wealth Asset Allocation Committee

Bruce Cooper on equities

Bruce Cooper, Chief Executive Officer and Chief Investment Officer, TD Asset Management Inc. and Senior Vice President, TD Bank Group

Asset Allocation Summary



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

What impact will protectionism and lower global trade have on the profits of U.S. companies?

Trade frictions between the U.S. and its trading partners could lead to market volatility, and if the new administration implements protectionist trade policies, it is likely that other countries, including China, would retaliate. This would be a lose/lose scenario that could weaken corporate profits and price/earnings multiples. And while we view a trade war as a low probability event, if one were to develop, it would have a broad deflationary effect and could lead to a global recession, which would obviously be a headwind for corporations, including those in the U.S.

Should investors feel comfortable investing in the U.S. given President Trump's volatile nature?

There is some uncertainty in the U.S., particularly around how successful President Trump will be at getting his policies through the legislative process, and we may well witness bouts of short-term volatility. However, we believe that the Trump tailwinds are real. His reflationary policies, such as tax cuts and deregulation, are likely to spur economic growth and earnings growth, both of which would be positive for equities.

With U.S. equity markets approaching or reaching all-times highs, are we due for a correction?

There is potential for a short-term pullback as valuations are stretched. In addition, the benefits from a number of the new administration's policies have already been priced into the market, but these policies will be implemented in political time, not market time, so there is potential for disappointment and volatility if policies are not implemented as swiftly as investors anticipate.

Overall, while price/earnings ratios may contract, we expect this will be largely offset by solid earnings growth, which should be supported by accelerating economic growth and the new administration's proposed corporate tax cuts.

With economic data improving in Europe, what are your expectations for European equities?

We recently increased our ranking of international equities from underweight to neutral, largely due to our expectations for European equities. They are cheaper than many of their global counterparts, and the economy there has more slack in it than the North American economies do, which means it has more potential to grow. Higher growth and inflation would help European companies grow their earnings, which would be beneficial for stock prices. While political risks are still a threat, investors appear to have discounted them.

How do we mitigate the risk of rising rates when older clients need to have sizeable fixed income exposure as part of their portfolios?

We continue to believe that rates will remain low for an extended period—what we refer to as a lower-for-longer environment. In Canada, there is still slack in the economy, and we believe the Bank of Canada will hold rates steady throughout 2017. In the U.S., President Trump's proposed policies are likely to spur growth and inflation, and the Federal Open Market Committee may well continue to raise rates modestly. However, a number of factors are likely to moderate rate increases, including modest capital utilization data; a strong U.S. dollar, which tends to restrain inflation; and demographics; which point to continuing demand for bonds, as does the current environment of uncertainty.

Overall, while we expect rates to move higher, we do not expect a significant increase or spike. Nonetheless, we believe that investors can benefit from holding diversified portfolios. For example, stronger economic growth and inflation tend to spur both interest rates and equities, so equities can provide a hedge against rising rates.

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How U.S. tax changes may impact Canadians (continued from page 1)

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Both the House Plan and the Trump Proposals recommend the repeal of the U.S. estate tax regime. President Trump has further proposed that capital gains on property held until death and valued over US$10 million will be subject to tax. While the repeal may prove to be a significant benefit to many taxpayers, details of any replacement plan remain to be worked out and any effect needs to be assessed.

As a U.S. citizen or U.S. expatriate living in Canada, how may the personal tax proposals impact me?

Both the House Plan and the Trump Proposals anticipate reducing the number of tax brackets from seven to three, lowering the top marginal tax rate from 39.6% to 33%, and substantially increasing the standard deduction for joint and single filers. While the Trump Proposals cap itemized deductions at US$200,000 for joint filers (US$100,000 for single filers), the House Plan eliminates all itemized deductions other than home mortgage interest and charitable deductions. As a corollary to repealing Obamacare, the 3.8% net investment income tax (NIIT) on certain high income earners will likely be eliminated.

For U.S. citizens living in Canada, these proposed tax measures may result in significant tax savings, even though they may be required to continue to comply with onerous U.S. income tax filings and other foreign reporting requirements. In view of the recent increase in Canadian personal income taxes on high income earners, it remains to be seen whether the U.S. tax proposals may incentivize a U.S. expatriate to return to the U.S.

What do the corporate tax proposals mean for my Canadian business?

The House Plan and the Trump Proposals intend to reduce the corporate tax rate from 35% to 20% and 15%, respectively. Both approaches contemplate immediately expensing the cost of certain capital investment and eliminating certain interest expenses, business deductions and credits. To reduce U.S. tax exposure, Canadian businesses may consider deferring certain income until the lower tax rate takes effect, or accelerating certain deductions subject to elimination or reduction. Canadian businesses looking to expand to the U.S. may wish to establish a U.S. subsidiary to benefit from the lower tax rate.

To finance tax rate reductions and infrastructure expenditures, both the House Plan and the Trump Proposals call for a repatriation tax on offshore earnings. Under the Trump Proposals, a U.S. parent company may pay a one-time 10% tax on deemed repatriated profits currently held offshore. The House Plan proposes a similar but lower one-time tax. This may lead a U.S. parent company to choose the one-time tax rate to repatriate Canadian profits to the U.S. Another area of concern may relate to the proposal to tax all goods and services entering the U.S. and not tax any goods or services exiting the U.S. This may be disadvantageous to Canadian exporters who may benefit from existing trade agreements in the sale of goods to the U.S. without such taxes. It would be interesting to see whether President Trump will withdraw totally from, or renegotiate aspects of NAFTA.

Significant tax reforms are likely forthcoming and final details are to emerge in due course. The changes may have major implications for your wealth and business planning. It would be beneficial to keep abreast of new developments and consult with your professional advisors to make necessary adjustments to your existing plans on a timely basis, in order to take advantage of or minimize fallout from potential U.S. tax reforms.

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