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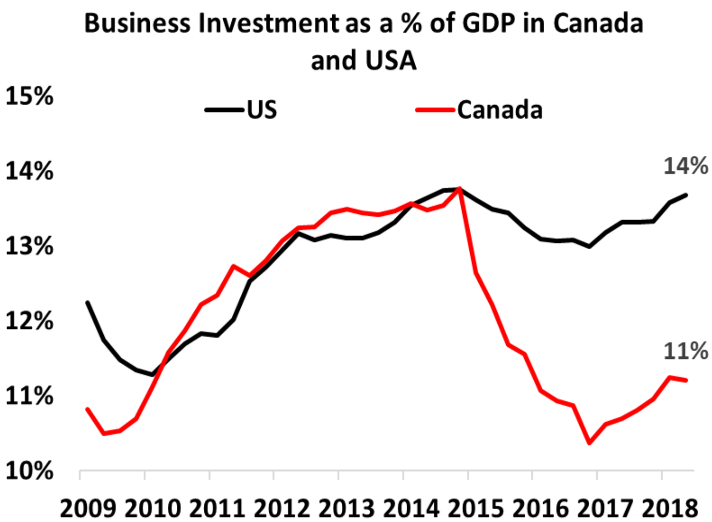
No Free Tax Lunch

For many years, Canada's structural tax advantage over the U.S. attracted an influx of investment to our economy. Unfortunately, this came to a halt in early 2017 when the U.S. implemented tax reform that reduced its corporate tax rate from 35% to 21% and modified rules to depreciate business assets. This has encouraged U.S. corporations to invest in capital programs and enhance productivity. Investors have responded with enthusiasm, causing a late cycle surge in the U.S. stock market, while Canada has been left behind.

The numbers speak for themselves. Between 2014 and 2017, foreign direct investment in Canada has dropped 50% according to Stats Canada. As seen in the chart below, our domestic business investment has also drastically decoupled from the U.S. and has since struggled to keep up.



Source: Stats Canada

In response to widespread calls from Canadians to address our country's waning competitiveness, Finance Minister, Bill Morneau, rolled out his fall fiscal update last week. While it did not specifically lower corporate tax rates, it did introduce accelerated depreciation through enhancing Cost of Capital Allowances (CCA). The change allows businesses to recover certain costs of investments quicker and encourages them to make investments that improve both productivity and profitability. At least this appears to have been the experience in the U.S.

For those of us who aren't tax accountants, a simplistic way to look at these changes is as follows. If Alberta Co. XYZ were to spend $10 million purchasing new manufacturing equipment, they could now reduce taxable income by the full amount in the first year, four times higher than the previously allowable amount. In year one, assuming a 27% corporate tax rate, this would result in tax savings of just over $2 million, which could then, in turn, be used for additional capital expenditures or be returned to shareholders. It is important to note that accelerated depreciation only relates to the timing of the deductibility of the asset purchased, rather than any true "cash savings." The true net benefit is dependant on the taxability of the company and the type of asset purchased.

CIBC performed analysis to determine which companies may be positioned to 'win' from these recent policies. Not surprisingly, their search identified the winners as those who generate a high percentage of their revenue in Canada, have high cash taxes as a percentage of operating cash flow, and who employ a meaningful capital program relative to market cap. The companies in our QV Canadian Small or Large Cap Equity Strategies that fit this mold and may stand to benefit against this new backdrop include Canadian Tire Corp, Parkland Fuel, Loblaw, Canadian National Railway, Mullen Group, Empire Co. and George Weston.

Time will tell if these tax changes will adequately address the issue of competitiveness in our country. For our economy to truly benefit from the CCA changes, we will need to see Canadian companies expand their capital programmes within Canada, which could, in turn, spur jobs and increase our productive capacity. While tax policy cannot solve egress issues for Western Canadian oil producers, eliminate steel tariffs, or convince GM to keep building cars in Oshawa, it is at least a step in the right direction to support Canadian businesses and provide incentive for further investment in this country.

The negative sentiment presently overshadowing markets gives us an opportunity to purchase high quality Canadian companies at valuations that are now lower than historical averages, setting the foundation for better returns when sentiment improves in Canada.