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Canadian stocks that will benefit the most – and the least – from U.S. tax reforms

Saputo Inc., a Montreal-based seller of an artisan line of cheeses, gets a large portion of its sales from the United States and may benefit from recent tax changes.

Christinne Muschi/The Globe and Mail

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The sweeping, quick-moving U.S. tax bill passed by Congress and signed into law late last year left a lot to unpack, beyond the headline news that the country's corporations were getting a cut in their income tax rate.

Indeed, it's turning out to be more complex than that, with winners and losers in the business community. Lest we forget, Canadian companies that operate south of the border pay meaningful U.S. taxes as well – and some of our top companies may benefit more than others.

How in the world can we tell? Well, we can take the deeply educated guesses of ***Veritas Investment Research*** analyst ***Dimitry Khmelnitsky***, whose recent report "U.S. Tax Tsunami Stirs Waves in Canada," examines the new law and which companies in the S&P/TSX 60 Index may be affected the most. Spoiler alert: ***Mr. Khmelnitsky*** thinks Saputo Inc., CCL Industries Inc., Alimentation Couche-Tard Inc. and Manulife Financial Corp. are the likely winners, with Valeant Pharmaceuticals International Inc., Thomson Reuters Corp., Gildan Activewear Inc. and Open Text Corp. possibly showing a bit of a hit to the bottom line.

Let me start by saying it is no insult to ***Mr. Khmelnitsky*** to refer to his report as "educated guesses." Public companies' disclosure of tax matters is opaque at best, and it's extraordinarily difficult, if not impossible, to predict with certainty how the companies' tax bills will change, based on current or future law.

However, companies' broad discussions of their businesses, including the countries where they operate, the subsidiaries they own, and their current tax practices, can allow an analyst to develop a view with some degree of confidence.

Let's take a simple premise: ***Mr. Khmelnitsky*** believes Canadian companies with higher U.S. sales exposure and higher overall cash tax rates, are most likely to benefit from a reduction in the U.S. corporate income tax rate. The U.S. sales exposure is easy enough to calculate, because S&P/TSX 60 companies typically disclose revenue by geographic segments. To identify the higher-taxed companies, ***Mr. Khmelnitsky*** pulled tax payments from the statements of cash flows and compared it with pretax earnings, using a three-year average to minimize the effects of outlier situations.

This is the analysis that pegged Saputo, CCL Industries, Couche-Tard and Manulife as potential winners; each gets between 39 per cent and 64 per cent of sales from the United States, and each has a cash tax rate between 21 per cent and 26 per cent, according to ***Veritas's*** calculations. Indeed, Manulife has already disclosed that after a one-time charge of $1.9-billion, related to writing down the value of future tax assets, it expects a $250-million per year benefit to its "core earnings."

Certainly, there are other companies with a chunk of U.S. revenue – but their overall tax rates are lower, and it may be because of tax-minimization techniques that are targeted in the new law.

One area of concern is when a company reduces its taxes by making cross-border payments to affiliated companies; to combat it, the United States has now introduced something called a Base Erosion Anti-Abuse Tax, or BEAT. These BEAT rules, ***Mr. Khmelnitsky*** says, will tax intercompany payments for services, royalties, management and other fees, including interest and reinsurance. Based on company disclosures, he believes Valeant, Thomson Reuters, Gildan, and Open Text are most likely to incur the new taxes.

Another area that may affect Open Text and Valeant, ***Mr. Khmelnitsky*** says, are rules on taxation of "Global Intangible Low-Taxed Income," which are designed to ensure that a U.S. company that pays ultra-low taxes on foreign earnings will face some minimum U.S. taxes instead. While the word "intangible" in the name refers to intangible assets, and suggests taxation of things such as intellectual property that can be shifted easily from country to country, ***Mr. Khmelnitsky*** says companies with hard assets such as plants and equipment may run into the tax if the assets are old enough to have been significantly depreciated.

What one realizes in reading through ***Mr. Khmelnitsky's*** thorough report is that no company is likely to see all benefit and no burden; while these example companies may come out ahead, or behind, every company is likely to find some areas of the new code that give, and some that take away. Waste Connections Inc. has a high tax rate and more U.S. exposure than any other S&P/TSX 60 company, so it would have made the list of top beneficiaries because of the overall rate cut. But ***Mr. Khmelnitsky*** believes it might get beaten up by BEAT.

Emera Inc. and TransCanada Corp. will benefit from new rules on capital expenditures and "bonus depreciation," but since they own regulated utilities in the United States, they'll likely see their rates, which are subject to regulatory approval, fall because income tax expense is one of the costs they can recover from ratepayers.

"Over all, we expect Canadian companies with U.S. operations to benefit from the U.S. tax reforms," ***Mr. Khmelnitsky*** tells ***Veritas's*** clients. "However, the benefit will be spread unevenly as the new measures have an incredibly broad impact on what was a very complicated U.S. tax system."

Really, no need for a past-tense verb; the U.S. tax system remains very complicated. Thanks to ***Mr. Khmelnitsky*** and ***Veritas*** for attempting to cut through the weeds and give Canadian investors some sense of how our companies will navigate the thicket.