

FOREIGN TAX CREDITS AND THE INTERNATIONAL
INTERDEPENDENCE OF CORPORATE TAX POLICIES

by

Glenn P. Jenkins & Antal Deutsch

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Abstract

This paper evaluates the degree to which the American tax treatment of foreign earned income neutralizes the incentive effects of changes in Canadian corporation income tax policies. The value of the tax transfers that would take place between the United States and Canadian treasuries for various changes in Canadian tax policies are estimated by industry for 1968. From this analysis the general conclusion is that for most United States owned corporations operating in Canada a change in their effective Canadian corporation income tax rates will alter their effective U.S. corporation income tax rates on this income by an equal amount in the opposite direction.

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I. FOREIGN TAX CREDITS AND DEFERRAL OF DIVIDENDS

Because residents of the United States are the primary owners of the foreign investments of the world, the tax policies of the U.S. which are directed at the income from these investments have a significant effect on the activities of international investors and the economies of the countries which are hosts to these investments. The purpose of this paper is to evaluate the extent to which the present international taxation agreements between the United States and the host country neutralize the incentive effects of changes in the latter's tax policies on the investment decisions of U.S.-based multinational corporations. Because Canada has received the largest amount of U.S. foreign investment of any country, we examine empirically the extent to which the effectiveness of Canada's corporation tax policies can be dampened by the provisions of the tax agreement with the United States.

In 1973 the Canadian government enacted legislation which reduced the corporation income tax rate applicable to manufacturing corporations by 10 percentage points and in addition, a two-year capital write-off provision for manufacturing and processing machinery or equipment was instituted to replace the previous

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general capital cost allowance of 20 per cent of the undepreciated book value of the assets. At the same time, the Canadian government proposed to renegotiate the tax treaty with the United States so as to increase the present 15 per cent statutory withholding tax rate to 25 per cent.¹ In this paper, we estimate the incentive and tax distribution effects between Canada and the U.S. for these changes in Canadian tax policy with reference to the actual tax and income statistics for 1968.

The most important feature of the tax treaties between the United States and the countries which are host to its foreign investment is the United States foreign tax credit. To reduce the extent to which income taxes interfere with the allocation of United States investment between countries, the U.S. taxpayer is allowed to credit most foreign income taxes against the United States income tax liability on foreign earned income rather than only claim such foreign tax payments as a deduction from foreign taxable income.² Foreign tax credits are restricted to being no larger than the United States tax liability on foreign earned income. Thus, the U.S. taxpayer is intended to pay, in total U.S. and foreign source income taxes, the higher of the two rates charged.

There are two ways in which a United States corporation may calculate the limitation on the amount of foreign tax credits that can be used to offset the United States tax liability on income from foreign affiliates. First, there is the per-country limitation where a separate computation is made of the United States tax liability and the available tax credits for each country where income is earned. Alternatively, the U.S. corporation may make a

once and for all election to calculate its U.S. tax liabilities of foreign source income on the overall limitation basis under which United States taxable income (and losses) from all foreign sources is pooled, as are all foreign tax payments. One aggregate computation of the United States tax liability is then performed using this pooled data. Under both types of limitation, creditable foreign taxes in excess of the limitation may be carried back for two years or forward up to five. Over two-thirds of the total United States taxable income earned abroad is taxed by the U.S. under the over-all method of computing the limitations to the foreign tax credit.³

Initially, we assume that the U.S. tax liability on income earned abroad is due in the year in which it is generated. In this situation, if a United States corporation is operating with the per country limitation in Canada when the rate of creditable Canadian income tax is less than the U.S. corporation income tax rate, then the rate of return on the replacement value of assets that the corporation earns net of all Canadian and U.S. taxes is expressed as follows:

(1)

$$R_C^n = \frac{S_C - S_{ctc} - S_C(T_{us} - T_C)}{K_C} = \frac{S_C(1 - T_{us})}{K_C}$$

Where: R_C^n is the private rate of return on capital invested in Canada net of all but personal income taxes.

S_C is the gross income generated by U.S. owned capital in Canada before all creditable income taxes but net of depreciation expense.

K_C is the net replacement value of the capital stock located in Canada (c) and owned by the U.S. resident corporation.

T_C is the rate of creditable income and withholding tax that is levied by Canada on income from U.S. owned capital.

T_{us} is the rate of U.S. income tax liability on the income earned by investments owned by U.S. residents but located in Canada.

Alternatively, if ($T_C > T_{us}$) then the net rate of return is expressed simply as:

(2)

$$R_C^n = \frac{S_C(1 - T_C)}{K_C}$$

The existence of the U.S. foreign tax credit leads to a situation where, if Canada's rate of income tax is less than that of the U.S., an increase in the rate of Canadian taxes up to the level of the U.S. rate will merely transfer tax revenues from the U.S. treasury to the treasury of Canada but will not lower the returns to the owners of the investment.

In order for a United States corporation to evaluate its net rate of return from additional investments in a foreign country, it must first determine if it initially has a surplus or deficit of foreign tax credits averaged over all its foreign operations. If it has an over-all surplus of foreign tax credits for the m countries in which it operates, i.e., $\sum_{f=1}^m S_f T_f > \sum_{f=1}^m S_f T_{us}$, then the net private rate of return from investment in a particular

country is the same expression as equation (2). (The symbols in capital letters are the same as in (1), but Canada (c) is replaced by (f) which stands for any country outside the United States). Alternatively, if the U.S. corporation has an over-all deficit of foreign tax credits ($\sum_{f=1}^m S_f T_f < \sum_{f=1}^m S_f T_{us}$) then the net rate of return from investment in country f is the same expression as equation (1).

If a U.S. corporation is calculating its available foreign tax credits by the over-all limitation method, and if it has an over-all deficit of tax credits, then any one of the countries (i) in which it operates can increase its tax rate (T_i), to the point where $T_i = \sum_{f=1}^m S_f (T_{us} - T_f) / S_i + T_{us}$, and yet not alter the incentive that foreign investors have to make investments in that country even though in an extreme case more than 100 percent of the profits in country i may be taken by i's tax authority. Similarly, decreases in one country's corporation taxes will not increase the incentive to invest by foreigners but will only transfer tax revenue from the foreign country to the United States Treasury.

The preceding analysis has been somewhat simplified because we have assumed that all foreign earnings are remitted to the United States corporation in the year in which the income is earned. In actual practice the U.S. Internal Revenue Code stipulates that the earnings of a foreign corporation, with at least 10 per cent of its outstanding voting stock owned by a U.S. domestic corporation, are not subject to the United States corporation income tax until the year in which the U.S. parent corporation receives the foreign earnings as dividends.⁴ On the other hand, all revenue from

foreign branches and certain majority owned U.S. subsidiaries must be included in the U.S. taxable income in the year in which it is earned, along with interest and royalty income from all foreign sources.⁵ The interest and royalty income are not subject to Canadian income taxes but only to withholding taxes. A potential method of U.S. income tax avoidance arises through the option of an American parent to defer the repatriation of Canadian subsidiary profits, and the accompanying payment of the tax difference to Washington. The greater the gap between the American effective tax rate on these profits and a lower Canadian rate, the greater is the value of the interest-free loan the parent can obtain through the deferral. A lowering of the effective rate in Canada through a reduction of the nominal rate on manufacturing profits and a liberalization of depreciation provisions will increase the gap on which deferral may be based. That, in turn, should lead to a reduction in cost to the parent of maintaining retained earnings with the Canadian subsidiary. If in fact additional earnings are retained on account of this mechanism, they may be used to reduce the subsidiary's debts, to increase its current assets, and/or to increase the investment in fixed assets.

II. EFFECTIVE RATES OF CANADIAN INCOME TAXATION OF U.S. OWNED INVESTMENTS.

The principal source of data which we use for this analysis is the Statistics of Income Supplemental Report, Foreign Tax Credit 1964 and 1968, which are compiled by the Internal Revenue Service of the U.S. Department of Treasury. At the present time the 1968 statistics are not published, but were made available by the

Internal Revenue Service. These data contain the U.S. taxable income that has been repatriated to the United States along with the foreign tax credits that accompany this income and are presented by country and by industrial sector within each country.⁶ Also these data are given in three levels of disaggregation with respect to the corporate structure of the multinational firms. First, the amounts of branch profits, dividends and interest plus royalties that are repatriated to the U.S. parent corporation are presented by the industry of the parent and the country where the affiliate resides. The income taxes paid in the foreign country are prorated according to the proportion of total profits repatriated and are presented along with the withholding taxes at this same level of disaggregation. These data series are available for both 1964 and 1968. Table 1, columns 1 and 2, contain these series for 1968 for the case of Canada.⁷

For the second level of aggregation, both the amounts of foreign and creditable foreign taxes are presented for the total foreign operations of the U.S. parent corporations which have investments in a particular industry and in a specific country. Thirdly, information is available on the taxes paid and total income which includes the income from both foreign and domestic services by the industry of the multinational corporations.

To derive the effective rate of income plus withholding taxes that Canada has levied during 1968 on all types of income from United States investments in Canada (column 3 of Table 1) we divide column 2 by column 1. The resulting effective tax rates are based on the United States definition of taxable income which

includes taxable profits, interest payments and royalties received by the U.S. parent from its Canadian subsidiaries. Because the United States corporation income tax is levied on this broader base, while the Canadian income tax is levied only on the profits of the affiliates, we find that the Canadian effective tax rate, defined as a per cent of U.S. taxable income (column 3), is generally lower than the 48 per cent rate used to calculate the U.S. income tax liability. Even though throughout the period from 1964 to 1972 the nominal rate of Canadian corporation income tax plus withholding tax has been greater than the nominal U.S. corporation income tax rate, the U.S. owned segments of Canadian industries have generally had to pay additional taxes to the U.S. treasury. This is due primarily to the broader U.S. income tax base and perhaps to the more restrictive expensing privileges which it applies to income from foreign sources. In 1968 we see, from Table 1, column 3, that only the metal mining, food and kindred products, and electricity, gas and sanitary service industries had an average tax rate in Canada larger than the United States corporation income tax rate of 48 per cent.⁸ The pattern of effective Canadian tax rates in 1964 was very similar to the 1968 result with only chemicals, stone and clay products and retail trade, in addition to the industries mentioned for 1968, paying a total amount of Canadian income and withholding taxes greater than their U.S. income tax liability.

For several U.S. corporation operating in Canada, the United States taxable income defined for corporation income tax purposes has been reduced by a special tax provision called the Western

Hemisphere Trade Corporation (W.H.T.C.) deduction.⁹

This provision reduces the U.S. taxable income of a W.H.T.C. by an amount equal to: $(.14(\text{U.S. corporation income tax rate}))$ (taxable U.S. income of foreign affiliate gross of this deduction). This preferential tax treatment applies only to certain U.S. corporations operating in the Western Hemisphere. To be eligible as a W.H.T.C. at least 95 per cent of the U.S. foreign affiliate's gross income for the preceding three year period must be derived from sources outside of the United States and 90 per cent of its gross income in that period must be derived from the active conduct of trade or business.¹⁰

In recent years when the nominal rate of the U.S. corporation income tax has been set at 48 per cent the W.H.T.C. provision has lowered the taxable income of these corporations by 29 per cent. In Canada the U.S. corporations which have been able to use the W.H.T.C. deduction have been concentrated in the mining, primary metals, petroleum refining and wholesale trade industries.¹¹ From the Canadian perspective this provision has been an implicit U.S. subsidy to the investment made in some Canadian sectors by U.S. corporations.

In column 5 of Table 1 we present the amount of the surplus or deficit of U.S. foreign tax credits from Canadian source income by industry. These values are derived by subtracting the U.S. tax liability on Canadian source income (after W.H.T.C. deduction has been made) of column 4 from the total creditable income related taxes paid to the Canadian treasury, column 2. In order to estimate the value of corporation income taxes paid to the United

Table I

CANADIAN SOURCE INCOME AND U.S. FOREIGN TAX CREDITS
OF AMERICAN CORPORATIONS WITH CANADIAN AFFILIATES

	(1)	(2)	(3)=(2)÷(1)	(4)=(1) × .48 (b)	(5)=(2)-(4)	(6)
Industry	Total income from U.S. investment in Canada U.S. \$'000 (a)(d) 1968	Total of income related taxes paid to Canada U.S. \$'000 (a) 1968	Canadian effective tax rate 1968	U.S. tax liability on Canadian Source Income before tax credits from Canada are deducted U.S. \$'000	Surplus or deficit (-) of tax credits Canadian source income U.S. \$ '000	Surplus or deficit (-) of tax credits from all non-Ameri- can and non-Canada Source Income U.S. \$'000 (c)
(Thousands of Dollars)						
PRIMARY INDUSTRIES						
Agriculture, Forestry and Fisheries	2614	830	.318	1255	-425	-200
Metal Mining	23965	19310	.806	11503	7807	165101
Crude Petroleum and Natural Gas	2700	797	.295	1296	-499	-13999
All Other Mining	36110	6788	.188	17332	-10544	9161
MANUFACTURING						
Food and Kindred Products	59118	29661	.502	28377	1284	-8439
Textile Mill Products	4563	1527	.335	2190	-663	-679
Apparel and other Textile Products	10318	4687	.454	4953	-266	-3697
Lumber and Wood Products	3497	331	.095	1679	-1348	287
Paper and Allied Products	36005	15604	.423	17705	-2101	960
Printing and Publishing	20841	8769	.421	10004	-1235	-358
Chemicals and Allied Products	161241	67181	.417	77396	-10215	-64992
Petroleum Refining	170355	69379	.407	81761	-12382	744154
Rubber and Misc. Plastics	10832	4401	.406	5199	-798	-5568
Stone, Clay and Glass Products	18408	8029	.436	8836	-807	-8679
Primary Metals Industries	38360	15393	.401	18413	-3020	239027
Fab. Metal Products	44312	18714	.422	21270	-2556	-12487
Machinery, Except Electrical	78405	28984	.370	37634	-8650	-52128
Electrical Equip. and Supplies	43081	12426	.288	20679	-8253	-36591
Motor Vehicles and Equip.	63238	30459	.482	30354	105	-2538
Other Transportation Equip.	25585	8347	.326	12281	-3934	-10832

Table I (Continued)

- 2 -

	(1)	(2)	(3)=(2)+(1)	(4)=(1) x .48 (b)	(5)=(2)-(4)	(6)
Industry	Total income from U.S. investment in Canada U.S. \$'000 (a)(d)	Total of income related taxes paid to Canada U.S. \$'000 (a)	Canadian effective tax rate 1968	U.S. tax liability on Canadian Source Income before tax credits from Canada are deducted U.S. \$'000	Surplus or deficit from Canadian Source Income U.S. \$'000	Surplus or deficit (-) of tax credits from all non-American and non-Canadian Source Income U.S. \$'000 (c)
(Thousands of Dollars)						
Scient. Instru.	55157	25421	.461	26475	-1054	-448
All Other Manufacturing	7994	2288	.286	3837	-1549	-4500
NON-MANUFACTURING AND SERVICE						
Contract Construct.	3131	1306	.417	1503	-197	-2762
Transportation	22529	5966	.265	10814	-4848	-3616
Communication	19444	4955	.255	9333	-4378	-43390
Electric, Gas and Sanitary Services	3379	1792	.530	1690	102	-200
Wholesale Trade	27730	9434	.340	13310	-3876	66883
Retail Trade	10087	4760	.472	4842	-82	-1017
Banking	16833	4729	.281	8080	-3351	-58273
Credit Agencies Other than Banks	24746	6641	.268	11878	-5237	-1297
Holding and other Investment Co.	27654	10284	.372	13274	-2990	1866
Insurance Carriers	196142	42921	.219	94148	-51227	-5333
Real Estate	879	127	.144	423	-296	-18
All Other Finance and Insurance	12292	2312	.188	5900	-3588	-3984
Services	21800	8693	.399	10464	-1771	-88206

(a) Source: Internal Revenue Service, Statistics of Income, 1968, Foreign Income and Taxes Reported on Corporation Income Tax Returns (Unpublished). The volume dealing with 1964, 1965 and 1966 has been published by the U.S. Printing Office, Washington, D.C. The income related taxes presented here are the income and withholding taxes that are allowed as foreign tax credits by the United States.

(b) 48% was the corporate income tax rate in the United States in 1968.

(c) Figures obtained from the source described in (a) for the global foreign tax credits of the United States corporations with income from Canada were reduced by the numbers shown in column (5) of this table.

(d) This includes income repatriated to the United States corporations by foreign affiliates where 10 percent or more of the equity of the affiliate is owned by the recipient of the funds. The dividends received are grossed up to include their share of income and withholding taxes paid. Where the Western Hemisphere Trade Corporation legislation applies, the income shown has been reduced by 14/48.

States on income generated in Canada we first are required to link the tax position of the U.S. parent corporation's income coming from Canada to its position with respect to all of its income from foreign sources. As discussed previously, if a company uses the overall limitation method and does not have enough tax credits from Canada to cover the U.S. tax liabilities from this income, then it can use any excess tax credits it has from other foreign operations to cover the residual tax liability on its Canadian income. Alternatively, if the United States parent has a deficit of tax credits on its income from Canada and is also in deficit on its worldwide operations, then the corporation must pay the United States Treasury the difference between its tax liability and its total tax credits both for the income from Canada and from all its other foreign operations. However, if the U.S. corporation has a surplus of tax credits in Canada, but has a deficit in its overall worldwide operations, then some of the extra taxes paid to Canada will lower the taxes that will have to be paid to the United States because of the deficit of foreign tax credits on the rest of its foreign operations.

The surplus or deficit (-) of tax credits from all non-U.S. and non-Canadian source income is presented in column (6) of Table 1. By comparing columns (5) and (6) of Table 1 we can estimate the amount of taxes that were captured by the U.S. treasury in 1968 on income from Canada because the latter's income taxes were too low. This will occur whenever there is a deficit of foreign tax credits for income generated in Canada in a particular sector accompanied by an overall deficit of tax credits

for the operations of this sector in its other foreign operations.

In 1968 only seven sectors of the thirty-five shown did not pay additional taxes to the U.S. on income earned in Canada.¹² From column 1 of Table 1 we find that these seven sectors accounted for 28 per cent of the total income repatriated to the United States from Canada. They also contain approximately 35 per cent of the foreign assets which are invested in corporations which are more than 50 per cent foreign owned.¹³

Looking at the sectors which do pay additional U.S. income taxes on income repatriated from Canada, our results show that for 72 per cent of this income a small change in the Canadian income taxes will only redistribute tax revenue between the treasuries of the two countries and will have little effect on the incentive to invest in these sectors. These sectors in 1968 contained 65 per cent of the foreign assets invested in majority foreign owned corporations, or 26 per cent of the book value of the total corporation sector in Canada.¹⁴ The results of a similar tabulation for 1964 show that approximately 47 per cent of the income repatriated to the United States from Canada was subject to additional United States corporation income tax; thus, it appears that from 1964 to 1968 there was a decline in the effective level of corporation income taxation in Canada relative to that of the United States.

When considering the ability of changes in corporation income tax policies to alter the incentives for investment, we find that the tax agreements between Canada and the United States are such that if the Canadian corporation income tax is altered there will be little change in the total tax burden for approximately 26 per cent of the total corporate sector in Canada, as measured by the

value of assets reported in the CALURA statistics. A slight change in the incentive to invest in this part of the Canadian corporate sector is due to the change in the value of the deferral provision. However, the primary effect of a change in the Canadian corporation income tax rates will be to transfer tax revenues between the Canadian and United States treasuries.

An examination of dividend remittance behaviour for the manufacturing sector in 1968 shows that Canadian dividends carried an excess of tax credits over and above the U.S. tax liability associated with those dividends for \$229.9 million out of a total of 355.7 million in dividends. The remaining \$125.8 million involved dividends where the tax liability to the U.S. was greater than the accompanying tax credits from Canada. Of this second group, excess tax credits from other countries in petroleum refining, as shown in Table 1, cancelled U.S. tax payments on \$99.5 million in Canadian dividends. Only on the remaining \$26.3 million, accounting for 7.4 per cent of total dividends; could the principals have postponed some U.S. taxes by deferring repatriation. As the total foreign tax credits available on income earned in foreign countries are prorated according to the proportion of total profits repatriated, the incentive to defer repatriation of profits is accurately represented by the relationship between the foreign tax credits and U.S. tax liability on dividends.

In Table 2, we present a comparison of what actually happened with estimates of the amount of taxes that would have been collected by the United States on the income that was actually repatriated from Canada to the United States in 1964 and 1968 using various assumptions about a number of possible Canadian tax policies. Case A

Table 2

Tax Transfers From Canada To United States Due to Changes in
Canadian Domestic Tax Policies

	Case A Taxes Paid to U.S. on Income Earned in Canada with Existing Income and Withholding Tax System.	Case B Taxes Paid to U.S. on Income Earned in Canada Assuming 40% Corporation Income Tax and Existing Withholding Tax System.	Case C Taxes Paid to U.S. on Income Earned in Canada Assuming 40% Corporation Tax and 25% Withholding Tax	Case D Taxes Paid to U.S. on Income Earned in Canada with Withholding Tax Increased to 25% and 50% Corporation Income Tax.
(Thousands of U.S. Dollars)				
Primary Industry				
1964	\$693	\$886	\$315	\$145
1968	2307	2928	471	285
Manufacturing				
1964	15571	42404	4811	2276
1968	42182	78114	11414	5495
Non-Manufacturing and Services				
1964	87750	93487	54397	52990
1968	76199	86007	45685	37516
TOTAL				
1964	104014	136777	59523	55411
1968	\$ 120688	\$ 167049	\$ 57570	\$ 43296

of Table 2 shows what the actual values of taxes paid to the United States treasury on income earned in Canada in 1964 and 1968 were. These values are calculated by adding up all the deficits of U.S. tax credits for the industries in Canada (Table 1, column 5) which have also a deficit of tax credits on their worldwide operations. For 1968 we find that manufacturing income produced in Canada paid \$42.2 million in United States taxes. The total taxes paid to the United States by the combined primary industry, manufacturing, non-manufacturing, and service sectors amounted to \$120.6 million. The important point to be made about these results is that these revenues collected by the U.S. governments could have been paid instead to the Canadian treasury with little or no change in the total taxes paid by the owners, if the effective Canadian tax rates had been higher.

Case B of Table 2 contains the value of corporation taxes that would have been transferred to the United States in 1964 and 1968 if there had existed a 40% Canadian corporation income tax instead of the actual 50% rate. The existing withholding tax rates are retained for this estimate. This case is quite similar to the actual situation that has existed since the tax changes of 1973. The liberal depreciation expense allowance also introduced in 1973 has not been considered here. The effective rates of Canadian income tax for Case B are calculated by first deducting the effective withholding tax rates for 1964 and 1968 from the actual total Canadian income plus withholding tax rate (for 1968 shown in column 3, Table 1).¹⁵ The value that remained after deducting the actual effective withholding tax rate is then multiplied by $(.40/.50)$ to give us the new effective corporation income tax rate excluding the

withholding tax. The total new effective rate of income and withholding tax for Canada is then arrived at by adding back the actual effective withholding tax rate.¹⁶ The difference between the new effective rate of Canadian taxation and the nominal U.S. tax rate is then multiplied by the amount of income repatriated from Canada in 1964 and 1968 (values for 1968 given in Table 1, column 1) to derive the value of the excess or deficit of foreign tax credits that would exist by industry for Canada. When we add up the values for the industries which are in deficit for Canada as well as in deficit on their worldwide operations we obtain the value for the total additional taxes that would be paid if this new rate of corporation income tax had existed in 1968. These values are presented in Table 2, Case B.

By lowering the Canadian corporation income tax to 40% from 50% the tax transfer to the U.S. would increase by approximately 10 million dollars for manufacturing and by approximately 46 million for the total of all foreign owned activities. This is an increase of 13 per cent and 38 per cent, respectively, over the values of tax transfers prior to the tax changes (Case A).

From these results we have found that by lowering the rate of corporation income tax the Government of Canada exacerbates its problem of having tax revenues on income produced in Canada transferred to the United States.

While this paper does not attempt to measure the effects of the accelerated depreciation provisions made available for manufacturing and processing machinery in the same 1973 budget, its impact is certainly relevant to the problem of tax transfers and investment incentives.¹⁷ For a domestic firm the initial effect

of tax depreciation in excess of real wear and tear is a temporary tax shelter equal in amount to the extra depreciation allowed. The shelter disappears when the real depreciation catches up with the amount recorded in the tax accounts, but meanwhile the taxpayer receives an interest-free loan from the treasury. This lowers the net cost of the equipment subject to the favourable tax treatment; thus firms have an incentive to engage in some substitution of this type of equipment for other inputs. By lowering the over-all costs of production, the tax concession may also lead to an increase in the total output of the industry and to additional purchases of all inputs.¹⁸

Where the tax savings through accelerated depreciation accrue to the Canadian subsidiary of an American parent, so as to lower the effective tax rates charged by Canada below those levied by the U.S. on repatriation, or to increase an existing gap, the resulting tax changes add on to the tax bill payable to Washington by the amount which was saved in Canada. Table 1 indicates that in the majority of categories listed there, a small increase in tax-credits of Canadian origin would not be offset by a surplus of credits from other sources; hence the situation described in the preceding sentence applies.

Case C in Table 2 shows the tax transfer situation between Canada and the United States when the corporation income tax has been lowered to 40 per cent, as in case B, but the withholding tax has been increased to an effective tax rate of 25 per cent. This case is quite similar to a proposal made by the Government of Canada in 1973 when it offered to renegotiate the tax agreement between the United States and Canada. Here we find that the amount of tax revenues transferred to the United States treasury decreases

by \$30.5 million in manufacturing and by \$63.1 million for the total of all industries or by 40 per cent and 52 per cent, respectively, from Case A, the existing situation in 1968. These results show that while the lowering of corporation income tax alone increases the amount of taxes transferred to the United States, the increasing of the withholding tax will more than offset the effects of the lower rate. With Case C the percentage of income repatriated to the United States that would not pay any additional corporation income taxes to the U.S. increases to 47 per cent from 30 per cent in Case A. The remaining 53 per cent of income would be subject to a substantially lower rate of additional United States tax. The corporations now subject to changes in the incentive to invest as Canadian tax rates are altered, account for approximately 50 per cent of the foreign assets invested in corporations which are more than 50 per cent foreign owned, against 35 per cent of those in Case A.¹⁸

The final set of tax assumptions we investigated (Case D) involves only increasing the withholding taxes from the actual effective rate of 13 per cent to 25 per cent. No change is made in the corporation income tax rate as it was applied in 1968. For this case we find that the value of tax revenues transferred to Canada from the United States treasury by increasing the Canadian withholding tax in 1968 is \$38.7 million for manufacturing and \$77.4 million for the total of all industries which contain foreign investment.¹⁹ This represents a decrease in tax revenues collected by the United States on income generated in Canada of 40% for manufacturing and 64% for all activities from the amount that was actually received in 1968.

At the present time, the type of disaggregated data used in

the estimations shown in Tables 1 and 2 is not available for the years since 1968. However, data are available for the amount of income repatriated to the United States for each year until 1972 by broad industrial classifications.²⁰ Since 1968 we find that the annual amount of income repatriated to the U.S. from Canada has risen by 39 per cent for manufacturing industries, 26 per cent for non-manufacturing, but fell 12 per cent for primary industries, for a net rise of 16 per cent over all industries totalled. The adjustment of the values of the tax transfers shown in Table 2 for the change in the amount of income repatriated from 1968 to 1972 would give an estimate of the size of these transfers for 1972.

The preceding analysis does not attempt to measure the effect that changes in taxation policies alter the rate of income repatriation from Canadian affiliates, and thus indirectly alter the amount of income that will be included in U.S. taxable income. For the changes in tax policy which we consider, the Canadian corporation income and withholding taxes could be raised significantly above their 1973 levels without altering the total tax bills of the bulk of the industries in Canada owned by U.S. residents.

For this study only taxation data by industry is available. Thus, the average tax position of an industry may not characterize the situation for each individual firm within it. The general conclusion must hold that for most of the foreign owned corporations in Canada a decrease in Canadian corporation income taxes will result in an increase of their tax payments to the United States treasury. In this way the incentive effect of a tax cut, which might be expected to expand investment by these corporations in Canada, is substantially reduced.

FOOTNOTES

1. Bill C-222, June 1972, and Bill C-192, July 1973, Government of Canada.

2. This is commonly known as the principle of capital export neutrality. See R.A. Musgrave (1969) p. 254.

3. U.S. Internal Revenue Service, Department of Treasury, Foreign Income and Taxes, Corporation Income Tax Returns Supplemental Statistics of Income 1964, Table 11, pp. 142-145. For U.S. income from Canadian sources in 1964, approximately 68 per cent of taxable income was taxed under the over-all limitation method.

4. Peggy B. Masgrave, United States Taxation of Foreign Investment: Issues and Arguments. Cambridge, Mass. Harvard University Law School, p. 9. There are also tax haven provisions which stipulate a minimum distribution of earnings from these areas. I.R.S., (1964), p. 316.

5. The provisions under which some U.S. controlled foreign corporations must repatriate their current income to their parent corporation are detailed in U.S. Internal Revenue Service 1964, p. 310.

6. The industrial classifications refer to the industry of the parent corporation, and not necessarily to that of the affiliate.

7. U.S. Internal Revenue Service, Statistics of Income Supplemental Report, Foreign Tax Credit 1964 Table 5 and 1968 Table 5. Details for 1964 are not repeated here for reasons of space economy. The interested reader may obtain a copy from the authors.

8. The unusually high effective tax rate in metal mining is the result of a wider definition of the income base in Canada, on account of less generous depletion provisions and WHTC provisions of the United States.

9. Commerce Clearing House Inc., U.S. Master Tax Guide 1974, Section 298, page 127.

10. Peggy B. Musgrave, "Tax Preferences to Foreign Investment, International Subsidies," Washington, Joint Economics Committee, June 11, 1972.

11. Internal Revenue Service, Western Hemisphere Trade Corporations, 1964 and 1968.

12. These sectors are: metal mining, food and kindred products, petroleum refining, primary metal industries, motor vehicles, electric, gas and sanitary services and wholesale trade.

13. Statistics Canada, Corporations and Labour Union Returns Act, 1970, p. 116, Table 2.12 for 1968.

14. Ibid.

15. For reasons of space economy the details of this calculation are not included here, but may be obtained on request from the authors.

16. The effective withholding tax rate for 1964 was .118 and for 1968 was .130. These values were obtained from the Canadian Department of National Revenue, Non-resident Tax Statistics, special analysis of NR-4 Summary returns compiled by District Offices.

17. The changes in effective income tax rates brought about by the 1973 changes in the depreciation regulations have been estimated for a number of assets by R.M. Hyndman (1974).

18. A good discussion of the economic consequences of accelerated depreciation can be found in a paper by Agnar Sangmo (1974).

19. Supra., note 13.

20. U.S. Department of Commerce, Survey of Current Business, 1973.

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