

Osgoode Hall Law Journal

ARTICLES

- Towards Longer Time Horizons
in Personal Taxation
DAVID SEWELL
- Considerations for
the Tax Mix
BOB HAMILTON, CHUN-YAN KUO,
& SATYA N. PODDAR
- The Impact of Changing Perceptions of Social
Equity on Tax Policy: The Marital Tax Unit
JACK R. LONDON
- Taxing Corporate Income in the U.S. Twenty
Years after The Carter Commission Report:
Integration or Disintegration?
ALVIN C. WARREN, JR.
- Politics, The Deficit and Tax Reform
DAVID A. WOLFE
- Equity and Neutrality in the International
Taxation of Capital
LORRAINE EDEN
- The Structure of the Sieve: Political Economy
in the Explanation of Tax Systems and Tax Reform
STANLEY L. WINER
& WALTER HETTICH
- Should the Current Tax-Transfer System be Replaced
by a Flat-Rate Income Tax?
BERNARD FORTIN

EQUITY AND NEUTRALITY IN THE INTERNATIONAL TAXATION OF CAPITAL*

BY LORRAINE EDEN**

I. INTRODUCTION

The international taxation of capital is a complicated subject. It affects the international allocation of capital, the distribution or gains from foreign investment between home and host countries, the returns to residents and non-residents in the host country, and the relative treatment of residents in the home country with domestic income and those with foreign-source income. In 1963, the OECD Fiscal Committee adopted a *Model Tax Treaty Convention on Income and Capital* to clarify "good behaviour" in this area. The *Convention* assigns the source or host country the primary right to tax business income earned within its borders. Where multinational enterprises (MNEs) are involved, the tax base is allocated internationally according to the concept of a permanent establishment. The various MNE affiliates are treated as separate legal entities and income is apportioned between them assuming

* Copyright, 1988, Lorraine Eden.

**Norman Paterson School of International Affairs. I am indebted to Carl S. Shoup for kindling my interest in this area and for his thoughtful comments and discussions over the years that have done much to shape my own views; though, of course, he is absolved from any responsibility for this paper. I thank Carl Shoup and the participants of *The Royal Commission on Taxation: Twenty Years Later* conference for comments on an earlier version of this paper.

VOLUME 26

NUMBER 2



SUMMER

1988

intra-firm transactions to take place at arm's-length prices. The *Convention* assigns the residence or home country the right to tax remitted income, with the host country having the prior right to levy a withholding tax, and recommends that the home country grant a foreign tax credit.

The legal rules that guide actual international taxation practices are known as the *source* and the *residence* principles. The residence principle holds that all income is taxable by the country of residence, that is, where a corporation is incorporated or managed. The source principle says that income is taxable where it originates. Shoup¹ distinguishes between countries using the source principle, taxing domestic income and exempting residents from tax on income earned abroad, and countries that use the residence principle, taxing all income paid to residents, including income earned abroad. Shoup argues that horizontal fiscal coordination is needed to prevent double taxation of foreign-source income. Most coordination is unilateral; the source country is considered to have the primary right to tax, so that the residence country generally modifies its rules to take account of source taxation. Usually the residence country taxes only repatriated profits, giving a foreign tax credit in order to achieve tax equity — "equal treatment of those equally circumstanced."² If host rates are close to or equal the home tax rate, the tax credit reduces the residence tax on foreign-source income to a negligible amount. As a result, Shoup concludes: "Thus the circle almost closes; what seems at first to be the opposite of a source-principle tax ends up by resembling it."³

The purpose of this paper is to review the economic literature on the equity and neutrality aspects of the international taxation of capital, and assess the contribution of the Report of the Royal Commission on Taxation⁴ in this area. We show that the

equity and neutrality analyses developed from the classic taxation models of one-way portfolio capital flows have straightforward policy implications. We argue that the Commission's recommendations were based on nationalist views of tax equity and neutrality, designed to shift the benefits from international capital flows to Canada. However, an assessment of recent work incorporating two-way capital flows, multinational enterprises, strategic behaviour, and retaliation leads us to conclude, as did Shoup much earlier, that the line between source- and residence-principle taxation is increasingly blurred in the literature, and the policy implications are correspondingly ambiguous. Based on this newer work, we conclude that Canada could have suffered a significant welfare loss had the *Report* been instituted. The Commission's proposed step away from international equity and neutrality could thus have been a costly one.

The outline of the paper is as follows. Section II reviews the international tax literature published prior to the 1966 *Report*. Section III analyzes the major recommendations of the Commission in the light of this classic literature, while section IV reviews the criticisms made after the *Report* was released. Section V briefly surveys the post-1966 literature and analyzes the Carter recommendations in the light of this newer work. Section VI concludes the paper.

¹C.S. Shoup, *Public Finance* (Chicago: Aldine Publishing Co., 1969) at 292, 296-98, 634-40.

²*Ibid.* at 634.

³*Ibid.* at 292.

⁴Canada, Royal Commission on Taxation, *Report*, vol. 4 (Ottawa: Queen's Printer, 1966) (Chair: K. LeM. Carter) [hereinafter *Report*].

II. EQUITY AND NEUTRALITY IN INTERNATIONAL TAXATION: THE CLASSIC VIEW⁵

Musgrave and Musgrave⁶ argue that the economic principles for a "good" tax structure, equity and neutrality, must be redefined in an international setting. In a domestic setting, equity implies that each person should pay a fair share of the tax burden; neutrality implies that taxes should minimize interference with economic decisions in otherwise efficient markets. In an international setting, equity can have two interpretations: inter-nation equity, and inter-individual equity. In addition, both equity definitions and tax neutrality can be treated from either an international or national perspective.

⁵The pioneering work was done by Peggy Musgrave. See P.B. Richman, *Taxation of Foreign Investment Income* (Baltimore: Johns Hopkins University Press, 1963); P.B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge, Mass.: Harvard Law School, 1969); P.B. Musgrave, "An Economic Appraisal" in *Proceedings of the 22nd Tax Conference - 1970* (Toronto: Canadian Tax Foundation, 1970) 308; P.B. Musgrave, "International Tax Differentials for Multinational Corporations: Equity and Efficiency Considerations" in United Nations, Department of Economic and Social Affairs, *The Impact of Multinational Corporations on Development and on International Relations* (New York: United Nations, 1974); United States Senate, Subcommittee on Multinational Corporations on the Committee on Foreign Relations, *Direct Investment Abroad and the Multinationals: Effects on the United States Economy* by P.B. Musgrave (Washington: U.S. Government Printing Office, 1975); R.A. Musgrave & P.B. Musgrave, "International Equity" in J. Head & R.M. Bird, 2eds *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (Toronto: University of Toronto Press, 1972) 63; R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice*, 3d ed. (New York: McGraw-Hill Book Co., 1980). See also B.J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto: Canadian Tax Foundation, 1986) at c. 2; C.F. Bergsten, T. Horst & T.H. Moran, *American Multinationals and American Interests* (Washington: Brookings Institution, 1978) at c. 6; D.J.S. Brean, *International Issues in Taxation: The Canadian Perspective* (Toronto: Canadian Tax Foundation, 1984) at cc 4, 10; R.E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge: Cambridge University Press, 1982) at c. 8; L. Eden, *The Importance of Transfer Pricing: Microeconomic Theory of Multinational Behaviour under Trade Barriers* (Ph.D. dissertation, Dalhousie University, Halifax, 1976) [unpublished] at cc 4, 5. This section follows *United States Taxation of Foreign Investment Income: Issues and Arguments*, *ibid.* at c. 7; *Direct Investment Abroad and the Multinationals: Effects on the United States Economy*, *ibid.* at c. 7; "International Equity," *ibid.*; and *Public Finance in Theory and Practice*, *ibid.*

⁶*Public Finance in Theory and Practice*, *ibid.* at 235, 769.

A. Tax Equity and Neutrality: an International Perspective

Inter-nation equity is associated with the source principle. It involves the allocation of national gains and losses from foreign investment (FI) between home and host countries (H and F, respectively). When residents of H invest abroad, the income generated by foreign investment is a national gain to H. If F taxes this income, the gain to H is reduced. Let r_h be the return from investments in H and r_f the return on investments in F. Taxation by F reduces H's gain from FI to $(1 - t_f) r_f$; the higher t_f the lower the net gain. A tax on residents does not have this effect; it simply redistributes national income from shareholders to the government, leaving total welfare unaffected. Inter-nation equity from an international perspective requires non-discrimination; that is, F should treat its domestic and foreign investors the same. This ensures capital import neutrality, since all investors in F, regardless of nationality, face the same tax rate.

The inter-nation equity principle is illustrated in Figure 1, which is based on MacDougall.⁷ D_f is the host country's demand for capital. The capital stock consists of κ_d in domestic capital and FI in capital inflows, both assumed in perfectly inelastic supply. In the absence of taxes, the initial equilibrium is point a where $r_h = r_f$. The return to κ_d is area 2 + 3; to FI, area 4 + 5; and to labour, area 1. Hence, F's gross domestic product equals 1 + 2 + 3 + 4 + 5. If H's investors repatriate all their earnings the gross national product of F is only 1 + 2 + 3. H receives 4 + 5 in foreign-source income, which adds to H's national welfare but not to F's. Now let F tax capital at the rate t_f . The demand curve rotates down to $(1 - t_f) D_f$ and the new equilibrium is at point b. Since the capital stock is unaffected by the tax, F increases its welfare by area 4, the tax on FI. The gain to H falls to area 5, since its investors now receive $(1 - t_f) r_f$. Thus area 4 is a revenue transfer from H to F. Note that the tax on F's residents (area 2) does not influence F's welfare unless the supply of domestic saving is less than perfectly inelastic.

⁷G.D.A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach" (1960) 36 *Econ. Rec.* 13.

The Inter-nation Equity Principle

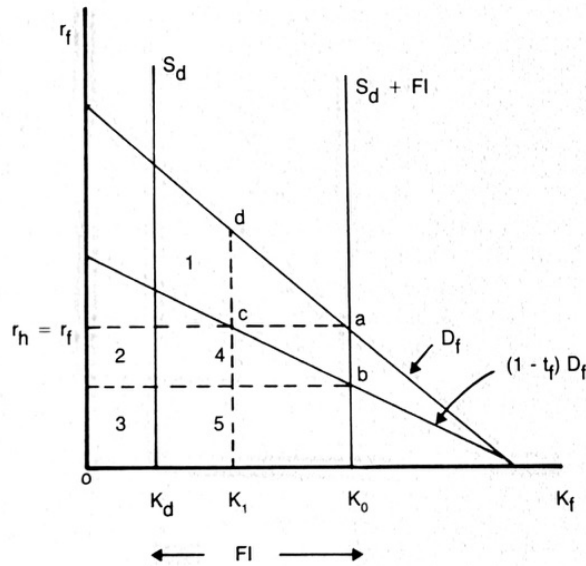


Figure 1

If the s_d curve slopes upward, the tax causes a fall in κ_d , which is replaced by FI inflows. This causes a decline in national income equal to the after-tax earnings on the replaced capital, which must be compared to the revenue transfer.⁸

Inter-individual equity derives from the residence principle. Equal treatment of equals implies that H should levy the same tax on each resident regardless of where the income is earned. Equal treatment from a global view, that is, international individual equity, implies that two residents with the same total income, one from domestic sources and the other earned abroad, should pay the same tax. If H taxes the global income of its residents and provides a full

gross-up and credit for foreign taxes (rebating the tax if $t_f > t_h$), the additional home tax is $(t_h - t_f) r_f$ bringing the total tax on FI income up to $t_h r_f$. Thus, equity is achieved.

International neutrality requires that the investor's choice of country should be unaffected by international tax differentials: the same total tax should be paid regardless of the source country. In a no-tax world, at the margin, capital is invested until the gross returns are equalized between H and F, or $r_h = r_f$. When both countries tax on the source principle (that is, H exempts foreign-source income from taxation) capital flows until after-tax returns are equalized: $(1 - t_h) r_h = (1 - t_f) r_f$. Complete tax harmonization can maintain global neutrality, but if $t_h \neq t_f$ the source principle causes a misallocation of capital. However, if H follows the residence principle and provides a full foreign tax credit, international neutrality can still be maintained, since both domestic and foreign returns are taxed at t_h . With a full credit that provides refunds if $t_f > t_h$, capital export neutrality is achieved, since the effective tax on foreign-source income is H's. If $t_f > t_h$ and credit is only provided up to t_h , then the effective tax on FI is t_f and capital import neutrality occurs.

International neutrality and inter-individual equity are illustrated in Figure 2, which assumes a fixed world capital stock of $\kappa = \kappa_h + \kappa_f$ where H owns part of F's capital stock. Each country has a downward-sloping demand for capital. In the pre-tax situation, perfect capital mobility ensures that $r_h = r_f$ at point a, with κ_h^0 in H and κ_f^0 in F. Assume F levies a capital tax so that its demand curve rotates downward to $(1 - t_f) D_f$. If H levies no tax, the equilibrium moves to point b where $(1 - t_f) r_f = r_h$ and capital flows from F to H to avoid the tax. International individual equity is not achieved, since H's residents investing in H pay no tax whereas those investing abroad pay $t_f r_f$. Similarly, global neutrality is not achieved, since the pre-tax return in F (point c) is higher than in H (point b), causing a world deadweight loss of forgone output equal to triangle abc. Now assume H imposes a tax on its residents on their worldwide income. H's demand curve rotates down to $(1 - t_h) D_h$. The new equilibrium depends on the form of foreign tax relief provided by H. If no tax relief is given, FI income is double-taxed and capital moves to point d where $(1 - t_f - t_h) r_f = (1 - t_h) r_h$. If H exempts its residents from taxes on FI income, the new

⁸See *ibid.*; D.F. Burgess, *On the Importance of an Endogenous Domestic Savings Response for Capital Income Taxation in Open Economies*, Discussion Paper (Ottawa: Economic Council of Canada, 1985).

equilibrium occurs at point e where $(1 - t_f) r_f = (1 - t_h) r_h$. Capital import neutrality occurs with capital flowing in (out) of F as $t_h > (<) t_f$. On the other hand, if H gives a full foreign tax credit, the effective tax on FI is t_h and inter-individual equity and capital export neutrality are achieved. Figure 2 assumes $t_h > t_f$; the extra tax due on FI is $(t_h - t_f) r_f$, moving F's demand curve down to $(1 - t_h) D_f$ and the equilibrium to point f directly below point a. All residents of H face the same rate t_h and global neutrality is achieved since pre-tax returns are equal at point a.

The International Interindividual Equity and Neutrality Principles

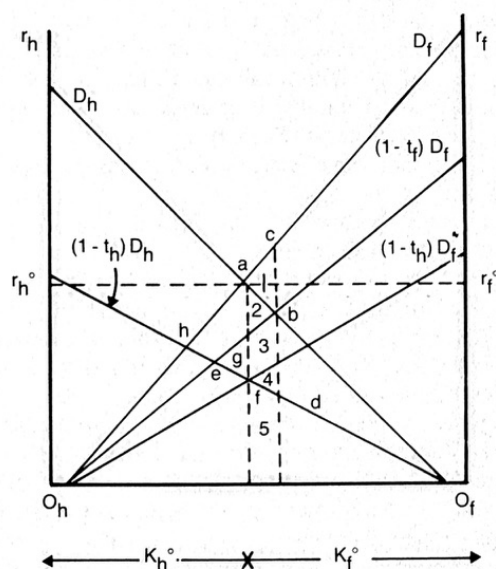


Figure 2

B. Tax Equity and Neutrality: A National Perspective

Inter-nation equity from a national point of view requires that the source country set its tax rate so as to increase its net benefit from FI; that is, F discriminates against non-resident investors. This can be done according to the national rental principle where F uses its taxes to raise its benefits from FI, or the redistributive principle where poor source countries set high rates to shift income from wealthy home countries. Note that both principles imply that F should levy higher taxes on non-residents than on residents so that capital import neutrality is violated. If H follows the residence principle and gives a foreign tax credit up to its tax rate, F should set t_f at or just below t_h , since any taxes not paid to F must be paid to H. Hence, F can raise its tax rate on FI, receiving the full revenue transfer without affecting capital inflows. In Figure 2, since F as the source country has first 'crack' at the return to FI, t_f can be set as high as t_h , maximizing F's gain from FI without affecting global neutrality, since the after-tax return remains $(1 - t_h) r_f$ regardless of the level of r_f . If H provides tax refunds, F should raise t_f above t_h , since F's treasury gains while H's loses, thus increasing F's national welfare at the expense of H's welfare.

Another argument for raising t_f is the monopsony buyer rationale, first suggested by Kemp.⁹ Suppose initially that capital inflows to F are perfectly elastic, so that F is a Small Open Economy (SOE) in the international capital market and the home country levies no tax. Then any tax levied by F causes a capital outflow and a net welfare loss for F. This does not occur in Figure 1, since the supply of FI is assumed to be perfectly inelastic. Assume instead that the FI curve is horizontal at point a. A tax by F moves the equilibrium, not to point b but to point c. The capital stock falls to K_f , the burden of the tax falls on domestic labour, and net welfare falls by the deadweight loss triangle acd. (Even if s_d were to slope upwards there would be no effect on domestic saving in this case.) Thus, the optimal capital tax for a SOE is zero. Note that this ignores FI taxation by H. If H taxes capital outflows at rate t_h

⁹M.C. Kemp, "The Benefits and Costs of Private Investment from Abroad: Comment" (1962) 38 Econ. Rec. 108.

and provides a foreign tax credit up to t_h , the optimal SOE host tax rate is not zero, but $t_f = t_h$. Thus, the first-crack principle applies to SOE host countries only if host taxes are creditable in H.

However, if the supply of capital imports is upward sloping, F can exploit its monopsony power in the capital market, trading off a deadweight loss against a terms-of-trade (TOT)¹⁰ improvement by forcing down H's net return from FI. Figure 3 illustrates this optimal-tariff argument where F has an assumed, perfectly inelastic supply of domestic capital (s_d) and H has an upward-sloping supply of capital exports (FI).

Taxing for Monopoly/Monopsony Gain

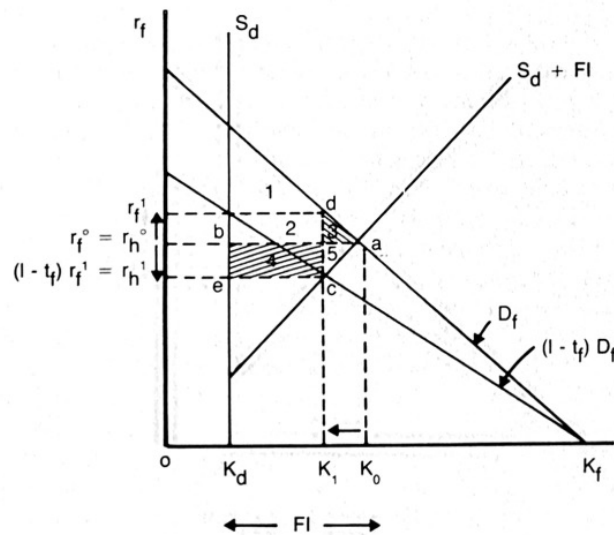


Figure 3

¹⁰The expression "terms of trade" usually means the ratio of the price of commodity exports to commodity imports. Here we interpret the TOT as the terms of lending abroad; i.e., the rate of return on foreign investment. F's TOT improve if it pays less for capital imports; H's TOT improve if it receives more for its capital exports. An improvement in F's TOT necessarily implies a fall in H's TOT.

Equilibrium occurs at point a where $r_h = r_f$. The capital stock is K_0 , with K_d domestic capital, and FI is equal to the distance ab. The benefit to FI to F is the "consumer surplus" area 1 + 2 + 3; the benefit to H is the "producer surplus" area 4 + 5 + 6. When F imposes a tax on capital, D_f rotates downward to $(1 - t_f) D_f$, the new equilibrium is point c where $(1 - t_f) r_f = r_h$, and FI falls to ce. The tax revenue from FI is area 2 + 4. F's benefit from FI is 1 + 2 + 4 for a net gain of area 4 (the TOT gain from forcing down the price of capital imports) minus area 3 (the deadweight loss imposed by F's tax on F's capital importers). The benefit to H from FI falls to area 6 (4 is the TOT loss and 5 H's deadweight loss from the tax). Global welfare falls by area 3 + 5. The higher t_f , the greater the TOT gain to F (area 4) but the larger the deadweight loss (area 3). F's optimal tax trades off the TOT gain against the deadweight loss, and is inversely related to the elasticity of the FI curve.

Inter-individual equity from a national viewpoint defines equal treatment in terms of H's taxes. Foreign taxes should be treated as a cost of doing business abroad and deductible against the home tax. Thus the pre-tax return from domestic investments equals the post-tax return from foreign investment: $r_h = (1 - t_f) r_f$ ¹¹ Similarly, since F has the first crack at income earned on FI, the national gain to H is only $(1 - t_f) r_f$, compared with a gain on home investments of r_h . Therefore, from a national-neutrality viewpoint, foreign taxes should be deducted rather than credited. Note that neither capital export nor import neutrality occurs, since domestic investors in F earn a return of $(1 - t_f) r_f$ whereas foreign investors earn $(1 - t_f)(1 - t_h) r_f$ compared with a return of $(1 - t_h) r_h$ in H.¹²

Inter-individual equity and neutrality from a national viewpoint are illustrated in Figure 2. If F has first crack at the income from FI and H gives a full credit for foreign taxes, the net return to H's treasury is only $(t_h - t_f) r_f$, which is likely to be zero if

¹¹Under a foreign tax deduction, the additional home tax is $t_h(1 - t_f) r_f$ for an after-tax return of $[1 - t_f - t_h(1 - t_f)] r_f = (1 - t_h)(1 - t_f) r_f$. The after-tax return on investments in H is $(1 - t_h) r_h$. If capital is mobile, it therefore moves from F to H until these returns are equated; $(1 - t_f) r_f = r_h$.

¹²*Ibid.*

F fully exploits the foreign tax credit.¹³ However, if H allows a foreign tax deduction its tax take is $t_h (1 - t_f) r_f$ which exceeds $(t_h - t_f) r_f$ raising H's share of the tax revenues on FI. The new equilibrium is point b; capital flows from F to H. The net loss to F is area 1 + 2 in tax revenues (since 3 + 4 + 5 would have been repatriated to H in any case). H gains an extra area 2 (3 + 4 are simply redistributed from home investors to H's treasury). World welfare falls by area 1, but H's national welfare is higher because of the capital inflow induced by the foreign tax deduction.

A second rationale for substituting a foreign tax deduction for a tax credit is the monopoly tax argument, also known as the inframarginal capital argument.¹⁴ This is simply the terms of trade argument from the home country's viewpoint. If H's capital exports bulk large in F's total capital stock, existing or inframarginal capital suffers a loss wherever new FI occurs. H can exploit its monopoly power by restricting capital outflows to the point where the marginal benefit from FI equals the marginal cost. In Figure 3, assume the initial no-tax equilibrium is point d and an inflow of FI moves the equilibrium to point a. H's return on investments abroad falls from area 2 + 4 + 6 (the "producer surplus") to area 4 + 5 + 6. Area 2 is the inframarginal capital loss transferred to labour in F, whereas area 5 is the investors' gain from the FI inflow. Private investors look only at area 5, ignoring area 2 and investing too much capital in F. A home tax on capital outflows restricting FI can raise H's welfare if the TOT gain exceeds the deadweight loss.

C. The Problem of Tax Deferral

From the viewpoint of maximizing global welfare, the classic literature on international tax implies that horizontal fiscal coordination should be based on international equity and neutrality. Residence countries should grant full credit for foreign taxes,

¹³See *supra*, note 1.

¹⁴See A.E. Jasay, "The Social Choice between Home and Overseas Investment" (1960) 70 *Econ. J.* 105; and M.B. Krauss, "Taxes on Capital in a Specific Factor Model with International Capital Mobility" (1979) 11 *J. Pub. Econ.* 383.

ensuring that pre-tax returns are not disturbed, capital export neutrality is maintained, and individuals are treated equally regardless of the source of their income. In practice, the recommendation is to credit only to the extent that $t_h > t_f$; otherwise, F would raise its taxes and rob H's treasury. The above is predicated on the assumption that investors cannot shift or avoid taxes; if shifting or avoidance occurs, even tax harmonization cannot achieve global neutrality or equity, so that the optimal tax policies may differ.¹⁵

There is one major exception to the above: the tax treatment by H can vary for foreign branches and subsidiaries. Income earned through a foreign branch is usually subject to current taxation by H; subsidiary income is normally deferred and taxed by H only when repatriated. Early writers recognized that tax deferral affects global neutrality.¹⁶ Depending on the dividend remittance ratio (δ), the effective rate of tax on foreign-source income (t^ϕ) is a weighted average of the home and host rates: $t^\phi = t_f + \delta (t_h - t_f) = (1 - \delta) t_f + \delta t_h$. If $\delta = 0$ (complete deferral), $t^\phi = t_f$ so that capital import neutrality prevails; if $\delta = 1$ (no deferral) $t^\phi = t_h$ and capital export neutrality prevails; neither is achieved with incomplete deferral. The incentive to defer occurs only when $t_f > t_h$, since if $t_f < t_h$ no additional tax is due in H in any case. The greater the gap between the tax rates, the larger the benefits of deferring taxes. In Figure 2, since $t_f < t^\phi < t_h$, deferral causes capital to flow from H to F, moving the equilibrium from point f to a point such as g, increasing the growth of FI, reducing capital growth at home, and causing a world deadweight loss. Shoup argues that delaying tax payments is equivalent to reducing the tax rate: "Since a delayed tax is a reduced tax ... if the delay lasts for, say, fifty years or more, the present value of the tax is reduced close to zero at usual rates of

¹⁵See *United States Taxation of Foreign Investment Income: Issues and Arguments*, *supra*, note 5 at c. 7; and Shoup, *supra*, note 1 at 296-98, 634-40, for detailed discussions of the impact of different shifting assumptions. Where business taxes are completely shifted forward to consumers, global neutrality requires that source rules should apply; H should completely exempt foreign earnings from taxation. This is also discussed in T. Horst, "A Note on the Optimal Taxation of International Investment Income" (1980) 94 *Q.J. Econ.* 793, in terms of demand and supply elasticities. He concludes that the optimal tax on foreign-source income should lie between exemption (too generous) and a full foreign tax credit (too restrictive).

¹⁶See Richman, *supra*, note 5; and Shoup, *supra*, note 1.

discount."¹⁷ Thus, if dividends are deferred long enough, deferral by H is equivalent to exempting foreign-source income from tax, moving the equilibrium to point e with a larger flow of capital to F.¹⁸

Let us now see how the classic literature on the international taxation of capital is reflected in the Carter *Report's* analysis and recommendations.

III. INTERNATIONAL EQUITY AND NEUTRALITY: THE CARTER COMMISSION VIEW

At the time of the *Report* (and up until the 1971 tax reform), the accepted international tax rules in Canada were similar to those outlined in the 1963 OECD *Model Tax Convention*, with some exceptions. Where Canada was the country of residence the taxes were: for foreign direct investment (FDI) through foreign branches, the corporate income tax (CIT) applied to all foreign profits on an accrual basis, with a credit for foreign profit taxes; for FDI through foreign subsidiaries, all earnings, whether distributed or not, were exempt from taxation of the parent company; for earnings from foreign portfolio investment (FPI) received by a Canadian corporation, the CIT applied, with credit for the foreign withholding tax. The distinction between FDI and FPI depended on the percentage of Canadian control of the foreign affiliate; greater than 25 percent Canadian control represented direct investment, and less than 25 percent, portfolio investment. When a corporation distributed its dividends, Canadian shareholders added the after-tax dividend to their income and were eligible for a 20 percent dividend tax credit against their personal income tax (PIT). The major exception to the

¹⁷ *Supra*, note 1 at 636-37, 323-24.

¹⁸ Arnold, *supra*, note 5 at c. 4, provides a good review of the arguments for and against deferral. He calculates (*ibid.* at 88-89) the effective tax rate for different time periods and interest rates; e.g., a one-year deferral at a 10% interest rate reduces the effective tax to 48.2% from 50%, a ten-year deferral to 37.8%, and a twenty-year deferral to 33%. The higher the interest rate, the lower the tax. See also *United States Taxation of Foreign Investment Income: Issues and Arguments*, *supra*, note 5; *Direct Investment Abroad and the Multinationals: Effects on the United States Economy*, *supra*, note 5; Bergsten, Horst & Moran, *supra*, note 5 at c. 6; and Breaun, *supra*, note 5.

OECD model was exemption of foreign-source dividends from home country taxation; in most industrialized countries tax deferral with credit to the level of the home country tax applied.

Where Canada was the country of source, the major taxes on non-residents were CIT and withholding taxes. Permanent establishments were taxed at the CIT rate of 50 percent plus a 15 percent withholding tax for an effective rate of 57.5 percent (withholding taxes were levied net of CIT). Foreign-owned branches in Canada paid a 15 percent special after-tax branch tax in lieu of the withholding tax. Non-resident-owned investment corporations paid a flat 15 percent tax, while foreign-controlled corporations were exempt from taxation on dividends. Due to its concern about the benefits from FI inflows, Canada followed the 1963 OECD *Convention* but refused to sign clause 4, the non-discrimination clause. Canada signed draft article 24, clause 1, which limits discrimination on grounds of nationality. Clause 4, however, was more restrictive, since it required that host taxes be no less favourably levied on non-resident establishments than on other enterprises; although it did not obligate host countries to grant non-residents the same tax preferences granted to residents.¹⁹ Canada therefore did not directly discriminate against non-residents, but used the tax structure to restrict tax preferences to residents.

The *Report* bases its recommendations on normative principles²⁰ designed to apply the Commission's standards of equity and neutrality in international taxation. The tax principles involve using a pragmatic approach that: first, increases the net benefits to Canada from international capital flows without impeding these flows; second, minimizes the use of tax deferment and tax havens; and third, gives some recognition to foreign taxes in determining Canadian taxation of foreign-source income.

¹⁹ See C.P.F. Baillie, *International Taxation and the Carter Report* (Ontario: CCH Can. Ltd., 1967); R.M. Bird & D.J.S. Breaun, "Canada/U.S. Tax Relations: Issues and Perspectives" in D. Fretz *et al.*, eds, *Canada/United States Trade and Investment Issues* (Toronto: Ontario Economic Council, 1985); H.J. Stitt & S.R. Baker, *International Tax Planning and the Carter Report* (Ontario: CCH Canadian Limited, 1967).

²⁰ These are mislabelled as "assumptions" in the *Report*, *supra*, note 4 at 483-84.

The stated major objective of the Carter Commission²¹ is tax neutrality, on the grounds that it contributes most to efficiency and is a prerequisite for equity. The *Report* defines *international neutrality*²² as occurring when the ratio of expected after-tax to before-tax returns is constant for each individual, so that the tax system does not distort before-tax returns between countries. This is the definition of global neutrality in Part II. The *Report* argues that neutrality requires tax harmonization between nations so that each individual is unaffected, from a tax viewpoint, by citizenship, residence, and the locations of property, business, and employment. All countries must provide the same public expenditures mix; finance with the same taxes at the same rates; avoid, shift, and adjust the taxes simultaneously; and tax each individual on worldwide income, defined uniformly, at the same rate as if all income were earned in the country of residence, with all countries having the same rates. The *Report* argues that none of these criteria are likely to be met in practice and that therefore international neutrality cannot be achieved.²³ Even if tax harmonization were possible, the Commission notes that tax revenues must still be allocated between source and destination countries (that is, the inter-nation equity issue), and in a world of other distortions international neutrality may not be a sensible goal (based on the theory of second-best). Thus, the Commission argues that Canada should pursue its own self-interest, be able to retaliate against foreign barriers, and not eliminate all its own tax barriers.

The Commission defines international equity²⁴ in terms of individuals on the ground that only individuals pay tax. Where Canada is the country of destination, equity requires that all foreign-source income received by Canadian residents, however earned, be subject to Canadian taxation on the same basis as domestic income. This is the international individual equity principle of Part II. The

²¹*Ibid.* at c. 26.

²²*Ibid.* at 491-96.

²³See, however, *ibid.* at 578, note 2.

²⁴*Ibid.* at 503-05.

Commission argues that the ability to defer tax and retain income in tax havens is inequitable and should be minimized, since both are equivalent to reduction or avoidance of home-country taxation.

As to international neutrality the *Report* concludes that the important question is the extent of the foreign tax credit. The Commission rejects full crediting because "every resident of Canada enjoys some public benefits and should bear some of the Canadian tax burden of providing these benefits and because the resident should be made aware that foreign investment imposes a revenue loss on Canada. For, from a restricted point of view, if the before-tax return on a Canadian investment is greater than the after-foreign-tax return on a competing foreign investment, Canada loses the amount of the differential if the foreign investment is undertaken."²⁵ This is a clear statement of the national neutrality principle of Part II. The Commission also argues that full crediting is too complex and that it would multiply the number of companies affected by the tax without providing much tax revenue. The *Report* states that the economic benefits to Canada of outgoing FI are uncertain and probably small; however, since Canada receives benefits such as tax revenue from incoming FI, failing to provide a foreign tax credit might lead to foreign retaliation and large losses (the reciprocity argument). The Commission therefore recommends a modified version of international neutrality, on the grounds of increasing Canada's benefits from FI abroad, simplicity and feasibility.

International equity where Canada is the host country is impossible to achieve, according to the *Report*,²⁶ because non-resident income cannot be taxed on the same basis as residents' without defining a comprehensive non-resident income base. The Commission argues that this is impractical and likely to cause retaliation, and therefore rejects equity for non-residents. On neutrality grounds, the Commission considers two alternatives: a uniform tax rate on all types of Canadian-source income, and different rates on different types. The first reduces avenues for tax avoidance; the second makes use of credits where Canadian taxes are

²⁵*Ibid.* at 506-07.

²⁶*Ibid.* at 537-38.

creditable against foreign taxes (this is the first-crack argument). Since lowering rates would reduce Canada's benefits from FDI without lessening overall taxes on non-residents, the *Report* argues that tax rates should be raised where creditable abroad. Different rates should remain but the differentials should be reduced in order to improve efficiency and minimize tax avoidance.

A. *Specific Recommendations for Canada as the Country of Residence*

The Commission's chief recommendations and justifications on the grounds of international equity and neutrality²⁷ can be summarized as follows. First, the definition of FDI is reduced from a 25 to a 10 percent Canadian interest in a non-resident corporation, business or property. All FDI income is subject to at least a 30 percent tax floor on an accrual basis, even if no dividends are remitted from abroad. The Commission argues that this proposal reduces the benefits from tax havens and deferral, and the gap in tax treatment between branches and subsidiaries. Second, the tax exemption for foreign dividends received by a resident corporation is withdrawn and replaced by an arbitrary tax credit of 30 percent when repatriated. No additional Canadian tax is due, however, until the dividends are distributed to shareholders. At that time a 20 percent withholding tax is levied on the corporation, so that 30% + 20% = 50% is creditable against the shareholders' tax. The Commission argues that this proposal eliminates tax avoidance through tax havens, reduces the significance of the foreign tax mix, simplifies computations and reduces uncertainty. The 30 percent rate gives Canada some revenue from foreign-source dividends without affecting the taxes paid by most Canadian shareholders.

We can explain the Carter proposal as follows. The tax on FDI on an accrual basis is $t_f + (30\% - t_f) = t_f + A$ where $A > 0$. An extra withholding tax is levied on the corporation when foreign-source dividends are distributed to resident shareholders.

²⁷ *Ibid.* at 486-91.

The effective CRT rate for the corporation is:

$$t^\phi = t_f + A + \phi (100\% - t_f - A) (20\%) / 70\% \quad (1)$$

where $A > 0$ and where ϕ is the proportion of foreign income, grossed up by 30%, that is distributed to Canadian shareholders. This is very different from the existing tax treatment in Canada, where $t^\phi = t_f$ because foreign subsidiary income is exempt from taxation. Where $t_f > 30\%$ and $\phi = 0$, however, the Carter proposal is identical to tax exemption, because $t^\phi = t_f$ in that case. Where $t_f = 50\%$ and $\phi = 1$ so that all earnings are distributed, $t^\phi = 50\%$ under the current exemption rules and 64.29% under the Carter proposal. The proposal thus encourages reinvestment of earnings rather than distribution to shareholders in order to avoid the extra 20 percent tax. For example, assume \$200 of foreign-source income is earned abroad and the foreign tax is 50 percent. Then dividends of \$100 are repatriated. Under the current rules the Canadian tax is zero, leaving the corporation with \$100. Under the Carter proposals the corporation has \$100 until it distributes the income to shareholders, leaving the corporation with \$71.43. Reinvestment at home therefore saves 20 percent in distribution tax.

This is quite different from the United States and the United Kingdom rules, where the tax is $t^\phi = t_f + \delta (t_h - t_f)$. Comparing the current Canadian, U.S., and Carter tax rates on the corporation, we see that the effective tax rates depend on t_h and t_f , the tax floor and distribution ratio ϕ under Carter, and the dividend remittance ratio δ under U.S. rules. This is illustrated in Figure 4. The ray OA represents the tax exemption for subsidiaries under the current Canadian rules, and the line BC the effective tax on branches under the Canadian rules (full accrual plus gross-up and credit). The U.S. rule lies in the area OBC and then along the ray CA, depending on tax deferral. The Carter proposal for branches and subsidiaries has a floor of DF and lies within the area AFDBHG, depending on the distribution ratio. It is clear that the Carter proposal generates the

highest taxes for $t_f > 30\%$ and $\phi = 1$; the current Canadian subsidiary rule the lowest for $\delta > 0$.²⁸

Taxation of Foreign-Source Income in Canada, the United States (pre-1971) and the Carter Commission Report

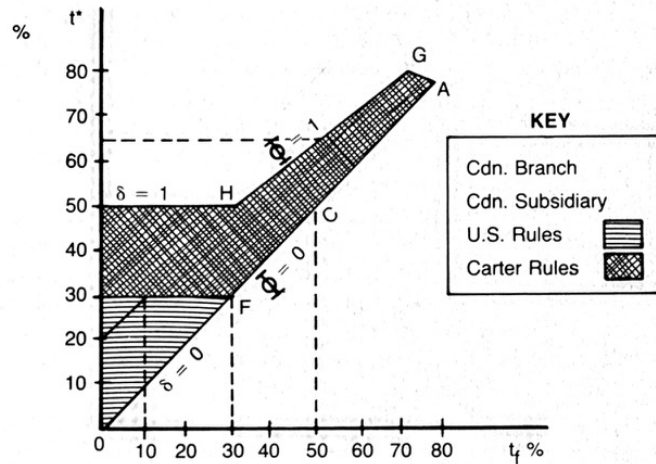


Figure 4

However, the Carter Report emphasizes equity in terms of the Canadian shareholder, not the corporation. Thus the extra 20 percent does not matter, since it is creditable against the shareholder's PIT. The effective shareholder's tax t_s is $t_p - 30\% - 20\% = t_p - t_h$ where $t_h = 50\%$ and t_p is the shareholder's PIT rate. Under current rules $t_s = t_p - 20\%$, since 20% of after-tax dividends

²⁸Under the Carter Commission recommendations there would have been tax payable of at least 30% (DF) on income in tax havens. If the Commission had recommended a full credit instead of 30%, HG would be parallel to FA, with the gap depending on the payout ratio times 20%. In the case of a subsidiary, the difference between the tax payable under the Carter recommendations and under the U.S. rules is the area ODF. However, since U.S. rules do tax passive income under Subpart F, this difference is more apparent than real.

can be credited against the personal income tax. Suppose $t_p = t_f = 50\%$; then the current tax method yields $t_s = 30\%$, whereas the Carter proposal yields $t_s = 0\%$. Using our previous example, the shareholder is left with $\$100 - [(.5 - .2) \$100] = \$70$ under the current method; and $\$71.43 - [\$71.43 / .5 (.5 - .5)] = \71.43 under the Carter method; a two percent gain. Thus, from the Canadian shareholder's point of view, the Carter proposals are more favourable than the current method. In the United States, dividends received by the shareholder are double-taxed, since no credit is given for the underlying corporate income tax; therefore $t_s = t_p$. Using the above example, the shareholder is left with $\$100 - .5 (\$100) = \$50$.

Thus, for the corporation, the Carter proposals markedly increase taxes on income earned in tax havens and income distributed to shareholders. Distributions are likely to be discouraged in order to avoid the tax; however, the problem of deferral discouraging remittances from abroad, which occurs under the U.S. and the U.K. rules, does not arise. For Canadian shareholders the proposals are more beneficial than the current rules. If corporations are widely held, the effect on the CIT probably has more influence; whereas closely-held businesses that regularly distribute earnings may place more weight on the PIT changes. Thus, the effects could differ depending on the ownership and distribution policies of the firm.

B. Specific Recommendations Where Canada is the Country of Source

1. The benefits from integration of the CIT and PIT are not extended to non-residents; they continue to pay the CIT and withholding taxes.
2. The statutory withholding tax on interest and royalties is raised to 30 percent, except where reduced by treaty. The Commission's rationale is that this reduces the variety of tax rates, raises tax revenue on income in tax havens, and is unlikely to cause retaliation because the statutory U.S. rate is also 30 percent.
3. An additional withholding tax is levied on service payments deductible against the CIT. The Report argues that this is the only tax levied by Canada on fees for services rendered in

Canada by non-residents; that the tax is useful in treaty negotiations; and that it has minimal effect on corporations because it is creditable against foreign taxes.

4. The current 15 percent withholding tax on dividends remains and a reduction to 10 percent is offered in tax treaties on the ground that higher rates might not be creditable against foreign taxes, thus discouraging FDI in Canada.
5. The foreign business corporation through which foreigners are incorporated in Canada and exempt from Canadian tax under section 71 is "openly discriminatory," "favouring international tax avoidance"²⁹ and should be eliminated. The non-resident-owned investment corporation, another loophole, should be eliminated.

The overall thrust of the recommendations is, therefore, to discriminate in favour of residents (by denying integration to non-residents) and to increase Canadian taxes on non-residents where the taxes are creditable abroad.

IV. CRITICISMS OF THE CARTER COMMISSION PROPOSALS

A. *International Equity and Neutrality*

General attacks on the international equity and neutrality concepts in the *Report* can be found in Stitt and Baker³⁰ and Baillie.³¹ Mieszkowski³² specifically attacks the Commission for stressing neutrality as a domestic objective but disregarding it for international investment. He argues that Carter's neutrality conditions are too restrictive; full crediting and removal of deferral guarantees that taxes are globally neutral. Disregarding neutrality can lower Canadian welfare since, if Canada does not provide a full

²⁹*Report, supra*, note 4 at 558.

³⁰*Supra*, note 19.

³¹*Ibid.*

³²P. Mieszkowski, "Carter on the Taxation of International Income Flows" (1969) 22 *Nat. Tax J.* 97.

foreign tax credit, the United States and United Kingdom are likely to retaliate by limiting their tax credits on investments in Canada. Mieszkowski also argues that the Commission's emphasis on individual equity is misplaced because the equity principles developed for domestic tax policy cannot be applied internationally: horizontal equity is impossible because foreign taxes are imposed on corporations, and vertical equity is impossible because investors are unaffected by host taxes if credits are available in resident countries. He concludes that Canadian tax policy should emphasize redistribution between countries, that is, inter-nation equity, since if full crediting is provided allocative effects are eliminated, leaving distribution as the sole policy issue.

Williamson is more negative than Mieszkowski. He contends that³³ "a major theme of the Commission's recommendations might be termed soak the nonresident" since an estimated \$222 million rise in tax revenues is based on a fall in taxes on residents of \$49 million and an increase on non-residents of \$271 million. The Commission's strategy is to tax non-residents up to the point where "foreigners are not quite deterred from investment in Canada and where foreign governments are not quite provoked to retaliating." He argues that this strategy is plausible but dangerous given Canada's stake in international flows.

B. *Tax Floor on Foreign-source income*

Davies³⁴ argues against the proposal for a 30 percent minimum tax on an accrual basis on the grounds that exemption under section 28(1)(d) is a "brilliant invention by the Canadian tax administration to save a great deal of work at a very low tax cost," and should be retained. Stitt and Baker³⁵ contend that partial accrual places Canadian MNEs at a disadvantage compared with other firms abroad since either the Canadian parent must pay the tax out

³³J.P. Williamson, "International Aspects - I" in *Proceedings of the 19th Tax Conference - 1967* (Toronto: Canadian Tax Foundation, 1967) 180 at 180.

³⁴A.G. Davies, "International Aspects," *ibid.* 189 at 192.

³⁵*Supra*, note 19.

of domestic earnings or repatriate foreign profits sufficient to pay the tax. Break³⁶ argues that the tax floor is a compromise between full accrual at Canadian rates and taxation on a cash basis only, which would fail to distinguish between tax haven operations and genuine investments in low-tax countries. Peggy Musgrave³⁷ notes that the choice between full accrual and tax exemption to achieve international neutrality depends on the shifting of the CRT. If the CRT is not shifted, the appropriate treatment is taxation on an accrual basis by the residence country, with full foreign tax credit. Since Carter assumes no shifting of the CRT, Musgrave concludes that the Commission's proposal to tax foreign income on an accrual basis goes further towards the neutrality goal than the U.K. and U.S. rules, which have neither full accrual nor refunds for excess credits. However, if the CRT is fully shifted everywhere, the exemption of foreign-source income by H is consistent with neutrality and the Carter proposals are non-neutral.

C. Tax Ceiling on the Dividend Tax Credit

Mieszkowski³⁸ argues that the Commission's rationales for the 30 percent foreign credit limit are not convincing since full crediting is administratively possible and the potential revenue loss can be recouped through other taxes. He believes the departure from neutrality is of minor importance practically but a serious compromise with principle, because Canada has received considerable benefit from U.S. adherence to neutrality and Canada should reciprocate. Stitt and Baker³⁹ and Break⁴⁰ argue that the 30 percent credit ceiling penalizes companies with subsidiaries in high-tax countries, since taxes above 30 percent are not creditable, making

³⁶G.F. Break, "The Report of the Royal Commission on Taxation and Economic Policy in Canada" (1968) 16 Can. Tax J. 229.

³⁷"An Economic Appraisal," *supra*, note 5.

³⁸*Supra*, note 32.

³⁹*Supra*, note 19.

⁴⁰*Supra*, note 36.

the return on FDI less than that on domestic investments. This can force subsidiaries to locate in tax havens in order to avoid double taxation. Smith comments that the "discriminatory tax penalty imposed by Canada against foreign source income ... [reflects] a reluctance to give a refund to Canadians for taxes paid by foreign subsidiaries to foreign governments."⁴¹ He expects Canadian companies at a disadvantage abroad to change residence and foreign countries to retaliate by withdrawing full credit for Canadian taxes. Break⁴² also emphasizes the potential negative impact on behaviour of managers of large corporations with FDI in high-tax countries; however, since foreign profits reinvested abroad are subject to no more taxes than they are currently and effective foreign tax rates are well below statutory rates, he concludes that the effects may not be severe. Break notes that 30 percent is the average Canadian shareholder's PRT tax rate on foreign-source income. Both Break and Richard Musgrave⁴³ argue that the Commission focuses on the shareholder rather than on the corporation. Musgrave concludes that the absolute foreign shareholder burden is little changed, but that the relative burden is substantially increased.

Given the negative comments above, the favourable review provided by Musgrave⁴⁴ is perhaps surprising. She computes the shareholder's after-tax income from domestic investment as a ratio of after-tax FI income: that is, $z = (1 - t_h) r_h / (1 - t^f) r_f$. If $z = 1$ the tax structure is neutral; $z > 1$ implies that the domestic investment is favoured and vice versa for $z < 1$. z also measures individual equity. If $z = 1$, international equity is satisfied; if $z < 1$, the tax on FI is too light; if $z > 1$, the tax is too heavy. Assuming the CRT falls wholly on capital with full distribution of earnings to shareholders and a 15 percent withholding tax, z is

⁴¹D.T. Smith, "The Report of the Royal Commission on Taxation: A Critique" in International Nickel Co. of Canada, Ltd., *An Examination and Assessment of the Report of the Royal Commission on Taxation* (Submission to the Minister of Finance, 29 September 1967) [unpublished] at A1.

⁴²*Supra*, note 36.

⁴³R.A. Musgrave, "The Carter Commission Report" (1968) 1 Can. J. Econ. 159.

⁴⁴"An Economic Appraisal," *supra*, note 5.

calculated as in Table 1.⁴⁵

Table 1

Type of Foreign Investment by a Canadian Corporation	Current Rules		Carter Proposals	
	$t_f = .5$	$t_f = .25$	$t_f = .5$	$t_f = .25$
Foreign branch	1.00	1.00	1.4	1.1
Foreign subsidiary in tax treaty country	1.18	0.78	1.4	1.1
Foreign subsidiary in non-tax treaty country	1.18	0.78	1.4	1.1
Corporation with foreign portfolio investment (individual investor with FPI)	2.00	1.33	1.4	1.1
	2.80	1.87	1.4	1.1

Musgrave argues that the Carter proposals score higher than the pre-reform rules because the size of the inequities is generally smaller and all forms of investment are treated more uniformly than the current system. Note that Musgrave's results are partly due to assuming 100 percent distribution; however, as Figure 4 and Smith⁴⁶ show, a widely-held corporation may have an incentive to avoid the extra 20 percent tax by not distributing its earnings to shareholders.

D. Failure to Provide Non-discrimination for Non-residents

Limiting the integration of the CIT and PIT to Canadians means that non-residents pay a 50 percent CIT plus a 15 percent withholding tax for an effective tax of 57.5 percent, while Canadians are taxed at their PIT rate. Williamson⁴⁷ contends that denying integration to non-residents violates the OECD non-discrimination clause. United States MNEs electing to use the overall limitation may be able to offset the extra tax, but MNEs operating in high-tax countries or using the per-country limitation face an extra tax burden. Small subsidiaries also suffer from the abolition of the 21

⁴⁵*Ibid.* at 318.

⁴⁶*Supra*, note 41.

⁴⁷*Supra*, note 33.

percent CIT rate on the first \$35,000 of taxable income. Smith⁴⁸ argues the contrary, that denying integration relief to non-residents does not violate the OECD *Convention*. Peggy Musgrave⁴⁹ concludes that non-integration increases non-resident taxes, raises the Canadian benefits from FI, and does violate the non-discrimination and reciprocity principles. However, "reciprocity need not spell uniformity"⁵⁰; non-integration can be justified by the inter-nation equity principle, since high withholding taxes are allowable where host CIT rates are low.

Mieszkowski⁵¹ argues that non-neutrality can be justified by Canada's status as a SOE since its policies cannot affect world efficiency. He sees the basic objectives of the *Report* as changing the form of foreign ownership from equity to debt, and increasing the Canadian share of equity in Canadian business. However, the Commission cannot achieve this through non-integration if full tax credit is given abroad; Canada simply ends up with a larger proportion of tax revenues without affecting capital inflows.⁵² This is an example of the first-crack principle that a SOE host country should raise its tax up to the creditable level in H since this transfers revenue from H to F without affecting global neutrality. Mieszkowski argues that retention of CIT and withholding taxes for non-residents is a distributive matter affecting government treasuries, not an allocative matter, and if home countries believe Canada receives too large a share of the benefits from FI, this inter-nation equity issue should be discussed separately from the *Report*.

Harberger⁵³ approaches this topic from the opposite angle, asking what would happen if Canada did provide full integration and

⁴⁸*Supra*, note 41.

⁴⁹"An Economic Appraisal," *supra*, note 5.

⁵⁰*Ibid.* at 326.

⁵¹*Supra*, note 32.

⁵²See also R.A. Musgrave, *supra*, note 43.

⁵³A.C. Harberger, "In Defense of Carter: A Personal Overview" (1969) 22 *Nat. Tax J.* 164.

repealed its CIT for non-residents. If the residence country taxes on an accrual basis, there is no allocative impact, although Canada's treasury loses while the home treasury gains. However, if the home country defers taxes until repatriation, Canada in effect becomes a tax haven, attracting FI by MNEs avoiding the home tax. Harberger argues there would be a massive inflow of FPI since Canada would not receive the full income tax on corporate savings and goodwill gains. This is equivalent, in Figure 2, to assuming t_f falls and δ is close to zero so that the equilibrium moves substantially closer to point h as capital flows from H to F. Hence, he concludes that granting non-residents the full benefits of integration would be disastrous if investors can defer taxes on foreign-source income.

E. Higher Withholding Taxes on Capital Outflows

The comments on higher withholding taxes are uniformly negative. Williamson⁵⁴ argues that the proposal to raise treaty rates above 15 percent is likely to provoke retaliation and reduce FDI in Canada. He prefers a statutory rate of 30 percent on all non-resident payments, since this provides an incentive for other countries to negotiate treaties with Canada. Break,⁵⁵ Mieszkowski,⁵⁶ and Smith⁵⁷ all stress that the Commission's reasons for raising the withholding rate on interest from 15 to 30 percent are weak, may double existing burdens, and may cause firms to shift capital elsewhere. Smith says that when the Commission assumes the tax is fully creditable abroad it ignores that tax credits are related to net, and not gross, income and that therefore the actual credit is less than the withholding tax. He also argues that the proposed 10 percent tax on payments made from Canada for services rendered outside of Canada is unlikely to be creditable abroad since normally

⁵⁴Supra, note 33.

⁵⁵Supra, note 36.

⁵⁶Supra, note 32.

⁵⁷Supra, note 41.

the income source is where the services are rendered, rather than where payment originates.

F. Summary of the Critiques

The main criticism appears to be that the Commission's proposals do not follow international neutrality and equity rules. Its nationalistic proposals fail to provide the standard foreign tax credit, on the ground that Canada receives little benefit from FI abroad. This raises the tax burden on Canadian investors abroad and may reduce the FI outflow. Non-residents do not receive integration benefits, and face higher withholding taxes. Non-discrimination is less of a problem than the withholding taxes, which are unlikely to be creditable against home country taxes. Thus, the proposals are designed to increase Canadian taxes from both capital inflows and outflows. In Part V, we turn to recent work on international taxation and its implications for the Carter proposals.

V. NEW PERSPECTIVES ON INTERNATIONAL EQUITY AND NEUTRALITY IN TAXATION

A. Taxing for Monopoly-Monopsony Gain

The classic literature on national equity and neutrality implies that either H or F can gain from individually raising its tax on FI. This conclusion still holds in recent work, although the optimal rate is unclear. First, the optimal capital tax for the host country is also affected by F's ability to influence world commodity prices through trade taxes. Bade⁵⁸ gives an early view, showing that host country welfare requires coordination of tariffs and taxes on FI. Brecher and Bhagwati⁵⁹ show that various trade policies may cause domestic

⁵⁸R. Bade, "Optimal Foreign Investment and International Trade" (1973) 49 Econ. Rec. 62.

⁵⁹R.A. Brecher & J.N. Bhagwati, "Foreign Ownership and the Theory of Trade and Welfare" (1981) 89 J. Pol. Econ. 497.

welfare gains but national welfare losses in the presence of foreign ownership. The links between tariffs and capital taxation are explicitly modelled in Miyagiwa and Young,⁶⁰ and Casas.⁶¹ Second, Das⁶² shows that if capital movements are sluggish, even a capital-importing SOE that cannot credit its taxes in H may profit from raising taxes on non-residents. In the short run, F can improve its welfare by the revenue transfer from H to F; in the long run, as capital mobility increases, this gain disappears and F suffers a welfare loss.

Figure 1 illustrates this where the short-run gain is area 4 and the long-run loss is triangle acd. Depending on F's rate of time preference, the optimal tax may be positive even though F is a SOE. Thirsk⁶³ offers some support for the Das hypothesis, modelling Canada as a capital importer with some monopoly power in international capital and goods markets. He calculates the welfare effects on Canada of raising its CIT, finding an overall welfare gain if the foreign export demand elasticity is -1 and the capital supply elasticity zero, assuming Canadian taxes are fully creditable abroad. However, as elasticities rise (to a maximum of -6 and 3), the net gain shrinks and would turn negative with higher elasticities.

The optimal capital tax for the home country is also less clear. Feldstein and Hartman⁶⁴ show that the home country's optimal tax depends on whether host countries choose their tax rates conditional on t_h , the impact of t_h on host wage rates (the inframarginal capital argument), and whether subsidiaries can borrow

⁶⁰K. Miyagiwa & L. Young, "International Capital Mobility and Commercial Policy in an Economic Region" (1986) 20 J. Int'l Econ. 329.

⁶¹F.R. Casas, "Tariff Protection and Taxation of Foreign Capital: The Welfare Implications for a Small Country" (1985) 19 J. Int'l Econ. 181.

⁶²S.P. Das, "Optimal Taxation of Foreign Capital When its Movements are Sluggish" (1986) 21 J. Int'l Econ. 351.

⁶³W.R. Thirsk, "Corporate Taxation in Canada" (1986) 41 Pub. Fin. 78.

⁶⁴M. Feldstein & D. Hartman, "The Optimal Taxation of Foreign Source Investment Income" (1979) 94 Q.J. Econ. 615.

locally. All three affect t_h positively. Hartman⁶⁵ extends this to include effects of foreign subsidiary production where the MNE possesses a firm-specific advantage in technology.⁶⁶ The optimal capital tax depends on the capital intensity of the subsidiary's product and whether it is F's export or import. If both countries are large, FDI can change relative commodity prices, giving H another channel through which taxes can raise welfare. The effects of U.S. tax changes on capital flows are investigated in several papers, starting with Musgrave;⁶⁷ Horst;⁶⁸ Murray;⁶⁹ Frisch;⁷⁰ Ballard, Fullerton, Shoven and Whalley;⁷¹ and Mutti and Grubert.⁷² These

⁶⁵D.G. Hartman, "The Effects of Taxing Foreign Source Investment Income" (1980) 13 J. Pub. Econ. 213.

⁶⁶Most work on FI implicitly deals with FPI, which is fungible and in perfectly elastic supply from abroad. FDI, on the other hand, is a package of capital, technology, and managerial skills that is not readily transferable between industries. Little work has been done modelling FDI in the international tax literature. For example, the possibility of complementarity between K_h and K_f is not considered, nor have the impact of technology, intra-firm trade flows, joint costs, *et cetera*, been discussed. The Hartman paper is one of the few to model FDI. See also M.B. Stewart, "U.S. Tax Policy, Intrafirm Transfers, and the Allocative Efficiency of Transnational Corporations" (1986) 41 Pub. Fin. 350, which incorporates production into the Horst model. (T. Horst, "American Taxation of Multinational Firms" (1977) 67 Am. Econ. Rev. 376.) Much more work remains to be done before a satisfactory theory of the international taxation of FDI flows is developed. Until then, the policy implications of these models must be taken with a large dose of salt.

⁶⁷*United States Taxation of Foreign Investment Income: Issues and Arguments*, *supra*, note 5; *Direct Investment Abroad and the Multinationals: Effects on the United States Economy*, *supra*, note 5.

⁶⁸*Supra*, note 66.

⁶⁹J.D. Murray, "The Tax Sensitivity of U.S. Direct Investment in Canadian Manufacturing" (1982) 1 J. Int'l Money & Fin. 117.

⁷⁰D. Frisch, "Issues in the Taxation of Foreign Source Income" in M. Feldstein, ed., *Behavioural Simulation Methods in Tax Policy Analysis* (Chicago: University of Chicago Press, 1983) 289.

⁷¹C.L. Ballard *et al.*, *A General Equilibrium Model for Tax Policy Evaluation* (Chicago and London: University of Chicago Press, 1985) at c. 11.

⁷²J. Mutti & H. Grubert, "The Taxation of Capital Income in an Open Economy: The Importance of Resident-Nonresident Tax Treatment" (1985) 27 J. Pub. Econ. 291.

instead of **H**, giving **F** a revenue transfer. Now assume **F** levies a tax higher than t_h so that the demand curve rotates down to $(1 - t_f) D_f$. Since **H** only credits up to t_h , the new equilibrium is point c and the capital stock in **F** contracts to κ_f . **F** suffers a loss in consumer surplus of area 2 + 3 and a net gain in tax revenue of area 2 + 6 - 7 - 8, for a net welfare change of 6 - 3 - 7 - 8. Area 3 is the deadweight loss from output contraction; area 7 + 8 is the fall in the revenue transfer induced by taxing above the creditable level in **H**; and area 6 is the terms-of-trade gain from driving down the price of imported capital. **F** gains if the TOT gain exceeds the deadweight loss plus the decline in the revenue transfer. If **F** were a SOE, the optimal tax would be $t_f = t_h$ since the TOT gain disappears, leaving only losses. (Note that we assume s_d is perfectly inelastic; if κ_d and **FI** are substitutes, a further loss occurs as the CIT depresses domestic savings.) The welfare effect on **H** is a producer-surplus loss of area 4 + 7 plus a tax savings gain of area 7 + 8 + 4 - 6 for a net effect of 8 - 6 where area 8 is **H**'s revenue transfer savings and area 6 its terms-of-trade loss. World welfare falls by the deadweight-loss triangle ade .

B. The Problem of Tax Deferral

The classic analysis of tax deferral models the effective tax rate on foreign-source income as $t^{\phi} = t_f + \delta(t_h - t_f)$. Since the longer a dollar of tax is deferred the smaller its net present value (NPV), MNEs have an incentive to avoid repatriating dividends. Warren takes issue with this conclusion, arguing that NPV is unaffected by deferral "as long as the tax rate remains constant and the base of a deferred tax increases over time by the rate of return generally applicable to investment of proceeds available after payment of an accelerated tax."⁷⁶ He proves that investing A of pre-tax earnings at rate r for n years at tax rate t yields the same return $(1 - t) A [1 + r(1 - t)]^n$, whether the tax is paid now or in n years. For example, if $A = \$1000$, $r = 10\%$ and $t = 30\%$, paying the tax now leaves \$70 for investment which earns \$70 (1.07) = \$74.90 next year; whereas investing \$100 now and deferring the tax also earns

\$74.90. Thus, although the NPV of one dollar of tax goes to zero as n rises, if the tax base grows at the going rate the NPV of the tax obligation is constant.

We can apply Warren's analysis to the taxation of foreign-source income. It suggests that deferral should be irrelevant to the MNE since the NPV of the extra tax is the same. We can explain this as follows. Assume $A = \$1000$, $t_h = 50\%$, $t_f = 30\%$, pre-tax returns are equal at $r_h = r_f = 10\%$ and **H** credits foreign taxes on remitted income up to t_h . Investment in **H** yields $A (1 - t_h) r_h = \$50$; investment in **F** yields $A (1 - t_f) r_f = \$70$, which, if repatriated, earns $[(1 - t_h) / (1 - t_f)] [A (1 - t_f) r_f] = A (1 - t_h) r_f = \50 . The extra tax is \$20. If dividends are not repatriated but reinvested in **F**, next year ($n = 1$) the subsidiary has:

$$[A (1 - t_f) r_f] [1 + r_f (1 - t_f)]^n = \$74.90 \quad (2)$$

which, after repatriation, yields a net return of:

$$[A (1 - t_h) r_f] [1 + r_f (1 - t_f)]^n = \$53.50 \quad (3)$$

The additional tax due in the second period is $\$74.90 - \$53.50 = \$21.40$ or:

$$[A (t_h - t_f) r_f] [1 + r_f (1 - t_f)]^n = \$21.40 \quad (4)$$

which, in net present value terms, is still $\$21.40 / 1.07 = \20 . Thus, the home tax cannot be avoided through deferral unless tax rates or investment returns change. The return on a two-period investment in **H** is:

$$[A (1 - t_h) r_h] [1 + r_h (1 - t_h)]^n = \$52.50 \quad (5)$$

If the MNE had repatriated the subsidiary income in the first period and invested it in **H**, the net return is also \$52.50:

$$[A (1 - t_h) r_f] [1 + r_h (1 - t_h)]^n = \$52.50 \quad (6)$$

In general, the return from investing in **F** until year n , repatriating to **H** and reinvesting in **H** until year m is:

⁷⁶A.C. Warren, Jr., "The Timing of Taxes" (1986) 39 Nat. Tax J. 499 at 503.

$$[A(1 - t_h) r_f] [1 + r_f(1 - t_f)]^n [1 + r_h(1 - t_h)]^{\phi n} \quad (7)$$

Comparing (3) and (6), a one-period deferral yields a higher return than immediate repatriation (or compared with an investment in **H**, see (5)); thus the NPV of an investment is affected by deferral, contrary to Warren's example. This is because his second assumption, that the base increases by the same rate of return, is violated given that the second-period investment returns between **H** and **F** differ.

A similar point on the inevitability of the extra tax on repatriated income is made by Hartman,⁷⁷ who argues that a mature subsidiary (one with surplus funds for investing) should be indifferent to **H**'s tax treatment of repatriated profits since the extra tax is an unavoidable cost. Because foreign earnings must at some time bear the tax, the only question for the firm is where earnings can be invested to produce the highest net return. The timing of the tax payment is irrelevant. Thus, changes in t_h affect investments in **H** but are irrelevant for foreign investment and repatriation decisions; that is, the effective tax rate on **FI** is $t^{\phi} = t_f$. The comparison of (3) with (5) shows capital flowing from **H** to **F**, ensuring that $(1 - t_h) r_h = (1 - t_f) r_f$, so that capital import neutrality occurs. If $n = 0$, there is capital export neutrality; whereas for $n > 0$ there is capital import neutrality, as Hartman argues. Eliminating deferral for mature subsidiaries is equivalent to setting this year's n equal to the deferral n so that capital import neutrality remains. However, for immature subsidiaries with new investment flows from the parent to the subsidiary, eliminating deferral is equivalent to setting $n = 0$, and hence generating capital export neutrality. Raising **H**'s tax rate lowers the return from investing in **H** but does not affect the return from investing in **F** (compare (5) with (3) or (7)). Vice versa, raising **F**'s tax rate lowers the return on investments in **F** but does not affect returns in **H**. In all cases, the Hartman analysis appears to be correct. For mature subsidiaries the home tax rate and the presence or absence of a foreign tax credit do not affect foreign

⁷⁷D.G. Hartman, "Tax Policy and Foreign Direct Investment" (1985) 26 J. Pub. Econ. 107.

investment or repatriation decisions; the effective rate is the host country's rate. Hartman therefore concludes, like Shoup (although their analyses are very different), that "the distinction drawn between the territorial and residence approaches to taxation is much less important in practice than is commonly believed."⁷⁸

The implicit policy implication that emerges from the Hartman paper is that the primary tax affecting **FDI** decisions is the host **CIT** rate, not the home rate. This implies that tax deferral is equivalent to tax exemption by **H**; shifting the equilibrium in Figure 2 from point **f** (no deferral) to point **e** (tax exemption). Lowering t_f implies a revenue transfer loss under the first-crack argument but may lead to an inflow of **FDI** from other source countries, offsetting this loss. On the other hand, raising the host rate, even if it is creditable in the home country, can cause **FDI** outflows. Thus, the first-crack argument, implying that t_f should never be set below t_h , since lower tax rates do not affect **FDI** inflows but merely redistribute tax revenues from **F**'s to **H**'s treasury, does not hold for mature subsidiaries. Lower tax rates induce capital inflows as long as **H** allows tax deferral. Similarly, discrimination between resident and non-resident investors by **F**, even if the extra foreign tax is creditable, discourages capital inflows. Hartman's analysis also implies that the host withholding tax levied when income is repatriated has a similar impact on the home country tax; that is, it is irrelevant for mature subsidiaries. Hence, higher withholding taxes, even if not creditable by the home country, do not discourage subsidiary investment and repatriation decisions, and capital import neutrality is maintained. A host country should raise withholding taxes rather than **CRTS** to avoid deterring **FI**.

C. Strategic Behaviour

The classic analysis of international taxation assumes that capital flows in one direction from **H** to **F** and that the other country does not retaliate. These assumptions also hold in the newer papers discussed above. However, they can lead to disastrous policy recommendations, as shown by Hamada and Beenstock.

⁷⁸*Ibid.* at 120.

Hamada⁷⁹ models strategic behaviour by both **H** and **F**, arguing that bilateral monopoly is the likely result since **H** has an incentive to behave like a monopoly and **F** like a monopsony. Bilateral monopoly reduces welfare for both countries; however, a tax treaty spelling out good behaviour can achieve the joint maximization solution, although such treaties usually favour **F** on account of the source principle. He concludes that optimal tax policy should be modelled as a strategic game rather than from one country's point of view, to avoid misleading policy implications. In Figure 2, Hamada's point is illustrated, that both home and host countries can gain by shifting the returns from **F1** in their favour, but global welfare is lower; a tax treaty can reach the optimal solution (point a).

Beenstock⁸⁰ also demonstrates that strategic behaviour may not pay if both countries are large and own part of each other's capital stock so that **F1** flows in both directions. If **H** raises its tax on foreign-source income, its residents shift their investments from **F** to **H**. The outflow from **F** raises the pre-tax return in **F** and lowers it in **H** (compare points d and c in Figure 3). However, **F**'s investors also own capital in **H**. Since their investment return in **H** is now depressed relative to the return available in **F**, part of **F**'s capital invested abroad returns to **F**. The presence of **F**'s capital in **H** acts as a "fifth-column" capital outflow, partly offsetting the capital inflow. Because under the source principle **H** gets first crack at **F**'s investments in **H**, the induced "fifth-column" outflow cuts **H**'s tax revenue, partly offsetting its terms-of-trade gain from driving up **F**'s pre-tax return. If **H**'s returning capital inflow is matched by its "fifth-column" capital outflow, the net impact is zero. Hence, raising t_h to reduce outward **F1** is successful only if there is no offsetting "fifth-column" outflow of foreign investors. In Figure 3, this is equivalent to **H**'s tax causing a movement from point a to point d and then inducing an inflow of capital from **H** to **F**, shifting S_d to the right and moving the equilibrium back towards point a. Two-

⁷⁹K. Hamada, "Strategic Aspects of International Taxation of Investment Income" (1966) 80 Q.J. Econ. 361.

⁸⁰M. Beenstock, "Policies Towards International Direct Investment: A Neoclassical Reappraisal" (1977) 87 Econ. J. 533

way capital flows are explicitly modelled in Mutti and Grubert,⁸¹ who find that a non-discriminatory reduction in the United States **CIT** causes U.S. investors to return home from abroad, and foreigners also to increase their U.S. investments. A discriminatory **CIT** reduction (such as denying non-residents the benefits of integration of the **CIT** and **PIT**) causes an outflow of foreign investment and a repatriation of capital to the United States from abroad. The capital stock grows much less under a discriminatory tax cut than under a uniform tax reduction. They conclude that denying tax benefits to non-residents may be counterproductive for a large home country like the United States.

D. Implications for the Carter Commission Proposals

The Commission's international tax proposals can be analyzed using the results of the work outlined above. First, the monopoly-monopsony tax argument depends upon the revenue transfer; the deadweight loss from output contraction; and the terms-of-trade effects, both in capital and commodity markets. Second, for mature subsidiaries tax deferral implies that the host **CIT** rate is the crucial rate determining reinvestment decisions. Third, the bilateral capital flows and strategic bargaining, both home and host countries can lose from restricting capital flows. No complete analysis incorporating all three of the above factors has been done; so that the overall policy implications of the international taxation of capital are still ambiguous. We can, however, draw some general conclusions, from this literature, with respect to the Commission's proposals.

The implications for the Carter *Report* are sobering. The line between source- and residence-principle taxation is blurred in the new literature, making policy implications correspondingly ambiguous. As to the residence principle, since Canada is an **SOE** in the capital market, nationalistic policies can be supported if capital flows are sluggish or commodity **TOT** effects are large. In general, if Canada raises its tax rate on outward **F1** above the rates of its major trading partners it is likely to suffer a deadweight loss, with

⁸¹*Supra*, note 72.

minor offsetting gains. The Carter proposal for an immediate 30 percent tax floor on FI income partially eliminates deferral, raising the effective home tax rate on income abroad and reducing outward FI. The proposal to limit the foreign tax credit to 30 percent in order to increase Canada's net benefits from FI abroad also raises the home tax on FI income. However, the extra 20 percent tax may not deter distributions, since the net present value of the extra tax is unchanged by its timing. Given the small stock of mostly immature Canadian subsidiaries abroad whose investment decisions are influenced by the home tax rate, higher Canadian taxes on foreign-source income can discourage outward FI flows and profit repatriations. However, the reduction in outward FI, even if matched by new investments in Canada, is unlikely to generate a TOT gain sufficient to offset the deadweight loss; so that Canadian welfare falls. The likelihood of strategic behaviour and retaliation by foreign countries can lead to even worse results. The restricted tax credit is likely to backfire given the large stock of inward FI in Canada, inducing a "fifth-column" outflow that offsets any returning capital inflow. Similarly, if the United States and United Kingdom retaliate, the outflow would be even larger. In summary, the Carter proposals for residence taxes, especially the limitation on the foreign tax credit, could be a long-run recipe for disaster.

As to the source principle, even if capital flows are sluggish, the short-run gains from restricting capital inflows are likely to disappear as time passes and foreign elasticities increase. The optimal policy may be to set the tax at the creditable ceiling abroad, earning a revenue transfer but avoiding the deadweight loss involved if taxes are set above creditable levels. In some sense this is what the Carter Commission tried to do: raise withholding rates up to creditable levels and deny non-residents the benefits of integration. To the extent that $t^{\phi} < t_h$, the policy may have been successful. However, in the light of Warren's and Hartman's analyses, this policy must be reconsidered under deferral. With deferral, the newer literature shows that $t^{\phi} = t_f$; the important tax rate for investment decisions is the host-country CIT rate. Since Canada has a large stock of foreign-owned mature subsidiaries, the Carter proposal to deny non-residents the benefits of integration in effect raises the tax on FI and could depress the long-run capital stock. However, integration for non-residents could induce a substantial capital inflow,

as Harberger predicted.⁸² The proposals to raise withholding taxes may, on the other hand, not cause a capital outflow, since taxes on repatriated earnings cannot be avoided through deferral even if the taxes are not creditable. These conclusions must be further modified when strategic bargaining and retaliation are brought into the picture. If Canada raises taxes on non-resident earnings above creditable levels, the initial capital outflow is unlikely to be offset by any subsequent "fifth-column" inflow, given the small stock of Canadian investments abroad. A significant contraction in the capital stock could also occur if foreign countries retaliate. Strategic behaviour by other host countries (for example, lowering withholding taxes while Canadian rates are rising), or home countries (for example, denying full credit to Canadian investments abroad) could induce MNEs to shift investments out of Canada, causing further welfare losses.

Therefore, we conclude that the nationalistic emphasis of the Carter proposals, given the SOE nature of the economy, large two-way flows of FI and likely foreign retaliation, is a disastrous prescription that could significantly lower Canadian welfare. Any attempt to extract national gains at the expense of foreign countries is likely to backfire, causing long-run losses.

VI. CONCLUSION

Harberger called the Carter Commission *Report* a "landmark in the annals of taxation"; however, its recommendations on the international taxation of capital did not meet with the same support. In fact, most of the proposals were never implemented. Using the classic theory of international taxation we showed that the proposals follow nationalistic views of equity and neutrality, designed to shift FI benefits in Canada's favour. A review of the criticisms made after the *Report* showed that most tax experts had misgivings about the move away from international good manners, particularly with

⁸² *Supra*, note 53.

respect to the credit ceiling and higher withholding taxes, but expected Canadian income to increase.

However, recent literature calls this conclusion into question. With large two-way capital flows dominated by mature subsidiaries and probable retaliation, Canada could have suffered a significant welfare loss had these proposals been instituted. The step away from international neutrality could have been a costly one. Canada had, and has, much to lose from short-run nationalistic policies that ignore the long-run potential benefits of ensuring good behaviour by all countries in the international taxation of capital.

This is true now, more so than in the past, because Canada's traditional role as a net capital importer has been reversed, although the stock of inward investment still far exceeds the stock of outward investment.⁸³ Canada's international tax goals in the 1990s are likely to be less nationalistic as its self-perception as a SOE capital importer changes to reflect its new status as a net capital exporter. Thus, the need to emphasize the long-run potential from freer capital flows is more important today than when the Carter *Report* was first released.

Osgoode Hall Law Journal

ARTICLES

- | | |
|---------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------|
| Towards Longer Time Horizons
in Personal Taxation | DAVID SEWELL |
| Considerations for
the Tax Mix | BOB HAMILTON, CHUN-YAN KUO,
& SATYA N. PODDAR |
| The Impact of Changing Perceptions of Social
Equity on Tax Policy: The Marital Tax Unit | JACK R. LONDON |
| Taxing Corporate Income in the U.S. Twenty
Years after The Carter Commission Report:
Integration or Disintegration? | ALVIN C. WARREN, JR. |
| Politics, The Deficit and Tax Reform | DAVID A. WOLFE |
| Equity and Neutrality in the International
Taxation of Capital | LORRAINE EDEN |
| The Structure of the Sieve: Political Economy
in the Explanation of Tax Systems and Tax Reform | STANLEY L. WINER
& WALTER HETTICH |
| Should the Current Tax-Transfer System be Replaced
by a Flat-Rate Income Tax? | BERNARD FORTIN |

⁸³See Arnold, *supra*, note 5 at c. 2; Brean, *supra*, note 5 at c. 5.

VOLUME 26

NUMBER 2



SUMMER

1988