CHAPTER 26

INTERNATIONAL ASPECTS OF INCOME TAXATION

A major objective that we have sought in our proposals for the domestic tax system has been tax neutrality. A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of the goods and services Canadians want, and is also a prerequisite of an equitable tax system.

It will be evident by now that the economic and administrative realities of the practical world have forced us to accept compromises with true neutrality and equity in our domestic tax proposals. In our proposals for the taxation of international income we have had to make even greater concessions since here the administrative and economic problems appear in a more acute form. Not only are the problems of valuation and enforcement more difficult in the international area, but market imperfections are likely to be more important. Hence, purposeful deviation from tax neutrality under certain circumstances may become a necessity. In addition to the extreme complexity of the subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle those controversies militate against the adoption of simple, generally accepted solutions. In this area more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternative policies, and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives. In the international sphere perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.

The subject is therefore a challenging one and one which Canada of all countries can least afford to ignore. Canada's heavy stake in foreign trade and investment gives this country a particular interest in well-ordered international tax arrangements. Fortunately a good deal of progress has been made toward some standards of conduct for international tax behaviour

by negotiation and agreement. Over the last half-century the leading tradi nations, under the auspices of world organizations, have developed a few basic ground rules that eliminate the grosser inequities and economic dislo cations that would otherwise arise. While these rules fall far short of th ideals of neutrality and equity, their embodiment in national taxing statut and in international treaties gives some order and certainty where chaos could otherwise rule. The value of these arrangements has also increased with the more extensive use of income taxes by both developed and developin countries as the major source of their revenue. The direct use of income t provisions by many countries for the achievement of domestic economic objectives, and the heightened sophistication of taxpayers in arranging their affairs to minimize their tax liabilities, will add further to the need for international tax arrangements in the future.

MAJOR ISSUES

While the subject bristles with complexities and controversies, the larger issues in international taxation are surprisingly few. Substantiall they are:

1. The treatment to be accorded income of non-residents at the time it is earned in Canada.

2. The treatment to be accorded certain forms of income of non-residents at the time it is withdrawn from Canada.

3. The treatment to be accorded foreign income of residents of Canada at the time it is earned outside Canada.

4. The treatment to be accorded foreign income of residents of Canada at the time it is received in Canada.

The practical questions to be settled are even fewer, since custom and the international tax treaties have already disposed of many of the issues that might have arisen under these headings.

1. For the foreign income of residents, two questions arise:

    a) To what extent should such income be taxed as earned abroad?

    b) What form of recognition should be given to the fact that the country of source of such income will have levied a tax on it?

2. For the Canadian income of non-residents, the main question is the level of withholding tax that should apply on the withdrawal of certain forms of payments from Canada.

In seeking to apply our standards of equity and neutrality to these problems we have proceeded on the basis of certain assumptions which should be stated here:

1. The treatment of foreign income of Canadian residents should include some recognition of foreign taxes levied on that income.

2. Foreign income of Canadian residents should also be taxed under the comprehensive tax base in accordance with procedures which minimize tax deferment and the use of tax havens, which are countries through which income can be channelled at little or no tax cost.

3. The benefits of integration of personal and corporation taxes should be restricted to domestic shareholders. We have adopted this position primarily because a similar alleviation of the tax on dividend distributions to non-residents would result in a cost to the Canadian treasury which would largely accrue to the benefit of foreign treasuries. This is admittedly a form of discrimination. However, we have assumed that this discrimination in favour of residents would not have adverse effects on foreign confidence, nor should it bring about retaliation as the tax position of the vast majority of non-residents would not be worsened relative to their present position except to the extent that non-residents would become worse off because of the removal of specific industry and corporation incentives, an impact that would apply equally to some residents.

4. We should strive for tax arrangements which maintain and, if possible, increase the net economic benefit that Canada derives from capital movements across its borders, consistent with our treaty obligations and the normal standards of international taxation. This implies that tax provisions that would permanently impede capital movements in either direction should be avoided. We do not review in this chapter the full discussion of the international economic issues covered in Chapter 5. In particular, the net benefits that might be secured by increasing foreign portfolio investment in Canada and reducing foreign direct investment correspondingly, are not dealt with further; nor is the question of Canada's dependence on a net capital inflow reopened. However, we take for granted that those who would eliminate the net capital inflow into Canada are not seeking to eliminate gross capital movements between Canada and the rest of the world. Capital movements may be impeded during the adjustment period following the introduction of our integration proposals, but it is not put forward as a measure intended to produce a permanent effect of this kind.

5. The net economic benefit that would result from higher taxes on dividend income going to non-residents would be too small and uncertain to warrant the risk in raising such taxes. An increase would probably provoke retaliation from foreign governments, particularly since the present level of Canadian corporation and withholding tax on dividends is close to, or in some cases even exceeds, the level of tax credit granted by the country of residence of the foreign investor. Where the tax on other forms of income going to non-residents is not subject to this constraint we have proposed an increase.

The domestic tax system which we propose as a means of more completely realizing Canada's economic and social objectives is radically different from the existing Canadian system and is unlike the systems in effect in other countries. Our most important task in this chapter is to develop tax provisions that would allow the adoption of a new domestic system without adversely affecting our economic ties with the rest of the world. This involves working out the technical problems resulting from the taxation of the income flows across the Canadian border. It also requires the development of tax provisions that maintain, and preferably increase, the net economic benefit that Canada derives from foreign investment in Canada and from the investment by Canadians outside of Canada, consistent with our treaty obligations and with the normal standards of international taxation.

The second task is to develop tax provisions that treat Canadians with foreign source income equitably relative to other Canadians. Thus, not only must all foreign source income be brought into the comprehensive tax base and be subjected to progressive rates of income tax, but it must be brought in under procedures that minimize tax deferment. In addition, it is necessary to eliminate the serious loopholes existing in the present system that allow some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries.

At the present time the rates of tax imposed on the Canadian source income of non-residents vary with the nature of the payment. Some payments (e.g., dividends) are subject to substantial Canadian tax, others to low rates of tax, and still others are not taxed at all. These disparities place an undue significance on the form of the payment, thus encouraging the adoption of procedures that lessen Canadian tax collections. Reducing these disparities is the third general task with which this chapter is concerned.

PRINCIPAL PROPOSALS

Our principal proposals deal with the form of tax credit to be granted to Canadians in respect of their foreign income, the manner in which such income should be taxed in Canada and the rate of withholding tax to be appli to the income of non-residents originating in Canada. These proposals are discussed in detail later in this chapter but are summarized here for convenience:

1. The present exemption from tax of certain foreign dividends received by a resident corporation which is provided by section 28(1)(d) should be withdrawn. Dividends received from foreign direct investment should be grossed-up at an arbitrary rate of 30 per cent and a foreign tax credit of the same amount allowed. If the dividend was received by a resident individual, then the applicable Canadian tax on the grossed-up amount would be payable at the time of receipt. However, if the divide was received by a resident corporation, no tax would be payable until the income was in turn distributed or allocated, at which time a withholding tax of 20 per cent of the grossed-up amount should be collected so that the resident shareholders would be entitled to a tax credit of 50 per cent of the grossed-up distribution (the original 30 per cent foreign tax credit plus the additional 20 per cent withheld).

2. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents:

    a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or

    b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

3. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If the foreign income taxes paid on this current income (including those paid by a non-resident corporation) were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income was immediately subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax paid on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect that it be taxed as portfolio investment income (i.e., income from an investment other than a direct investment) with credit only for withholding taxes paid.

4. For the purpose of these computations, foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement) with certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed, and we will suggest an additional modification that should mean that computations would rarely be necessary for most income derived from the United States and the United Kingdom.

5. Canadian portfolio investors (investors who were not direct investors) should be given an option:

   a) to be taxed on the same basis as direct investors as described above; or

   b) to be taxed as at present with a credit only for withholding taxes paid.

6. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests, income from employment in Canada and the income portion of payments from pension plans, in addition to interest, royalties, etc. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for certain interest payments to tax-exempt entities) and reduced by treaty for certain payments to specified countries.

7. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These services might well be rendered outside Canada but the benefit from them would be obtained in Canada. This withholding tax should not apply to amounts paid in reimbursement of expenses.

8. In certain specific cases non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

   a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

   b) where a non-resident received certain kinds of income from Canada, including gifts, inheritances, the income portion of pension and annuity payments and employment income.

The implementation of these recommendations would, we believe, confer the following important advantages:

1. Substitution of a 30 per cent gross-up and credit for the section 28(1)(d) exemption:

   a) Removal of the exemption under section 28(1)(d) for foreign dividends received by a Canadian corporation from a company in which it held at least a 25 per cent interest would eliminate a major loophole in the present tax system through which some Canadians have in effect avoided the payment of their full Canadian tax on Canadian source income which has been diverted through companies in tax havens.

   b) The use of an arbitrary flat-rate tax credit would reduce, to a great extent, the significance of the tax mix of the source country. Thus, the balance between income taxes and withholding taxes would be unimportant and the extent to which other taxes (e.g., sales taxes) were utilized in the foreign jurisdiction would be less important.

   c) Once it was decided that a broad exclusion like section 28(1)(d) was not appropriate, the use of an arbitrary rate would simplify the computations and remove much of the uncertainty. Both of these advantages would be particularly important to ensure that Canadian corporations were not discouraged from establishing foreign operations. Although the procedure would require the measurement of the underlying foreign source income from most countries, this would not generally apply to income derived from the United States or the United Kingdom (from which over three quarters of the foreign source dividends of Canadians are derived). This special treatment could perhaps later be extended to other countries after experience has been gained in administering the provisions. In any case, the adjustments required for the other countries, although arbitrary, would be relatively simple. Because property gains would be taxed in full to Canadians on realization, full Canadian tax would be

collected in the long run. Arbitrary procedures to compute the annual tax liability therefore would not be as inequitable as they might otherwise be.

d) A flat-rate gross-up and credit would result in the progressive rate schedule being applied to foreign source direct investment income.

e) Adoption of a rate of 30 per cent for the gross-up and credit would have two advantages: Canada would derive some (albeit small) net revenue from foreign source dividends, and most shareholders in Canadian companies with foreign direct investments would pay no more Canadian tax on foreign source dividends than they do at present.

f) The gross-up rate could be adjusted from time to time to meet particular circumstances. A reduction in the rate might be necessary if over time the expected before-tax rates of return on corporate assets in Canada declined following the adoption of the integration proposal.

2. Requiring payment of income tax on foreign direct investment income at a rate of at least 30 per cent;

   a) A requirement that taxes of at least 30 per cent be paid each year to either the foreign jurisdiction or to Canada as the foreign income was accrued would reduce the tax deferment and the minimization advantages provided directly or indirectly by tax havens.

   b) The recommended procedure would reduce the importance, from a taxation viewpoint, of the form of organization adopted for carrying on foreign operations. It would also largely eliminate any effect Canadian taxes might have on the decision to retain or remit funds from the foreign operation.

3. Increasing the level and scope of withholding taxes:

   a) The increase in the standard withholding tax (on most payments other than dividends) to 30 per cent would narrow the gap between the rates of tax imposed on different types of return on capital. It would reduce the attractiveness of some of the present methods employed to reduce the Canadian tax liabilities on income derived from this country and would thereby increase Canadian tax revenues.

   b) The application of a withholding tax to another form of remittance from Canada, namely, service fees, would ensure that at least some tax revenue was collected on income from services enjoyed in Canada and performed by non-residents who were not physically present in Canada when the services were rendered.

The balance of the chapter is devoted to further consideration of the concept of neutrality and its implications for our specific tax proposals, to an outline of the actual tax systems in effect in Canada, the United States and the United Kingdom, and to separate consideration of the tax issues and of our proposals for Canada as a country receiving income from abroad and as a country which is the source of income going abroad. We then examine some of the administrative aspects of international taxation and finally we review the nature and effect of the tax treaties.

NEUTRALITY AS AN INTERNATIONAL CONCEPT

Because of its key position in our consideration of the various proposals for international taxation, we will explore at some length in the following paragraphs the meaning of "neutrality" as a guiding concept for these proposals.

To achieve complete international tax neutrality, the tax systems of all nations would have to be so harmonized that each individual would be indifferent, from a tax point of view, about his citizenship, his country of

residence, the location of his property, the location of his business and the location of his job. This would require that all nations:

1. Provide the same public goods, services and transfer payments to those residing or carrying on business in the country 1/.

2. Finance the provision of these public goods, services and transfer payments with the same kinds of taxes levied at the same rates.

3. Avoid, shift and adjust to the same taxes to the same degree and at the same time.

4. Tax each individual on his world income, defined in a uniform manner, at the same rates as those at which he would be taxed if he derived all of his income from his country of residence; these rates would have to be the same whatever his country of residence 2/.

In deciding where to work, where to invest and where to carry on business, tax considerations could be ignored because the ratio of the expected after-tax rate of return to the expected before-tax rate of return would be a constant for each individual. If these conditions were realized, expected before-tax rates of return in different countries would not be distorted, relative to one another, as a result of differences in national tax systems.

The conditions cited above would be extremely difficult to realize even with the best of intentions on the part of all nations. If all nations were to provide the same kinds and levels of public goods to their residents with the same bases and tax rates, per capita national incomes would have to be approximately the same. This condition is unlikely to be met in the foreseeable future—if ever. Differences in national preferences between public and private goods and between different kinds of public goods will continue to prevail. National resource endowments, national market sizes and national mixes of industries are so diverse it is difficult to imagine that

avoidance, shifting and adjustments to taxes will ever be the same in all nations.

In Chapter 19 we discuss how before-tax rates of return on productive assets change in response to changes in taxation. It is useful to briefly review that discussion here.

Unless all taxes are avoided or shifted to exactly the same extent and at the same speed, the imposition of what purports to be a completely neutral tax will nevertheless change the allocation of resources among alternative projects. To illustrate what is involved, assume that in a world with no taxes there are two kinds of projects, types A and B. Each kind of project is expected to yield a before-tax rate of return of 10 per cent. Suppose that a tax of 50 per cent is imposed on the net gains from both kinds of projects and that there is no avoidance. If the tax on the income from type A projects is fully shifted, the before-tax income is doubled and the after-tax income is unchanged; if the tax on type B projects is not shifted the before-tax income is unchanged but the after-tax income is cut in half. Investment in type A projects would be much more attractive than that in type B projects. However, over time the higher rate of return would lead to increased investment in type A projects which would increase the output of the goods produced by these projects. The increased supply of these goods would gradually force their prices down. As a result the before- and after-tax rates of return on investments in type A projects would decline. Conversely, the reduced investment in type B projects over time would result in an increase in the before- and after-tax rates of return from type B projects. Under simplifying assumptions, the before-tax rates of return on both kinds of projects would, in time, converge and once again be equal.

These adjustments of before-tax rates of return to changes in taxes must be taken into account in analyzing international income taxes. Resources would not necessarily be allocated efficiently throughout the world if expected before-tax rates of return were the same in all countries.

The expected before-tax rates of return may differ between two countries not because capital was more productive in one than the other but because the same taxes imposed at the same time in both countries were not shifted to the same extent and the investment adjustment process had not yet reduced the return in the tax-shifting country or raised it in the non-shifting country.

Because of market imperfections, differences in expected before-tax rates of return among alternative projects are an imperfect indication of the net benefit that would be derived from different investments within a nation. The interpretation of international differences in expected before-tax rates of return is even more difficult because, in addition to the "normal market imperfections, nations not only have different tax systems but have purposely adopted substantial barriers to the flow of goods, capital and labour. Because of the distorting effects of these differences in tax structure and of countervailing national economic barriers we cannot presume that the allocation of resources on a world basis in accordance with these expected before-tax rates of return would lead to greater world output.

Realization of the fourth condition would be particularly difficult in a world consisting of debtor and creditor nations. If the types and amounts of each nation's foreign source income were equal to the types and amounts of its domestic source income flowing to (or attributable to) non-residents, the problem would be straightforward. All nations could agree to tax income on a destination basis. Whatever their views about the "proper" allocation of revenues between origin and destination countries, if they all adopted the same policy there would be neither revenue gain nor revenue loss, for the additional revenues obtained from fully taxing the foreign source income of residents would just be offset by the revenues forgone by not taxing the domestic source income of non-residents. But because some nations are net debtors and some net creditors such an easy solution is not possible. To tax solely on a destination basis would mean that debtor

nations would be worse off; to tax solely on a source basis would mean that creditor nations would be worse off.

Thus, even if all nations had identical tax systems, there would be an inescapable conflict between net debtor and net creditor nations as to the "proper" division of revenues between source and destination countries. Debtors would continue to argue that the major share of the revenue should go to the country in which the income originated; creditors would continue to argue that the major share of the revenue should go to the country of residence of the recipient of the income.

From this discussion of the conditions necessary for the realization of international tax neutrality, it is obvious that such an objective is unattainable within the foreseeable future. But what is even more important, international tax neutrality may not even be desirable while other international economic barriers exist (such as tariffs, immigration laws, foreign investment guidelines, and foreign exchange controls). All of these artificial barriers to the free movement of goods, capital and labour among nations distort the international allocation of resources just as much or more than unneutral tax systems. It would only make sense to strive to develop an internationally neutral tax system if by doing so a more efficient international allocation of resources throughout the world would be achieved. As long as these non-tax barriers between nations prevailed, an improvement in the international allocation of resources would probably require national tax systems that deviated from neutrality to compensate for the other barriers.

Once this point is reached we are forced to admit that it is impossible to make any general statements about how international income flows should be taxed by any particular country if the purpose is to achieve an efficient allocation of world resources. It depends entirely upon the particular circumstances. While compensating deviations from a neutral tax system are theoretically possible, it would be extremely difficult in the present state

of knowledge to determine the form and magnitude they should take.

This is a depressing conclusion because we know that, in the absence of all barriers to the movement of labour, capital and goods between nations (or with offsetting adjustments if they could not be removed), world output would be greater. The nations that would gain from the removal of barriers to international mobility could more than compensate the nations that would lose, and still be better off. Although it would be naive to expect that this idyllic state of the world will soon be attained, men of good will must not lose sight of this long-run objective. If they cannot further its realization, they can at least refrain from creating obstacles to its ultimat attainment.

We do not advocate the unilateral removal of all international barriers by Canada. It is impossible to say, except in terms of the particular facts, whether or not a unilateral reduction in a particular barrier would be in our long-run interest. Some Canadian barriers are probably necessary to compensate for the barriers erected in other countries. If other nations raise international economic barriers Canada may have no alternative but to raise countervailing barriers. We need this retaliatory capability. However we should try to avoid situations that would require retaliation by Canada or would lead to retaliation by other countries against Canada.

We do not doubt that Canada should pursue its self-interest. But we believe that a world with lower national barriers to the movement of labour, goods and capital would be in Canada's long-run self-interest. We can hardly expect reductions in international barriers to be made by others if we are busy erecting our own.

PRESENT TREATMENT OF INTERNATIONAL INCOME IN THE UNITED STATES, THE UNITED KINGDOM AND CANADA

As a background to our specific proposals it is useful to set forth a brief composite picture of the present Canadian, United States and United

4. Royalties—copyright royalties are not subject to withholding tax; film and tape royalties—10 per cent; all other royalties—15 per cent. A recipient of timber royalties may elect to be taxed on his net Canadian income by filing a return as in the case of a recipient of real estate rentals.

5. Estate and trust income and patronage dividends—15 per cent.

A 15 per cent tax in lieu of any other tax (including the withholding tax on dividends and interest paid) is imposed on the income of a non-resident-owned investment corporation—a corporation substantially owned abroad whose income is substantially from investments.

Employment Income. A non-resident of Canada who has been employed in Canada must report his Canadian income and pay tax on that income at the usual graduated rates. An appropriate proportion of the Canadian concessions and allowances is granted as a deduction in determining taxable income.

The foregoing describes the main elements of the Canadian tax system for non-residents under the Income Tax Act. Modifications made by treaty have not been discussed.

TAXATION IN CANADA AS THE COUNTRY OF DESTINATION

Equity Considerations

Equity requires that all foreign source income, whether it results from working, investing or carrying on business abroad, be taxed to residents on the same basis as domestic source income. Under our proposal for the full taxation of property gains, this would mean that residents holding rights to or interests in property located outside of Canada would be taxed on the disposition of such rights or interests (including a disposition on death) or on the net gains deemed to have been realized on giving up Canadian residence.

Because income not brought into Canada must necessarily result in an increase in the value of the resident's interest in foreign property (ignoring foreign source income that the resident spends on personal consumption outside of Canada), all foreign source income would ultimately become subject to Canadian taxation. This would close what is now a substantial loophole in the tax system. Residents can now establish a foreign corporation to hold their income-earning assets in a country with low corporation taxes. The income can be retained in the foreign corporation and the resident can realize this income without Canadian tax by the sale of the shares in the foreign corporation.

Unfortunately the full taxation of property gains poses significant problems. If the property gains on rights to or interests in property located outside of Canada were brought into income only when realized, there would be a deferment problem. We have already demonstrated that the postponement of taxes can be about as advantageous as the avoidance or reduction of taxes. On the other hand, if such gains were taxed on an accrual basis, it would be difficult to determine the market value of property located in another jurisdiction.

Our proposal for the domestic tax system initially brings only realized property gains into income. We have also proposed that, unless the current earnings of Canadian intermediaries are brought into the income of shareholders and beneficiaries annually, such income should be subject to tax in the organization—usually at the top personal rate. This prevents the deferment of tax that would otherwise be possible if distributions were subject to additional personal tax. To place residents with interests in foreign corporations and trusts on the same basis as persons with domestic investments, the interest of Canadian residents in the income of these foreign organizations should also be taxed currently at the top personal rate. However, if these organizations did not make cash distributions, some Canadian shareholders or beneficiaries might

not have the cash available to pay the Canadian tax imposed in respect of the accrued income. In addition, there would be a number of administrative problems involved in the determination of the amounts to be taken into account each year.

These administrative questions would basically be concerned with determining what was the foreign source income for Canadian tax purposes, when the foreign income should be brought into account and what was the amount of the foreign tax credit that was to be deductible in determining the Canadian tax liability. Obviously business income for tax purposes in the source country need not be the same as business income for tax purposes in Canada—and in fact the differences in legislation are apt to result in substantial variations. A recomputation of the foreign source business income on the basis of Canadian rules could be an extremely complex procedure for the taxpayer, and yet, without such a recomputation, the amount included in the Canadian tax base would not properly reflect the Canadian rules for the determination of income. The question of timing also has administrative implications because it affects the determination of the amount of foreign source income and taxes that should be taken into consideration in each year.

Economic Considerations

There are economic as well as administrative questions that have to be considered in any attempt to attain neutrality in the taxation of the foreign source income of residents. The principal question is the extent to which Canada should give residents credit for the taxes paid to other governments on their foreign source income. At the one extreme, it can be argued that in so far as the Canadian government is concerned, the taxes paid to a foreign government by a Canadian-controlled foreign corporation are simply an expense of doing business abroad, and no credit should be given for foreign taxes (corporation or withholding taxes) against the resident's Canadian tax liabilities. This would mean that in deciding whether to invest in Canada or in another country that imposed income taxes,

the expected before-tax rate of return on a foreign project would have to be higher than the expected before-tax rate of return on a Canadian project.

At the other extreme, it can be argued that Canada should give full credit for foreign taxes paid against Canadian tax liabilities—even to the point of refunding foreign taxes if they exceeded the Canadian tax liability. If this were done, the Canadian investor would be completely indifferent to the taxes imposed by other countries. Other things being equal, projects with the same expected before-tax rates of return would be equally attractive wherever their location because they would all have the same expected after-tax rate of return to the Canadian resident.

For the reasons outlined in our discussion of international tax neutrality, we are convinced that it is impossible to say categorically what this foreign tax credit should be if Canada wished to achieve an efficient allocation of capital throughout the world. We simply do not know the extent to which the expected before-tax rates of return in different countries reflect the "true" return from capital. We are forced to fall back on pragmatic considerations.

Ignoring the implications of the adoption of our integration proposal, which will be discussed later, we reject the proposition that Canada should provide a full credit for foreign taxes (including the making of refunds if the foreign taxes paid exceeded the Canadian tax liability). We likewise reject the proposition that Canada should give no credit for foreign taxes. The granting of full credit with refunds is rejected because this would require Canada to rebate taxes it had never collected and would leave the Canadian treasury at the mercy of foreign treasuries. Full credit for foreign taxes up to the Canadian tax is rejected because we believe that 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.

The net economic benefit that Canada derives from foreign investment by Canadians is uncertain. Some Canadian direct investment extends markets for Canadian goods, secures supplies, and improves Canadian technology. It is undoubtedly profitable to individual Canadians and economically advantageous to the nation. At the other extreme, some foreign portfolio investment is only profitable to individuals because Canada gives credit for the withholding taxes imposed by other governments, and presumably confers little if any net economic benefit on Canada. Unfortunately, there are no adequate measures of the net benefit from either.

Changes in the Canadian tax treatment of residents that would deter investment abroad are less likely to shake international investor confidence in Canada or lead to foreign retaliation than adverse changes in the tax treatment of non-residents who invest in Canada. However, we cannot be indifferent to the reactions of non-residents and foreign governments to changes in Canada's treatment of Canadians who invest abroad. If Canada deters its residents from investing abroad we are obviously in no position to complain when other nations seek to deter their residents from investing in Canada. Although the immediate net benefit to Canada of foreign investment by Canadians may be small (conceivably negative), if Canada adopts tax provisions that discourage foreign investment by Canadians and this results in foreign retaliation, Canada could lose more elsewhere than it would gain through the reduction of foreign investment by Canadians. How this net loss could come about can be readily explained.

Canada obtains a net economic benefit from most investment in Canada by non-residents. The revenues obtained from taxing the income earned by such investments are an important part of that benefit. The revenues that can

be raised by taxing foreign investment in Canada without deterring such foreign investment are dependent upon the credit that foreign governments give to their residents with respect to the taxes paid to Canada. If foreign governments gave lower or no credits for taxes paid to Canada, Canada would be forced to lower its taxes on the income of foreign investments in Canada to prevent a sharp drop in such investment 3/. This would reduce the net benefit we obtain from foreign investment in Canada.

We do not know whether foreign governments would remove or reduce their foreign tax credits if Canada refused to give Canadian residents credit for foreign taxes. But the gains from reducing foreign investment by Canadians would be small and uncertain even if there were no foreign retaliation, while the losses would be large and predictable if there were retaliation. Therefore, we reject the idea that Canada should seek to inhibit investment abroad by Canadians by withdrawing credits for foreign taxes paid on the income resulting from foreign investments by Canadians.

Specific Types of Income

It will be recalled that we are concerned with the tax treatment in Canada of three main types of income: business income, property income and employment income.

Property Income and Employment Income. A discussion of the treatment of property and employment income can be readily concluded since we propose no substantial changes in the present procedures, except for dividends which will be discussed in detail below.

Property income from abroad is now included in Canadian income grossed-up for any withholding tax imposed by a source country and with a credit allowed against the Canadian tax for such a foreign tax to an

amount not exceeding the Canadian tax on the foreign source income. We see no reason for departing from this procedure.

For employment income earned by Canadians abroad we propose continuation of existing procedures without change.

Direct Investment Income (Including Business Income). We bring income derived from direct investment in a foreign corporation and foreign business income together for the present discussion because their underlying similarity raises the same general issues. The conduct of business in a foreign country through a wholly or substantially owned subsidiary differs little, from an economic point of view, from direct operation through a branch, and the same general issues of taxation are involved. The singular difference for tax purposes under the present law is that interposition of the foreign corporation means that the Canadian company operating abroad through direct investment in a corporation includes as income only dividends actually received from that corporation, whereas the Canadian company operating directly through a branch is regarded as having earned and received the full profits of the branch each year and obtains credit for the foreign tax thereon. As we have seen, in the United States and the United Kingdom the same general procedure—the full gross-up and credit procedure—is used for both direct business activity and direct investment income. Canada, although ostensibly reaching much the same general objective by the two routes, has adopted different forms of treatment for branch income and dividends from direct investment. Branch income, as we have said, must be included in Canadian income grossed-up for the foreign income tax and recalculated to conform to Canadian rules for computing taxable business income. The Canadian tax is calculated on the foreign income so adjusted and a credit is allowed for the foreign tax paid, but not in an amount that exceeds the Canadian

tax. On the other hand, dividends derived from direct investment in a foreign corporation—at present where more than 25 per cent of the voting shares are owned—are exempt from Canadian corporation income tax on receipt in Canada. The only condition for this exemption is the required degree of ownership.

It is apparent that within the Canadian treatment of foreign source business income may be found the two classical extremes of allowance for foreign taxation. One provides for the full, accurate and precise measurement of the foreign income and tax liability, with a precisely computed credit against Canadian tax. The other grants an exemption from tax under conditions very easily met. The United States and the United Kingdom have followed the first method both for branch income and direct investment income, and no provision comparable to section 28(1)(d) of the Income Tax Act may be found in the tax system of either country. There are some examples of exemption of foreign dividends to be found in other countries, but Canada is virtually unique in its adoption of a provision as sweeping as section 28(1)(d). Its origins and effects are therefore of considerable interest.

The exemption contained in section 28(1)(d) appears to have had as its original purpose the achievement of an equitable and administratively simple alternative to the complexities of the gross-up and credit procedure. At the time of its introduction in 1949, the bulk of Canadian foreign source income originated in countries having corporation taxes as high as the Canadian, mainly the United States and the United Kingdom. The effect of this section was undoubtedly to provide directly for the virtual exemption of foreign source income from Canadian tax which was the end result of the complicated gross-up and tax credit procedure previously in force. Its origins in section 4(r) and subsections (2A) and (2B) of section 8 of the

Income War Tax Act are clearly discernible, and the fact that both of these sections were repealed in 1949 on the enactment of section 27(1)(d) (now section 28(1)(d)) supports the conclusion that, initially, the provision was looked on mainly as a device for administrative simplification. At first the ownership requirement was 50 per cent or more but in 1951, following the recommendation of the Advisory Committee on Overseas Investment, the ownership test was reduced to its present 25 per cent as a means of encouraging foreign investment by Canadians. It has since remained at that level.

One result of these provisions is that the Canadian taxpayer has enjoyed a much greater simplicity and ease of calculation for foreign income than his United States or United Kingdom counterparts. The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d).

There is also evidence that the provision has offered the possibility to use Canada itself as a tax haven for international business. Data compiled for us by the Taxation Division show that over a period of years a very substantial part of the dividends reported under this section has originated in jurisdictions imposing little or no tax, and that a very high proportion of these dividends has been received in Canada by holding companies not having a substantial Canadian economic interest but representing for the most part foreign ownership. Of a total of $1,500 million received by all Canadian corporations (including those that were owned by non-residents) in the five years from 1957 to 1961, only 10 per cent came from the United States and 4 per cent from the United Kingdom.

The defects of the present section 28(1)(d) are obvious, and we therefore recommend its repeal.

Full Gross-up and Credit

The most obvious alternative to the present Canadian treatment of income from direct investment (it is already in effect in Canada for direct business activity in a foreign country) is that employed by both the United States and the United Kingdom—the so-called "full gross-up and credit" method. We have recommended the full gross-up and credit method as the appropriate basis for the taxation of Canadian corporation income for residents. The logical counterpart would be to extend the same principle to the foreign direct investment earnings of Canadian corporations and individuals. The effect would undoubtedly be to produce a more exact calculation of the foreign tax credit and a more accurate allowance of that credit against the Canadian tax.

One serious disadvantage of the full gross-up and credit system in the international field is that it is far more complicated than the present Canadian method and would introduce a whole new range of administrative complexities for both taxpayers and tax authorities. In principle, it would require that the foreign corporate income being grossed-up be completely recalculated on the same basis as the Canadian, so that the taxable income, the tax to be credited and the tax credit limitations would be comparisons of like with like. Such adjustments are required now only in a relatively limited number of cases for direct business activity, mainly involving branches. But the extension of the full gross-up treatment to all foreign companies in which there was a Canadian direct investment would greatly multiply the number of companies affected. Also, consideration would have to be given to allowing a similar grossing-up procedure for the subsidiaries of the main foreign subsidiary (i.e., sub-subsidiaries) in order to carry the taxes of the sub-subsidiaries through the main subsidiary to the Canadian parent. (The United States law now provides for inclusion of only the

second level of foreign subsidiaries.) Furthermore, questions of the method for calculating the average rate of tax, the identification of years in which income was earned by the subsidiary and received by the parent and a host of other problems not now of significance would take on great importance for all Canadian companies having a direct investment in a foreign company.

The effect of the full gross-up and credit system is to bring up to the level of Canadian taxation the corporation income tax on business income earned anywhere in the world. While we do not in general favour the use of taxation for international competitive purposes, we are forced to recognize that in many new countries one of the few means available for granting economic incentives is taxation. To require that the tax on business income earned in those countries must ultimately be at least 50 per cent would completely frustrate, or "neutralize", any incentives extended by the new countries. Also, in these same countries indirect taxes are frequently a large element in the tax mix. These represent a burden on any business operating in a country of source which, in the present state of international taxation, is not taken into account in determining the tax credit in the country of destination. In bringing the ultimate corporation income tax burden up to a rate of 50 per cent, we would be disregarding the existence of these indirect taxes.

The recent experience in the United States with attempts to cope with similar problems is indicative of the complexities that can be encountered where the full gross-up and credit system is extended to overcome tax avoidance through foreign tax havens. As a measure to assist the balance-of-payments problem, President Kennedy recommended to the Congress in 1961 that foreign-earned corporate income be deemed to have been received and to be taxable in the United States as it accrued abroad. It was reasoned that if tax deferment were removed, United States companies would immediately bring home their foreign earnings. The proposal met with a storm of protest from United States industry and, after protracted hearings and Congressional

studies, a measure emerged directed not at tax deferment in general but at deferment of tax on certain forms of income accruing in tax-haven jurisdictions. Income of a "controlled foreign corporation" of a specified character (generally of a "passive" type, that is, not related to the conduct of an economic activity in the actual location of the foreign subsidiary) is deemed to be received by the United States shareholders owning 10 per cent or more of the voting shares of the corporation and is then taxable. Exceptions are made where certain minimum distributions are made by the controlled foreign corporation, where the controlled foreign corporation is operating in a less developed country or where it is a corporation devoted exclusively to export trade 4/.

We have considered this United States legislation as a possible model for Canadian action but have concluded that it is far too complex in its detailed application for our more limited goal. The role of the United States in the world economy is so crucial that a measure of this sort must meet a wide and conflicting variety of objectives, and in the process assume such complexity that its full ramifications are not even yet fully apparent. Much of this complexity stems from the fact that the objective of the legislation was to bring into taxation, at full United States rates, accumulating foreign source income, the natural result of applying the full gross-up and credit mechanism. The conditions under which this onerous treatment should apply and the nature of exemptions from it, therefore, had to be defined with great care. We have concluded that our much less ambitious objectives could be achieved by adopting somewhat more arbitrary but simpler methods. We have designed our proposal with this in mind.

The remaining objective we have sought, a degree of integration of foreign corporation taxes with Canadian personal income tax, could as well be achieved under the gross-up and credit method as under any other by adopting some arbitrary and simplified procedures. However, we have already concluded that full integration of foreign corporation taxes with the

Canadian personal income tax is not acceptable, as it would mean that the Canadian government would be required to make massive refunds to Canadian shareholders of taxes collected by other governments. This, then, is the primary reason for rejecting the use of the full gross-up and credit. We have therefore sought in our solution a degree of integration that is something less than would be achieved by the system of full gross-up and credit for foreign direct investment income.

Our Proposal

We have concluded that Canadian objectives can be met adequately by a solution somewhere between the full gross-up and credit at the one extreme and the exemption provided under the present section 28(1)(d) at the other. We are primarily concerned at this point with the position of companies having foreign subsidiaries which now qualify under section 28(1)(d). The future status of business activities carried on directly abroad through branches will be referred to later.

Foreign Direct Investment Income

Scope of application. We propose that the treatment outlined below should apply to a foreign direct investment. A foreign direct investment would be an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group held a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group held a 10 per cent or greater interest. This percentage is smaller than the 25 per cent now specified in section 28(1)(d), but would appear to be a reasonable dividing line between an investment which is not made for purposes of having a direct influence in the affairs of a company, and one which can carry with it some measure of control. However, because of other provisions discussed below, this artificial dividing line should not result in any inequity for a taxpayer who had less than a 10 per cent interest and, accordingly, was not

able to qualify for the 30 per cent gross-up and credit. In the case of an investment in a foreign company, the 10 per cent would only apply to direct shareholdings. Subsidiaries of a foreign company in which a direct investment was held should be included if an interest of 50 per cent or more was held by the foreign parent and by other shareholders who were not dealing at arm's length with that company.

Procedure. Where a direct investment was held, the following procedure would apply:

1. The income and tax liability would be computed (as described below) generally in accordance with the broad principles of the Canadian tax law.

2. In the case of a Canadian individual with a direct investment in a foreign property or business, his proportionate interest in the income earned in the foreign jurisdiction would be included in his income for Canadian tax purposes in the year it was earned, the net income after foreign tax being grossed-up to include the foreign taxes paid or deemed to be paid, not exceeding 30 per cent. Therefore, the applicable Canadian tax would become payable immediately and credit would be allowed for the foreign taxes paid or deemed to be paid up to the 30 per cent maximum.

3. In the case of a Canadian individual with a direct investment in a foreign company or with an investment in a Canadian company that itself had a direct investment in a foreign company, property or business, the procedure would be more complex:

   a) Where foreign taxes were paid or were deemed to have been paid at the rate of 30 per cent or more on the foreign source income so recalculated, generally no Canadian income tax should be payable until the foreign income was distributed to Canadian individuals. Thus, no Canadian tax should be payable by a Canadian

shareholders pay only a Canadian withholding tax on distributions paid from foreign direct investment income flowing to a Canadian company in which they hold shares. Because such dividends would continue to be subject to the regular non-resident withholding tax, it is not intended that the total taxes imposed on these shareholders should be increased. Accordingly, the special 20 per cent withholding tax should not be deducted or paid in respect of distributions to non-resident shareholders. In the case of shares beneficially owned by non-residents but registered in the names of Canadian nominees, the special 20 per cent withholding tax on distributions out of foreign direct investment income would, of course, be withheld and remitted to the government by the corporation making the distribution or allocation. In this case the non-resident beneficial owner of the shares should be entitled to apply to the government for a refund.

Where a Canadian corporation had a substantial interest of, say, at least 10 per cent in another corporation which made a distribution or allocation out of foreign direct investment income, the receiving corporation should be entitled to apply to the government for a refund of the 20 per cent tax withheld by the corporation making the distribution or allocation. It could be provided as an alternative that such a receiving corporation could file a form with the distributing corporation which would exempt distributions or allocations to the receiving corporation from the special withholding tax. In either case the distribution or allocation made out of foreign direct investment income would be treated as foreign direct investment income of the receiving corporation, so that the 20 per cent would be withheld when the receiving corporation itself made a distribution.

Effect of Our Proposal for Direct Investment Income. Some effects of the proposal just outlined may be briefly summarized:

1. For income received from direct investment in foreign countries levying direct taxes on corporate income of 30 per cent or more, the simplicity at present achieved under section 28(1)(d) would be retained. Some countries obviously fall into this category. We

suggest that they should be named by the administration as qualified sources. We have in mind particularly the United States and the United Kingdom.

2. The effect of requiring that at least a 30 per cent tax be paid on an accrual basis on the income of a foreign direct investment would at least partially restore equity among individual Canadian shareholders by ensuring that a substantial rate of income tax was paid on all investment income no matter where earned. We believe that this device would reduce tax avoidance by Canadians through the use of tax havens.

3. Foreign source income would be subject to progressive rates of tax. The use of an arbitrary gross-up and credit would extend to foreign source income the same procedure as that applied to Canadian corporate income. This would ensure that the progressive rate schedule would be equitably applied.

4. The credit permitted for foreign income taxes paid would be the maximum credit which is consistent with the collection of some Canadian tax revenue from foreign source direct investment income.

5. An unfortunate side effect of the proposal, although it is not as serious as it would be under a system of full gross-up and credit, would be that the tax concessions granted by under-developed countries would be "neutralized". We chose this alternative rather than the complicated provisions necessary to separate a legitimate investment in an under-developed country from a tax-haven operation. To reduce this undesirable effect, we propose that "tax sparing"—the allowance of a credit for a foreign tax whether payable or not—be authorized on a country-by-country basis. This could be done by treaty.

6. The partial integration of foreign corporation income tax with Canadian personal income tax would restore the relief that would be lost on

withdrawal of the dividend tax credit. This credit is now allowed on dividends declared by a Canadian corporation from foreign source income.

Compared with other countries (for example the United States) the foreign tax credit we recommend might appear small. The Canadian credit would be limited to 30 per cent in respect of foreign corporation and withholding taxes. In some countries the credit is 50 per cent or more. It must be borne in mind, however, that while a credit is given against the United States corporation income tax for the full amount of the foreign taxes (up to the effective United States corporation tax rate), the credit does not go beyond the United States corporation. Its value to the individual shareholder is the benefit he may derive indirectly from a reduced corporation tax. Under our proposal the benefit to the shareholder would be reflected in a direct reduction in his personal income tax and possibly in a refund of tax. The amount of the refund could be material for a low income shareholder. Throughout this Report we have emphasized that it is the tax burden on the individual that is the crucial consideration.

Business Income. The proposal detailed above also encompasses the disposition of business income earned in a foreign country through an unincorporated branch. It is now dealt with simply as income of the Canadian resident. It is taxable in full on a grossed-up basis in the year earned, whether distributed or not, with a credit for direct taxes paid to the foreign jurisdiction. We have had to bear in mind particularly that foreign branch profits of a Canadian company can be the source of dividends distributed to Canadian shareholders. We concluded that foreign business income of a branch should, as far as possible, be dealt with in the same way as income from direct investment in foreign corporations. This would, in general, provide neutrality between the different possible procedures for carrying on business or holding property in a foreign country. The credit for foreign income taxes paid would therefore be limited to 30 per cent,

and the income included in the return of the Canadian taxpayer would be the result of grossing-up the net after-tax foreign business income for taxes deemed to be paid at the rate of 30 per cent, regardless of the actual foreign income taxes paid. Also, the Canadian corporation would not be subject to any Canadian tax, over and above the amount of any special tax due if the foreign income taxes were less than 30 per cent, until such time as the foreign source direct investment income was allocated or distributed to resident shareholders. One discrepancy between forms of business organization would remain, however, as Canadian individuals operating unincorporated businesses abroad would in effect be taxed on the full accrual basis, while incorporating the business would permit them to defer their Canadian tax liability until the profits were both remitted to Canada and distributed or allocated to resident shareholders.

Portfolio Investment Income

Portfolio investment income would be that income received from foreign investments where less than a 10 per cent interest was held in a corporation, a business or a property. We recommend that, generally speaking and subject to the option referred to below, portfolio investment income should continue to be taxed as at present and that the dividend or other payment should be grossed-up for the amount of foreign withholding tax (if any) and included in income. Credit should be allowed only for the foreign withholding tax paid on the dividend or other income and not for any underlying corporation tax. However, for the reasons outlined below, we also recommend that a portfolio shareholder should be permitted to elect to be taxed as a direct investor on certain dividends received. In practice, we would expect that this election would only be used for dividends from United States and United Kingdom companies or companies in other countries designated in the regulations as being countries for which the full 30 per cent credit was allowed. However, it might be extended to other cases if the shareholder was able to provide the necessary detailed and verified information concerning the income of the foreign company and the taxes paid by it.