Document generated on 12/15/2024 2:52 p.m.

Revue de droit de l'Université de Sherbrooke

RDUS

THE TAXATION OF UNDISTRIBUTED INCOME EARNED BY CONTROLLED FOREIGN CORPORATIONS

An Analysis of the Canadian and United States Systems

Denis Crevier

Volume 7, Number 2, 1977

URI: https://id.erudit.org/iderudit/1110792ar
DOI: https://doi.org/10.17118/11143/19634

See table of contents

Publisher(s)

Revue de Droit de l'Université de Sherbrooke

ISSN

0317-9656 (print)
2561-7087 (digital)

Explore this journal

Cite this article

Crevier, D. (1977). THE TAXATION OF UNDISTRIBUTED INCOME EARNED BY CONTROLLED FOREIGN CORPORATIONS: An Analysis of the Canadian and United States Systems. *Revue de droit de l'Université de Sherbrooke*, *7*(2), 357–428. https://doi.org/10.17118/11143/19634

Tous droits réservés © Revue de Droit de l'Université de Sherbrooke, 2023

This document is protected by copyright law. Use of the services of Érudit (including reproduction) is subject to its terms and conditions, which can be viewed online.

https://apropos.erudit.org/en/users/policy-on-use/

érudit

This article is disseminated and preserved by Érudit.

Érudit is a non-profit inter-university consortium of the Université de Montréal, Université Laval, and the Université du Québec à Montréal. Its mission is to promote and disseminate research.

https://www.erudit.org/en/

THE TAXATION OF UNDISTRIBUTED INCOME EARNED BY CONTROLLED FOREIGN CORPORATIONS

An Analysis of the Canadian and United States Systems*

par Denis Crevier**

TABLE OF CONTENTS

I. INTRODUCTION 358

II. BASIC PRINCIPLES: A MODEL TAX SYSTEM 360
2.1 Jurisdiction to Tax: Legal Bases 361
2.2 Jurisdictional Connections: International Aspects 362
2.3 Double Taxation 366
2.4 Equity and Deferral 376

III. THE CANADIAN POLICY 385
3.1 Phases of the Canadian Tax Reform 385
3.2 The Pre-1972 System 386
3.3 The Carter Proposals 389
3.4 The White Paper Proposals 396
3.5 The Current System 404

IV. THE UNITED STATES APPROACH 411
4.1 Basic Rules 411
4.2 Historical Background 414
4.3 Partial Elimination of Deferral 418

V. CONCLUSION: GUIDELINES 422
5.1 Elements of Comparison 422
5.2 Interdependence 427

---

* Le présent article reprend substantiellement le texte du mémoire de maîtrise de l'auteur soumis à l'Université de Harvard en mai 1977.

** D.E.C., LL.L. (Sher.), LL.M. (Harvard), avocat attaché au district de Montréal.

I INTRODUCTION

The expression "taxation of undistributed income earned by a controlled foreign corporation" may be described in the following manner:[1]

"Undistributed income" refers to the amount of income earned in a fiscal year by a corporation. This amount is considered before tax and therefore before any declaration of dividends.

"Controlled foreign corporation" refers to a corporation which is under a tax jurisdiction different from the one exercised over the shareholders controlling such corporation.

The taxation of UICFC refers to a situation where the shareholders (and not the CFC) of a CFC are taxed on a pro rata share of such undistributed income by the tax authority exercising its jurisdiction over the shareholders.

This essay approaches the taxation of UICFC by looking at tax principles which should be taken under consideration in any tax policy decision-making process. Along with Musgrave, it is assumed that "There are certain principles that should be followed in taxing foreign source income."[2] We may mention equity among taxpayers and neutrality among locations of investment as examples of principles dealt with in the current study. It may be said that these principles are concerned with meeting the interests of the taxpayers considered individually.

Although it seems logical to think that a tax system embodying these principles should enable a country to be better off while preserving the interests of its taxpayers, the outcome may be somewhat different. It may appear that the interest of the nation differs from the interests of some of its taxpayers. Therefore, a tax authority may depart from the basic principles; it may voluntarily create discriminations among taxpayers and distortions among investments in order to safeguard the interest of the nation.

In this context, a tax policy decision has to be understood as an appraisal of the economic situation prevailing in a country at a given time. The purpose of the appraisal is to discover the economic wants of the country and the extent to which a tax measure would

1. "Undistributed income of controlled foreign corporation" will hereinafter be referred to as "UICFC" and "Controlled foreign corporation" will be referred to as "CFC."

2. P. MUSGRAVE, *United States Taxation of Foreign Investment Income*, 109 (1969).

answer such wants. Provided that a tax measure is judged appropriate, a tax mechanism is developed in the light of both the nation's and the taxpayers' interests. The tax mechanism is further integrated into a global tax system. As a result, the influence of the tax system on the economy is foreseen to be somewhat changed in order to create a beneficial effect on the country involved.

In consequence thereof, a policy-maker may face situations where basic principles and individual interests are in accordance with the interest of the nation and he may face situations where they are not. At any event, he will have to size up precisely the situation and, assuming that the interest of the nation should be favored, he will have to justify all departures, if any, from the basic principles.

For the purpose of this paper, it has been judged that the interests of the taxpayers should be considered at the outset. It has been decided that a sound first step would be to assume that the interest of the taxpayers would be identical with those of the nation and it has been further decided to build a model tax system under this assumption.

It is thought that this approach will present two important advantages: (1) It will provide the reader with a precise answer as to what is the tax treatment applicable to foreign subsidiary earnings when equity, neutrality and world efficiency requirements are respected. Such answer may appear to be a useful point of reference for any further analysis. (2) It will provide the reader with adequate fiscal background for the understanding of the Canadian and United States tax system.

With respect to this second advantage it is worth stressing the importance of such fiscal background:

From a technical standpoint, the analysis of UICFC involves several tax mechanisms since the tax measures under study are fully integrated parts of global tax systems. Understanding these tax measures requires a fair knowledge of all the tax mechanisms related to the issues focused on.

From a policy standpoint, basic decisions dealing with the general orientation, the framework of a tax system, will constitute the premises from which will follow other decisions. For example, the choice of jurisdictional connections or the question as to whether foreign source income should be taxed at all obviously constitute decisions upon which depends the tax treatment of a CFC.

Once the model is formed, we will focus alternatively on Canada, the United States and then on both countries in order to

analyze and compare their tax systems and in order to find out how the treatment they apply to UICFC departs from the one given by the model.

It may be said that we will indeed find some departures. In our imperfect economic world, different endowments, various rates of growth, tax rate differentials, tariffs and duties, etc. will segregate capital flows and create distortions in locating investments. In consequence thereof, states will react, adopt countervailing measures and depart from the basic principles.

To measure these departures will constitute our point of interest. We will examine the legislative history of each country and attempt to evaluate the arguments advocated as representative of the taxpayer's interests. We will focus on the decision-making process, point out what has been judged as the nation's interest and describe the underlying rationale for such judgement.

More precisely, our interest is based on the fact that both Canada and the United States currently tax the UICFC. The economic situation of each country being different, the treatment given to such income is not identical although it presents some similarities: basically, under both systems the undistributed income is taxed in a limited manner under special circumstances and may be perceived as a compromise between two schools of thought, one for the exemption and the other for the taxation of this income.

In both countries, this situation of compromise now leaves unsatisfied the supporters of both trends and arguments stressing the pros and cons are advocated, pointing out economic consequences and establishing relationships with taxpayers' claims and interests.

Our analysis will comprehend a study of the debates leading in both countries to the implementation of the current system. We will also compare with each other the current outcome of the debates or in other words, we will compare the current systems applicable to the taxation of UICFC.

As a final concern, we will attempt to outline trends and guidelines stressing the aspect of inter-relationship and interdependence among countries.

II BASIC PRINCIPLES: A MODEL TAX SYSTEM

In order to achieve a sound revenue structure, it has been proposed that the ten following criteria should be considered:[3]

3. *Report of the Ontario Committee on Taxation*, Queen's Printer, vol. 1, no 16-72, 6-22 (1967).

(1) *Equity:* Based on the principle of equal treatment of equals; this criterion is proposed as the prime but by no means, the sole characteristic of a good tax system.

(2) *Adequacy:* As a capacity to provide the flow of funds that a government deems appropriate in a given period.

(3) *Flexibility:* As a structural feature which will allow easy modifications.

(4) *Elasticity:* As a faculty to answer economic changes without requiring structural changes.

(5) *Balance:* As an adjusted mix of means and mechanisms meeting the four previous criteria.

(6) *Neutrality:* As an absence of interference with regard to the investment choice of a taxpayer.

(7) *Certainty:* As a precise and correct determination of time of payment and amount of tax.

(8) *Simplicity:* As a structural feature rendering the system accessible.

(9) *Convenience:* As a source of information and services to the taxpayer.

(10) *Economy of collection and compliance:* As a bureaucratic and enforcement efficiency.

Although it is worth keeping the totality of these criteria in mind, our purpose being more related to substantive issues rather than to administrative or purely structural issues, we will particularly focus on the criteria of equity, neutrality and simplicity. We will consider their application in the setting up of tax structures dealing with the taxation of foreign source income and will give them the connotation appropriate to this context.

2.1 JURISDICTION TO TAX: LEGAL BASES

Let us assume that a sovereign state is organizing a tax system and as a preliminary question,inquires into the scope of its right to tax under International Law.

It is held that there is no rule of International Law which limits or restricts a sovereign state's jurisdiction to tax.[4] It is important to

4. See: *S.S. "Lotus"*, PCIJ, Serie A-No. 10 at 19 (1927); NORR, "Jurisdiction to Tax and International Income", (1962) 17 *Tax Law Rev.* 431; RADLER, "Corporate Taxation in the Common Market", in *Guides to European Taxation*, vol. II, Part IV at IV-A:2-3.

point out that this statement implies, among other things that the state's jurisdiction is extended to foreign source income earned by its taxpayers. Therefore, income earned abroad by a domestic taxpayer can be taxed in the taxpayer's country whether this income is earned directly by the taxpayer, by his branch or by his controlled foreign subsidiary. Futhermore, it follows that nothing precludes the state from taxing either the distributed or the undistributed income of a CFC.[5]

We shall now examine the alternatives offered to a State in determining how to exercise its right to tax.

2.2 JURISDICTIONAL CONNECTIONS: INTERNATIONAL ASPECTS

Although the absence or quasi-absence of international rules is generally accepted, it is also argued that a link must exist between the State issuing the tax and the income reached by the tax; such links are referred to as jurisdictional connections. As an example, a tax system providing for the taxation by State A of the income earned in State B by a taxpayer citizen or resident of State B or of State C is likely to appear as a discriminatory and arbitrary tax and therefore to be contrary to general principles of International Law.[6]

In consequence thereof, a State may have the following choices in determining the manner in which it will exercise its taxing powers:

As a first alternative, the tax may be imposed on the income which is earned within the State's territory. Under these circumstances the jurisdictional connection will be the "source" of the income: the income will be taxed to the extent it is earned within the territory, as this may be defined.[7] This approach is referred to as either the source or the "ad rem" jurisdiction.

As a second alternative, the tax may rather be imposed on the income of the taxpayers which are under the state's territorial jurisdiction. Following this approach, individual citizens or residents will have their income subject to tax. With respect to

5. *Id.*, NORR, 432; RADLER, IV-A:4.

6. *Id.*, RADLER, IV-A:4.

7. On jurisdictional connections, see: SURREY, "International Income Tax Rules: Introduction to Concepts and Issues", in E. OWENS, *International Aspects of the United States Income Taxation*, 20-60 (Draft 1969); SATO and BIRD, "International Aspects of the Taxation of Corporations and Shareholders", XXII, No. 2, *IMF Staff Papers*, 384, 395-99 (1975).

corporations, either those incorporated under the law of the state or managed within the state will have their profits taxed. Under these circumstances, the taxpayer himself acts as a jurisdictional connection between the state and the income. This approach is referred to as the personal jurisdiction.

From an international standpoint, the first alternative will entitle the state to tax the income earned in its country, irrespective of whether this income is earned by domestic or foreign taxpayers. On the other hand, the second alternative will entitle the state to tax the income earned by domestic taxpayers irrespective of whether this income is earned within or without the country. The state may therefore be inclined to use both jurisdictional connections, that is to tax foreign taxpayers on their domestic income and domestic taxpayers on their worldwide income.

However, the source rule may appear to some economies, namely developing economies, as being more relevant to their financial objectives. Indeed, developing countries may very often be in a position where no substantial revenues would be collected by taxing foreign source income. Besides, the administration of a domestic income tax system presents an important burden from both a technical and a financial point of view. Therefore, the collection and enforcement of a foreign source income tax may be beyond a developing country's current possibilities.[8]

Furthermore, a state may voluntarily exclude the possibility of taxing foreign source income and adopt the source rule as a feature of a "tax haven" policy.[9] By "exempting" foreign source income a country may seek to favor the establishment of foreign held companies involved in investment or business activities in third countries. Such establishment may bring foreign currencies, human capital and goods into the country, open a market for domestic products, yield revenue by indirect taxation and therefore compensate for the absence of foreign source income revenues.

However, the application of the source rule may also present several drawbacks:

8. See SURREY, "Tax Administration in Underdeveloped Countries", (1958), 12 *U. of Miami L. Rev.* 158, Winter ed., reprinted in R. BIRD and O. OLDMAN, *Readings on Taxation in Developing Countries*, 3rd ed., 479, 480-81 (1975).

9. The expression "tax haven" refers to a country through which income can be channelled at little or no tax cost. See W. DIAMOND and D. DIAMOND, *Tax Havens of the World*, 2 Vol. (1977); B. SPITZ, *Tax Havens Encyclopedia*, (1975).

First, the implementation of the source rule may create a discrimination among taxpayers by favoring those with foreign source income. The tax principle calling for absence of discrimination is "equity" and the source rule violates this principle.

Secondly, since such a system does not provide for any tax equalization mechanism between domestic and foreign taxes, lower foreign tax jurisdiction will be favored and a distortion will be created among the locations of foreign investments. A tax principle calls for the elimination of such distortions; it is referred to as "international tax neutrality."[10]

Thirdly, a tax system based on the source rule may present structural problems specially with regard to the notion of flexibility and elasticity:

Indeed the system is based on the distinction between domestic and foreign source income since the tax liability depends upon the source of earnings. Such a setting places a great pressure on the rules defining what is domestic source income and what is not.

Moreover, several related economic activities may simultaneously take place within as well as without one state's border. A system attempting to cover exhaustively such activities may generate a rather complex set of provisions.

Furthermore, economic growth and industrialization will promote exportation of goods and capital. These activities may create substantial foreign source income. The reaching of such income under the source rule will require the adoption of either one of the two following means: (1) The extension of the notion of territorial jurisdiction in order to tax more income under the label of domestic source income. (2) The superimposition of a personal jurisdictional connection on the system in order to include foreign source income into the taxpayer's tax base.

The first alternative creates an artificial framework whereby the source income may be taxed by two countries as domestic source income. Since no country will grant a foreign tax relief with respect to its domestic income, a potential double taxation will occur.[11]

10. The principles of equity and international tax neutrality will be explained below in sub-section 2.3(c).

11. Double taxation is the subject of section 2.3 below.

With respect to the second alternative, the setting up of a system, whereby the *ad rem* jurisdiction is the basic rule and the personal jurisdiction is the exception, may create a tax structure were the general base is likely to disappear under very broad exceptions. When the taxation of foreign source income is seeked, it is suggested that a system based on a personal jurisdiction, applying a comprehensive base to all resident taxpayers, would constitute a desirable approach. Indeed, the superimposition of a partial personal jurisdiction on a source rule system has lead in different cases to the creation of rather uneasy and also inequitable systems.[12]

Following from this discussion, it may be stated that the adoption of the source rule will answer very limited economical purposes. A system based on the source rule will embody a breach of the concepts of equity and international tax neutrality. Such system will present inadequate features with respect to the taxation of foreign source income.

A global tax system, including all income into a comprehensive tax base may be seen as the right approach to the application of a uniform tax burden on the taxpayers of a given country. The logical consequence of a tax system based on the personal jurisdiction is the taxation on a current basis of income from all sources,irrespective of the type of investment and irrespective of the investor. Consequently, all taxpayers will be treated equally and the investors will be "neutral" with respect to the location of their investments. Likewise, such system may free capital flows and improve allocation of resources.[13]

The adoption of the personal jurisdiction approach will also relax the pressure exercised on the rules distinguishing domestic from foreign source income since the income from all sources will be taxed. However, these rules will remain necessary for several reasons. One of these reasons is related to the concepts of equity and neutrality. Indeed, the application of an equal tax burden on all taxpayers will require the state of residence to take into consideration the existence of foreign taxes imposed by the country of source and to grant a relief for these taxes. Consequently, the income upon which the foreign taxes are imposed will need to be determined.

---

12. See OLDMAN, "Taxation of Foreign Income and Income of Foreigners", excerpts from *Taxation of Foreign Income,* Tax Institute of America, 74-79, 84-88 (1966) reprinted in R. BIRD and O. OLDMAN, *supra,* note 8 at 201-08.

13. See the discussion on world efficiency on p. 372 below.

Rules differentiating sources of income will also be important to allocate the income generated by transactions between a domestic parent corporation and its foreign subsidiary. These rules are also relevant in the determination of the income earned within the country by non-resident taxpayers.

Another important point for the adoption of a personal jurisdiction connection is a revenue argument. However, as outlined above, there is also an argument favoring this type of jurisdiction for its capacity of achieving international tax neutrality and equity. Along with the latter argument, a foreign tax relief is granted which may offset in totality or in part the revenue yielded through the imposition of foreign source income.

In making its choice between raising revenue and granting a foreign tax relief, the country adopting the personal jurisdiction will have to take into account the interest of the country as a whole, the interests of its different taxpayers and the interests of other countries. We will now focus on further aspects of the elements involved in such decision.

2.3 DOUBLE TAXATION

(a) Nature

International double taxation may be sub-divided in two broad categories: (1) the juridical double taxation referring to the case where the same income or capital is taxable in the hands of the same person by more than one state. (2) The economic double taxation where the same income or capital is taxed more than once in the hands of more than one person.[14]

The latter case generally occurs where technical rules overlap in the allocation of deemed earned income. For instance, more than 100% of the undistributed income of a subsidiary may be allocated to its shareholders when the allocation rules of more than one country are involved.[15]

The former case is related to the basic framework of a tax system and therefore relevant to our discussion. This case may arise in three situations: (1) Where a taxpayer is deemed resident in more than one country, thus creating an overlapping of personal

14. On double taxation see *Draft Double Taxation on Income and Capital, Report of the OECD Fiscal Committee*, 140 (1963), (hereafter *OECD Report*); RADLER, *supra*, note 4, at IVA: 8-10.

15. This situation is discussed in section 5.1 on pp. 423-24.

jurisdictions. (2) Where a taxpayer is deemed to have earned his income within the territory of more than one country, which creates an overlapping of source jurisdictions. (3) Where there is a conflict of personal and "ad rem" jurisdictions. In this situation, a taxpayer resident in one state derives income from another state and both states impose tax on that income, respectively under the personal and source jurisdiction.

The economic double taxation as well as the juridical double taxation with respect to the case (1) and (2) described hereabove involve primarily problems of definition. For instance, two states having similar notions of "residence" and "source" would avoid the juridical double taxation (1) and (2). Though somewhat different in nature, the economic double taxation, with respect to the example given above, would be solved by an adjustment of the rules of allocation implemented by both states. As a consequence thereof, these cases of double taxation need the intervention of two states in order to make the required adjustments and therefore relief will be provided on a bilateral basis.

Assuming uniform definition of "residence" and "source" the juridical double taxation, situation (3), would still occur since one country exercises its power to tax under a personal jurisdiction while the other uses an "ad rem" jurisdiction approach. Under these circumstances either one of the countries or the two of them would have to restrict their jurisdiction in order to avoid double taxation. Such case of double taxation may therefore be dealt with either from a unilateral or from a bilateral standpoint.

(b) Unilateral Relief

A state may adopt various attitudes when faced with a conflict between personal and ad rem jurisdictions. It may grant no or various forms of foreign tax relief.[16] We will briefly outline relief alternatives and state the international consequences which result from the adoption of either one or another of these alternatives.

As a preliminary remark, it is worth pointing out that it is recognized by countries involved in relief of double taxation negotiations that the country of source would have a prevailing

---

16. On unilateral relief see NORR, *supra*, note 4 at 439-42; SATO and BIRD, *supra*, note 7 at 399-403; *OECD Report, supra*, note 14 at 141-45; E. OWENS, *supra*, note 7 at 61-74.

right to tax. Consequently to the extent that a unilateral relief is granted, it should be granted by the country of residence.[17]

However, a country of residence may refuse to recognize the foreign taxes and include income from all sources in a comprehensive base without granting any relief. No formal rule of International Law would formally forbid such attitude, although it would be contrary to international tax standards as developed by bilateral tax agreements.[18]

As a first relief, a state may recognize the existence of taxes paid in the source country but consider them as expenses incurred in earning income. The foreign taxes will therefore be deducted from the tax base in computing the taxable income. It is obvious that this procedure does not recoup in the country of residence the tax paid in the country of source and is consequently insufficient to provide full relief from double taxation.

Another approach would be for the country of residence to purely exempt foreign source income from domestic tax. Such exemption will generally be granted under the condition that the foreign source income is taxed in the source country. Obviously, such method radically eliminates double taxation.

As under the exemption approach a state may also leave out the foreign source income but may take such income under consideration when determining the rate of tax to be imposed on the domestic income. This method is known as "exemption with progression." The effect of this method is to tax the domestic income at the progressive rate applicable to the total income.[19]

Another method of relief is the reduction method whereby the income earned and taxed abroad is domestically taxed at preferential rates. A different method, however, called "proportional reduction method" will reduce the total tax due by an amount equal to the proportion to which the foreign income bears to the total income. This last technique will achieve the same result as the exemption with progression method.

Other methods use the credit system which may basically take two forms:

---

17. See *OECD Report, supra*, note 14 at 145-50.

18. On international tax standards see *OECD Report, supra*, note 14; *Double Taxation of Income and Capital*, OECD, (1974); E. OWENS, *supra*, note 7 at 121-25.

19. Both exemption and exemption with progression method are proposed by the OECD. cf. *OECD Report, supra*, note 14 at 141.

(1) The state of residence may grant a relief for the total amount of tax paid in the state of source. Such approach implies that in the case where the foreign tax liability exceeds the domestic tax liability, the country of residence will pay a refund to the taxpayer equal to the difference between domestic and foreign taxes. The method is known as the "full credit" method and will clearly eliminate double taxation.

(2) The "ordinary credit" method will limit the credit granted to a proportion of domestic tax which the foreign source income bears to the total income. Under these circumstances, the credit is granted to the extent of the domestic tax liability and no refund is available. Consequently double taxation will occur in cases of higher foreign tax liability.[20]

We shall now introduce certain fundamental principles in order to analyze and contrast the different relief methods and in order to outline the international consequences of the adoption of such relief methods.

(c) Fundamental Principles

(i) *International Tax Neutrality*

This concept refers to a situation where tax systems, domestic and foreign, would be harmonized or equalized in such a way that a given investor would be indifferent or "neutral" with respect to the location of his investments. This notion in its extreme sense implies no effective rate differentials among countries since variations in tax burdens would affect the taxpayer's choice.[21]

This notion will be better understood by introducing two other concepts, namely the notions of capital-export neutrality and capital-import neutrality.[22]

A capital-exporting country may achieve neutrality by taxing its resident taxpayers on a worldwide basis and by granting a complete relief for the foreign taxes imposed by the country of source. Under this assumption, income from all sources will be taxed at the rates applied by the country of residence. From the country of

20. The ordinary credit method is also a relief method proposed by the OECD, cf. *OECD Report, supra,* note 14 at 141.

21. On international tax neutrality see R. MUSGRAVE, *Fiscal Systems,* ch. 10, (1969); P. MUSGRAVE, *supra,* note 2 at 109-21; *Report of the Royal Commission on Taxation,* vol. 4, 491-96, (1966), *infra,* note 60.

22. See R. MUSGRAVE, *supra,* note 21; P. MUSGRAVE, *supra,* note 2; SATO and BIRD, *supra,* note 7 at 408-417.

residence's standpoint, the investor should therefore be neutral with respect to the location of his investments. However, from the country of source's standpoint, rate differentials may exist between the local investors and the foreign investor.

With respect to relief methods, the full credit method is the only one which achieves adequately capital-export neutrality.[23] However, one may find a reluctance from the residence country to pay the foreign country's taxes when rate differentials call for a refund to the resident taxpayer. Consequently, the ordinary credit method may be adopted by the residence country. In this case, to the extent that the taxes are higher in the country of source than in the country of residence, double taxation will occur and capital-export neutrality will fail to be met.

A capital-importing country may achieve neutrality by implementing a system based on an *ad rem* jurisdiction and apply the same tax structure to all income earned within the country. As a consequence thereof, capital funds coming from different creditor countries as well as capital funds coming from the country itself will compete under equal tax conditions within the capital-importing country. The exemption method will achieve capital-import neutrality.[24]

From the country of residence's standpoint, achievement of capital-import neutrality means that the jurisdiction to tax resident taxpayers on their foreign source income is left to the country of source. Consequently, in the presence of rate differentials among countries, investors will be attracted by the countries offering a lower tax rate and distortions will be created among locations of investment.

It is now easier to understand that rate differentials among countries are at the basis of the distinction between capital-import and capital-export neutrality. When both capital-export and capital-import neutrality are achieved, the requirements of international tax neutrality are consequently fulfilled.

(ii) *Equity*

The concept of equity calls for the application of tax measures

23. Such statement assumes that income taxes are not shifted to the consumers.

24. This statement assumes that the source country taxes are shifted to the consumers.

under which taxpayers with equal global income pay the same combined taxes.[25]

This notion stands strongly as long as it is applied to the rights of individuals before a tax system. When corporations are involved in this conceptual approach, the difference between corporate and individual rates renders difficult the application of the principle.[26] The analysis must then compare individual's income earned either directly or through a corporation and take into consideration any "integration" measures. These problems are dealt with in a further section.[27]

From an international standpoint, the notion of equity as described above would require the inclusion of income from all sources into a comprehensive tax base.[28] It would also require the granting of a complete relief for taxes imposed in the country of source in order to equalize the tax burdens between taxpayers earning foreign source income and those earning domestic source income. A system adopting this approach will be said to adopt an international tax equity approach.

Another attitude towards equity is referred to as national equity.[29] Under this proposal, taxpayers are deemed to be treated equally when all expenses incurred in the process of earning income are granted the right to be deducted from the tax base. It is further assumed that foreign taxes must be considered as such expenses and accordingly,right of deduction is granted for taxes paid abroad. It is worth mentioning that the deduction method will achieve national equity.

At this stage a relationship may be stressed between the personal jurisdictional connection, international equity, capital-export neutrality and the full credit method. These four tax measures are consistent with one another and may well be integrated into the same tax system.

---

25. See R. MUSGRAVE, *supra*, note 21 at 243-46; see also MUSGRAVE and MUSGRAVE, "Inter-Nation Equity" in R. BIRD and J. HEAD, *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup*, 63, 68-09 (1972).

26. See P. MUSGRAVE, *supra*, note 2 at 121.

27. See sub-section 2.4 (b) on p. 381.

28. On international equity see P. MUSGRAVE, *supra*, note 2 at 121-30.

29. *Id.*, at 122.

Opposite to these notions are the concepts of source jurisdiction, capital-import neutrality and exemption method.[30] Indeed, while capital-import neutrality calls for the exemption of foreign source income, capital-export neutrality requires its taxation under the rate applicable to domestic source income. In this respect, it is worth insisting on the fact that the concept of capital-import neutrality violates the concept of international equity since it discriminates against taxpayers earning domestic source income vis-a-vis those who receive foreign source income. Therefore, as far as a model tax system is concerned, the achievement of equity among taxpayers calls for the application of a personal jurisdiction and for the granting of a full foreign tax credit. Under these assumptions the system will achieve capital-export neutrality.

(iii) *World Efficiency*

This concept follows from the notion of international tax neutrality. It is assumed that an absence of tax impediments with respect to the location of investment would free capital flows and would favor a better allocation of resources.[31]

It must be insisted on the fact that the abolition of rate differentials and the establishment of a neutral international tax system would not automatically imply the creation of a perfect capital allocative efficiency on a worldwide basis. It will only favor it.

Indeed, allocation of capital will certainly be influenced by tax factors but also by artificial trade barriers or subsidies established by national governments. As a whole, foreign investors will consider all social, political and economic factors in choosing the location of their investments.[32]

Under the capital-export neutrality assumption, the capital outflows will be rather directed towards source countries offering a tax treatment similar to the one applied in the residence country. Indeed, investments in low tax rate jurisdictions would place the foreign investor under a heavier tax burden than the one borne by

30. The notion opposite to international equity would be international inequity rather than national equity. The national equity approach requires the taxation of income from all sources in a comprehensive base. It departs from international equity by using the deduction method rather than the full credit method.

31. See R. MUSGRAVE, *supra*, note 21, 248-54; SATO and BIRD, *supra*, note 7 at 407-17.

32. SATO and BIRD, *supra*, note 7 at 407.

the local investors. To the extent that the country of residence adopts high rates, the achievement of capital-export neutrality may favor domestic investments.

The capital-import neutrality approach will definitely favor low tax jurisdictions. To the extent that a country of source offers a more favorable tax treatment than the country of residence, the foreign investor will have the opportunity to earn income taxed at a lower effective rate under equal competitive terms with local investors. Capital-import neutrality measures may favor foreign rather than domestic investments.

A concept worth contrasting with world efficiency is known as national efficiency.[33] A state tends to national efficiency when tax measures discouraging foreign investment are adopted. The deduction method and the notion of national equity are linked to this conception of efficiency.

(iv) *Inter-Country Equity*

The principle of inter-country equity is not focused on the taxpayer but rather on the taxing authority. It is not primarily concerned with allocation of capital but rather with allocation of tax revenues between residence and source countries.[34]

To such extent, the notion of inter-country equity is based on the assumption that international tax neutrality and world efficiency fail to be achieved in practice and that rate differentials may lead to an unfair distribution of tax revenues among countries.

For instance, a capital-exporting country achieving capital export neutrality will apply the domestic rates to domestic taxpayers receiving foreign source income. Let us assume a rate of 50% in the country of residence. Let us further assume that $100 is earned in the source country and subject to a 20% tax and that full foreign tax relief is granted by the country of residence.

Under these circumstances, the country of source will receive $20 of tax revenues, $30 will be the country of residence's share, double taxation will be avoided and international equity will be achieved. However, the question asked by the inter-country equity

33. See P. MUSGRAVE, *supra*, note 21, 248-54; SATO and BIRD, *supra*, note 7 at 407-17.

34. On inter-country equity see R. MUSGRAVE, *supra*, note 21 at 246-48; P. MUSGRAVE, *supra*, note 2 at 130-33; SATO and BIRD, *supra*, note 7 at 421-29; BIRD, "International Aspects of Integration", 28 *Nat. Tax J.* 302 at 309-14 (1975); MUSGRAVE and MUSGRAVE, *supra*, note 25, at 63-85.

approach is: Why should 30% of income earned in the country of source end in the country of residence? Is such an outcome an equitable allocation of tax revenues?

These questions raise two issues: One related with the allocation of the tax base and the other with the determination of the tax rates.

With respect to the first one, the example above assumed that both countries included the full amount of income in the taxpayer's tax base. One may argue that it should be differently. The nature of the income or the economic relations of such income with the countries involved may provide arguments to advocate that the totality or part of the income should be taxed by one country and not by the other.[35]

With respect to the determination of tax rates, various criteria are proposed in order to adjust the tax rates between capital-exporting and capital-importing countries. It is proposed that the rates in the country of source could be either based on benefits granted to foreign investors by government expenditures or on economic rents accruing to the foreign capital invested in the source country. Such rate could also be based on a world income distribution plan whereby rates would be adjusted among countries, etc.[36]

For our purpose, it is important to stress that in the presence of rate differentials, the concept of inter-country equity calls for adjustments between capital-exporting and capital-importing countries. Under these circumstances, the application of domestic rates to income from all sources and the achievement of capital-export neutrality may not produce a desirable outcome. A policy maker must therefore seek to apply an equal tax burden on the resident taxpayers while taking into consideration the interests of trade partner countries.

(d) Bilateral Relief

Double taxation cases which originate either from an overlapping of personal jurisdictions or from an overlapping of source jurisdictions may be solved by agreement on the meaning and scope of personal and "ad rem" jurisdictions. Indeed, a uniform application of the notions of "residence" and "territorial jurisdiction" will

35. P. MUSGRAVE, *supra*, note 2 at 131-32.

36. SATO and BIRD, *supra*, note 7 at 423-29; MUSGRAVE and MUSGRAVE, *supra*, note 25 at 72-75.

avoid these cases of jurisdictional double taxation. The situations of economic double taxation may also be solved by agreement on the extent and effect of the rules allocating income.

With respect to conflicts involving both personal and source jurisdictions, bilateral negotiations may achieve in a more effective way the results sought by unilateral foreign tax reliefs.[37]

Double taxation may be avoided by identifying items of income and by allocating the tax base of the items between capital-exporting and capital-importing countries. This technique derives from the exemption method and may serve inter-equity purposes. However, it is based on a capital-importing neutrality approach and will present its adverse effects.

When an agreement cannot be reached on the exemption of an item of income or when the parties do not consider such approach, a given amount of income may be taxed in more than one country, and the relief methods will have to intervene in order to neutralize taxes on income. Bilateral negotiations may help countries to achieve this neutralization process.

Let us assume for instance that country A, as a capital-exporting country favors the achievement of capital-export neutrality and is willing to grant a credit for the taxes imposed by the source country B. Furthermore, country A may also import capital from country B and would appreciate that country B grant a credit to its taxpayers so that investment would not be discouraged in country A. Since the same reasoning may be applied to country B, it may be said that both countries are interested in the granting of foreign tax relief by the other country.

However, if the effective tax rate is higher in country B and if country A is not willing to offset its domestic revenues by granting a full tax credit, double taxation will occur.

Under these circumstances, it is proposed that country A and B adopt a tax system which for international purposes would be provided with a flexible set of withholding taxes. If judged equitable, these taxes may further be adjusted by treaty in order to equalize the effective tax rates between country A and country B.[38]

37. See SATO and BIRD, *supra*, note 7 at 403-06; NORR, *supra*, note 4 at 442-43.

38. See NORR, *supra*, note 4 at 442; see also BIRD, *supra*, note 33 at 310-11: Bird deals with the flexible withholding tax technique for achieving inter-country purposes in presence of integrated systems.

Tax rates may also be adjusted by treaty in order to achieve inter-country equity purposes.

Consequently, bilateral negotiations may enable countries to develop tax measures whereby unilateral relief mechanisms will be completed. The credit method has been judged as a useful device in achieving tax neutrality but also as lacking precision and entailing practical difficulties.[39] Tax agreements may be an appropriate way to overcome these shortcomings and reach neutrality.

This discussion on double taxation has provided us with all the elements necessary to understand the issues raised by the taxation of income earned through foreign corporations.

It has been pointed out that the concept of international equity leads to the adoption of a system achieving capital-export neutrality rather than capital-import neutrality.

It has been explained that a system achieving capital-import neutrality will favor investment in low rate jurisdictions. While a system achieving capital-export neutrality will favor investment in countries offering a tax treatment similar to the one applied in the residence country.

It has been outlined how treaty may be used efficiently to foster capital-export neutrality and how adjustment in tax rates through tax treaty negotiations may produce a better inter-country equity.

In the next section we shall analyze the implications of these principles for the taxation of domestic corporations and their controlled foreign subsidiaries.

2.4 EQUITY AND DEFERRAL

The principles governing the taxation of foreign source income having been discussed, we may add new elements in order to find out how the previous arguments stand in a more complex and complete model.

It must be assumed that the taxpayer may either be a corporation or an individual. The taxpayer may invest domestically or abroad and consequently earn domestic or foreign source income.

39. See P. MUSGRAVE, *supra*, note 2 at 113.

In the domestic setting the taxpayer is deemed to earn all items of income either directly or through a corporation. At the international level, since our discussion needs further distinctions, the taxpayer is deemed to make either; (1) portfolio foreign investments through a corporation, or (2) direct foreign investments which may produce income either through a branch or a corporation.[40]

Income earned in different manners will obviously render more difficult the application of an equal treatment among taxpayers. We will briefly compare different alternatives in earning income and attempt to point out the general principles that may be followed.

One initial problem is created by the fact that income may be earned by two different entities, namely individuals and corporations.

Equity among individuals calls for a comprehensive base and progressive rates. However, with respect to corporations, the application of a flat rate appears to be an adequate approach.[41] In consequence thereof, a given amount of income may be imposed at different rates depending upon the corporate or the individual nature of its recipient.

Furthermore, to the extent that corporations and individuals are considered as separate taxpayers, double taxation will occur upon distribution of corporate earnings to individual shareholders. For this reason, a separate entity approach does not comply with the concept of neutrality. However, it offers a very simple structure which will appear to be important at the international level and which is capable of yielding substantial revenues.

(a) Separate Entity System

At the domestic level, the separate entity system implies that individuals will be taxed currently on the income produced by their direct investments but that the corporate investment income will be taxed only upon distribution.[42] Indeed, the presence of a corporation between the economic activities and individual investors will entitle such investors to postpone the payment of their personal

40. The expression "branch" being generally used in relationship with a corporate investor, we will rather use the expression "direct business income" when referring to an individual investor.

41. Taxing corporations under a separate rate system would induce the creation of several corporations involved in related activities in order to split income and reach lower tax brackets.

42. See SATO and BIRD, *supra*, note 7, at 387-88, 411-17.

taxes until distribution of the corporate earnings to the shareholders. This effect, known as "deferral" may favor upper-bracket shareholders who prefer the corporate rate to their individual rates.[43]

With respect to corporations, deferral at the domestic level has no consequence between parents and subsidiaries since all income is taxed at the same rate. Moreover, it is assumed that, intercorporate dividends are exempt from tax in order to avoid multiple taxation.

Considering this domestic setting as a framework, we shall extend its features to the international level while respecting the principles of international tax equity and neutrality.

(i) *Corporate Taxpayers*

With respect to corporate taxpayers, since all income earned at the domestic level is taxed under one corporate rate, the logical implication is to tax foreign source income at the same rate. In order to do so all foreign source income earned by domestic corporations should be taxed currently and a full credit should be granted for foreign taxes.[44]

It must be stressed that this statement implies that foreign branch profits are included in the tax base on the one hand and that profits earned through a foreign subsidiary are included on the other hand. In the subsidiary case, the parent corporation would include in its tax base a proportion of the subsidiary's net income in proportion to its equity participation in such foreign corporation. This share of the subsidiary's income would be included as it is earned by the subsidiary whether it is distributed or not.[45] Conse-

43. It is assumed that the corporate rate is lower than the highest individual rate.

44. See P. MUSGRAVE, *supra*, note 2 at 112-15, 123-24; it may also be advocated that a strict separate entity approach would require the granting of deferral and the limitation of the foreign tax credit to withholding taxes. However, this approach violates the concept of equity. See MUSGRAVE and MUSGRAVE, *supra*, note 25 at 76-77.

45. The parent corporation would be deemed to have paid the foreign taxes applicable to its share of income and would therefore receive full credit for these taxes. Since this credit is not granted for taxes paid directly by the parent corporation it is referred to as "deemed" or "indirect" credit. Foreign taxes affecting branch profits and withholding taxes will be paid directly by the parent corporation and a direct credit will cover these taxes.

quently further distribution would not be taxed by the country of residence.[46]

The taxation of undistributed income of foreign corporations will achieve an equal treatment between foreign branch profits and foreign subsidiary profits. It will also treat equally foreign source income and domestic source income. The application of this measure is the mere extension of the principle whereby income from all sources must be included in a comprehensive base. The coupling of this measure with a full credit against foreign taxes will suffice to meet international equity and capital-export neutrality requirements.

It is worth noticing that on the basis of providing an equal treatment between foreign branches and foreign subsidiaries, it may be argued that only controlled foreign corporations (CFC) should be subject to the undistributed income measures.[47] Like branches, CFC have their economic activities directed by the domestic corporations and therefore taxation of UICFC would achieve an equal treatment. However, foreign corporations in which the domestic corporation possesses only a minority equity ownership would not have their dividend and business policy managed by the domestic taxpayer and the investment would rather be in the nature of a portfolio investment. Individual portfolio investors being granted the privilege of deferral, corporate portfolio investors would require the same treatment.

Although this argument may have some value in terms of equity between branch and subsidiary, it must be pointed out that corporate portfolio and corporate direct investors are taxed under the same rate at the domestic level. Furthermore, such treatment would favor portfolio investments in low rate jurisdictions and would be in violation of the principles of capital-export neutrality and world efficiency. However, a good argument for restricting the tax on undistributed income to CFC may be a practical one: the supplementary administrative operations that represent the

46. However, the country of source may impose a withholding tax on the dividends declared to the domestic corporation. This tax may be either credited to the domestic corporation or "passed through" and credited at the individual shareholder's level. Under the "passed through assumption" the corporation distributes a dividend grossed-up by the amount of the withholding tax. The shareholder further offsets his personal tax by an amount equal to the gross-up. If the individual foreign investor is granted a credit for withholding taxes, equity calls for the "passing through" of same. See P. MUSGRAVE, *supra*, note 2 at 112-15.

47. See R. MUSGRAVE, *supra*, note 21 at 266-67.

allocation and imposition of undistributed earnings may appear too expensive with respect to minority shareholders.

(ii) *Individual Taxpayers*

As mentioned previously, individuals at the domestic level will be taxed currently on the income produced by their direct investments whereas the corporate investment income will be included in their tax base only upon distribution.

A similar system should therefore be established at the international level. Such system would provide for current taxation of direct business profits and for deferral with respect to portfolio and direct corporate investments.[48]

However, the granting of a "simple" right to deferral for corporate foreign investments may create rate differentials between domestic and foreign deferrals. For instance, an investor may be able to defer domestically after a 50% corporate rate has been applied to corporate earnings but benefit abroad from a 40% corporate rate. In order to protect the equity concept, the investor should be given the right to defer abroad, but after a corporate rate equal to the domestic rate has been applied to corporate earnings. The implementation of such a treatment may however be rather difficult. In fact, the domestic corporate rate could be applied to the individual's share in the undistributed income of the foreign subsidiaries in which he has an interest. Full direct credit would be granted at the same time for the foreign taxes affecting such income. Moreover, dividend distributions would be directly included in his tax base and taxed exactly as domestic dividends. Upon distribution a direct credit would be granted for the foreign withholding tax.[49]

The extension of the domestic setting to the international level will grant to the individual investing in foreign corporations a right to defer personal taxes. Such extension of the domestic setting respects the principles of international equity. However, deferral favors corporate as opposed to branch investments and hinders the achievement of capital-export neutrality.[50]

A domestic setting neutralizing the differences between direct and corporate investment would be likely to achieve capital-export neutrality when adapted to international purposes.

48. See P. MUSGRAVE, *supra*, note 2 at 126.

49. *Id.*; BIRD, *supra*, note 34 at 307; SATO and BIRD, *supra*, note 7 at 416.

50. This discussion involving deferral and individuals is pursued further on p. 382; see also p. 383-84.

(b) Integrated Systems

Neutralization of differences between direct and corporate investments calls for an integration of the corporate and individual taxes.

A first approach would be to achieve a full integration by considering corporations as mere conduits to shareholders and to treat corporate profits as constructively received by the shareholders. Consequently at the domestic level, the corporate tax would be, for all practical purposes abolished and no earning would be retained by the corporations.[51]

At the international level, parent corporations would be deemed to receive their share of the undistributed income of the subsidiaries in which they have interests and full indirect credit would be accorded for foreign taxes. In turn, such corporate earnings would be imputed to the shareholders and the foreign tax credit would also be extended at the shareholder level.

Full integration also means that individual investors in foreign corporations would be taxed currently and that full indirect credit would be accorded for foreign taxes. Such treatment would be in accordance with the domestic setting if individual investments in domestic corporations are taxed currently under their personal progressive rates.[52]

Although this approach achieves in theory both international equity and capital-export neutrality, practical shortcomings may deter its implementation:

Under this system, a tax authority would have to increase drastically the individuals' rates, whether directly or in terms of withholding corporate tax, in order to raise an amount of revenue equal to the one provided by a separate entity system.[53]

Full credit for foreign taxes will need to be extended to all shareholders, including foreign shareholders. Such extension means that a state would grant a foreign tax relief in favor of residents of third countries. Such outcome may be desirable if two countries, reciprocally importing and exporting capital, adopt an integration formula in their respective tax system. In other circumstances the

---

51. See SATO and BIRD, *supra*, note 7 at 393-94.

52. BIRD, *supra*, note 34 at 308.

53. See SURREY, "Reflections on "Integration" of Corporation and Individual Income Taxes", 28 *Nat. Tax J.* 335-36 (1975).

implementation of a full integration approach may call for bilateral adjustments.[54]

Furthermore, the actual retention of the corporate earnings by either parent or subsidiary may pose liquidity problems to individual shareholders. Such retention will also render difficult the equation of tax burdens among taxpayers.[55]

Other approaches to integration, known as partial integration formulae may also eliminate the corporate tax but rather than taking place when the corporate income is earned, they will take place upon distribution.[56]

These techniques by postponing integration until the distribution will embody a deferral approach. Consequently, upper-bracket shareholders will be privileged at the domestic level. If the domestic setting is extended on the basis of equity to the international level, upper-bracket shareholders will also be privileged. With respect to deferral by individuals, the partial integration systems will present drawbacks similar to those presented by the separate-entity system and will also lead to a breach of the capital-export neutrality concept.

The application of a uniform corporate rate at the domestic level will ensure that the parent corporations will be taxed at the international level on the undistributed income of their subsidiaries and that full credit will be granted. Partial integration will require that such full credit be passed to the shareholders, including foreigners, upon distribution. Consequently, bilateral adjustments may be required. Finally, problems of loss of revenue may likewise pose a practical barrier to the adoption of a partial integration system.[57]

With respect to individuals, it may be put forward that the abolition of their right to deferral at the domestic level will permit the achievement of capital-export neutrality at the international level. However, it follows from the current discussion that such abolition leads to very serious practical drawbacks. Although a solution may reside in bilateral adjustments granting effective reciprocity, it is suggested that a separate entity system, achieving equity among individuals may represent an adequate solution from a more practical standpoint.

54. BIRD, *supra*, note 34 at 308; SATO and BIRD, *supra*, note 7 at 441-46.

55. BIRD, *supra*, note 34 at 308. See SURREY, *supra*, note 53 at 336.

56. See SATO and BIRD, *supra*, note 7 at 388-93.

57. *Id.*, at 416-17; BIRD, *supra*, note 34 at 308-09; SURREY, *supra*, note 53 at 338-39.

It may be recalled that under a separate entity system, international equity and capital-export neutrality are achieved with respect to corporations by adopting a current taxation and full credit system. With respect to individuals, international equity is achieved when the domestic deferral privilege is extended to the international level. Application of the corporate rate and full credit would achieve this result.

(c) Note of Deferral

It is worth recalling that the adoption of measures leading to the current taxation of foreign source income is required by the existence of rate differentials among countries. In the absence of rate differentials the mere adoption of an exemption method would achieve international neutrality. In their presence, either the failure to tax foreign source income or to tax it currently may generate similar effects.

Indeed, the taxation of subsidiary profits upon distribution (deferral) has to be considered in parallel with an exemption of foreign source income. Before repatriation, deferred income and exempt income are treated in the same manner since the only applicable tax is the one levied by the source country. Furthermore, distribution of the deferred income may never occur,which creates perfect parallel with exempt income.

Assuming now a future distribution and a lower rate in the source country, it is true to say that during the deferral period a potential domestic tax is kept and capitalized in the foreign subsidiary. Upon distribution, the domestic tax will be paid but the advantages of the capitalization will remain. Example: $200 of after tax foreign source income are kept in a foreign subsidiary throughout 10 years. Assuming a rate of interest of 8% and a domestic rate of 50%, the $100 of potential domestic tax will be worth $154 after the period of deferral. Under these circumstances, deferral would save the investor more than half of the tax.

Consequently, deferral may permit either an exemption or reduction of domestic taxes. In broad terms, it must be considered as a tax device achieving capital-import neutrality and to this extent related to the "ad rem" jurisdiction and to the exemption method. The adverse effects provoked are basically: (1) A discrimination among taxpayers resulting from the privilege given to taxpayers earning subsidiary income in low rate jurisdictions; such an effect being in violation of the concept of international equity; (2) A distortion in capital flows and location of investments which results

from the fact that investors are entitled to take advantage of the rate differentials existing among countries; this distortion is contrary to the achievement of world efficiency;[58] (3) As corollaries of these adverse effects, foreign investment is favored in low rate jurisdictions and foreign source income may never be repatriated. A national loss of revenue follows from this situation. Furthermore, deferral in low rate jurisdictions may favor the creation of CFC through which foreign source income will be diverted in order to reduce the domestic corporation tax liability. This abuse of the privilege of deferral leading to tax avoidance is referred to as "tax haven" operation.

With respect to the establishment of a model tax system it is suggested that such system should be founded on the principles of international equity and capital-export neutrality. For this purpose, a separate entity system may be used.

With respect to corporations, this system would permit the achievement of both international equity and capital-export neutrality by the adoption of a current taxation and full credit policy. It would consequently call for the abolition of deferral.

With respect to individuals, international equity will be achieved by the extension of the domestic deferral privilege to the international level. Application of the domestic corporate rate to foreign source income and full credit will achieve this result.

This use of the domestic corporate rate will deter canalization of investments toward low rate jurisdictions and also tax haven abuses although it will not achieve capital-export neutrality.

The application of such a system to individuals offers an interesting compromise between neutrality and practical considerations. Indeed, this setting presents a clear advantage of simplicity when compared to other systems.

We shall now examine the Canadian and United States systems in the light of the principles stated in this chapter.

58. Under a system achieving capital-export neutrality, investors may not take advantage of rate differentials among countries since they will tend to invest in countries offering a tax treatment similar to the one offered by the country of residence. This situation may not be more favorable to the achievement of world efficiency but will fulfil international equity requirements.

III THE CANADIAN POLICY

3.1 PHASES OF THE CANADIAN TAX REFORM

With regard to the taxation of foreign source income, the Canadian system remained basically unchanged during the 20 year period between 1952 and 1972.[59] However, the reform was initiated 10 years before in September 1962 when the Canadian Royal Commission on taxation was appointed to study and revise the Canadian tax system in its entirety. The Commission released a voluminous report in February 1967 proposing new approaches in the field of international taxation.[60]

The report was submitted to critics and further studies during two and a half years and the Canadian tax policies appeared to be substantially transformed at the time the "Proposals for Tax Reform" were delivered by the Honorable E.J. Benson in his White Paper of 1969.[61]

Modified after hearings, the Proposals became a law which came into force on 1 January 1972.[62] However, one part of the provisions dealing with the treatment of income earned abroad by Canadian residents became effective only in 1973 and another part, including the sections providing for the taxation of undistributed income earned by controlled foreign affiliates came into force only for the taxation years commencing after 1976. Indeed, the last piece of regulation, known as the FAPI regulations was published in the Canadian Gazette and therefore effective on October 25, 1976.[63]

It follows that the Canadian tax reform took exactly 14 years to reach fruition, as far as the taxation of foreign subsidiary income is concerned.

We shall retrace the principles involved in this reform, analyze how they were applied to the taxation of the undistributed income earned by foreign subsidiaries and compare them with the principles developed in the previous chapter.

---

59. The Act in force throughout this period was the *Canadian Income Tax Act*, R.S.C. 1952, c. 148 as amended up to 1972, (hereafter *1952 ITA*).

60. *Report of the Royal Commission on Taxation*, 6 vols., Ottawa: Queen's Printer (1966), (hereafter *Carter Report*).

61. *Proposals for Tax Reform*, Ottawa: Queen's Printer (1969), (hereafter *Proposals)*.

62. Canadian *Income Tax Act*, S.C. 1970-71-72, c. 63 as amended, (hereafter *1972 ITA*).

63. *Income Tax Regulation*, SOR/DORS/76-704, (1976) 110 Canada Gazette, Part II, 2964 (no 21, 25/10/76).

3.2 THE PRE-1972 SYSTEM

(a) Treatment of Individuals

With respect to individuals, the 1952 ITA provides that Canadian residents will be taxed on their income from all sources at progressive rates ranging from 11% to 80%.[64]

At the domestic level, corporate investment income is taxed upon distribution, and individuals are granted a credit equal to 20% of the dividends received.[65]

At the international level, all income is taxed as earned but the corporate investment income which is taxed upon distribution. In spite of the 20% domestic credit, no indirect credit is granted against underlying foreign taxes affecting the dividends received.

However, an ordinary direct credit is granted and covers all foreign income and profit taxes, including withholding taxes paid directly by an individual taxpayer.[66]

Furthermore, a 4% surtax is imposed on the foreign source income which is in excess of either $2,400.00 or the individual's personal exemptions.[67]

The analysis of tax treatment applied to individuals may be succintly summarized: a 20% domestic credit for dividends and an absence of foreign indirect credit coupled with a 4% surtax on foreign source income form a set of measures aimed at discouraging foreign investment and particularly portfolio investment in high rate jurisdictions. The system presents a clear departure from capital-export neutrality and a promotion of national efficiency.

(b) Treatment of Corporations

According to Canadian case histories, a corporation is resident for tax purposes in the country where its control and management are exercised. Furthermore and in general terms,

---

64. *1952 ITA*, Sec. 1, 32; for a technical analysis of the 1952 *ITA* provisions, see *Carter Report, supra*, note 60, vol. 4 at 509-12; J. McDONALD, *Canadian Royal Commission on Taxation, Foreign Investment and International Transactions*, 4 (1967).

65. *1952 ITA*, Sec. 38.

66. *1952 ITA*, Sec. 41.

67. *1952 ITA*, Sec. 32 (b).

under the 1952 ITA a corporation is deemed to be resident in Canada when incorporated in this country after April 26, 1965.[68] A Canadian resident corporation is taxed on its worldwide income at a 50% rate.[69] Intercorporate dividends are exempt from tax.[70]

A resident corporation operating abroad through a subsidiary will be taxed upon distribution of the subsidiary's income. On the other hand, a resident corporation operating through a branch is currently taxed on the branch profits.

Although no indirect foreign tax credit is available, direct foreign tax credit is granted to domestic corporations. Therefore, resident corporations are only entitled to offset against their Canadian tax liability: (1) the foreign taxes affecting the branch profits; (2) the withholding tax imposed on the dividends. This credit is limited by the Canadian tax liability.[71]

An important element completes this structure: Under article 28(1)(d) of the Act, dividends received from a non-resident corporation, more than 25% of the full voting rights of which are beneficially owned by the Canadian parent corporation, are deductible in full in computing the taxable income of the Canadian corporation.

In terms of equity the uniform corporate rate and the current taxation of branch profits would have called for a current taxation of subsidiary profits and the granting of a full direct and indirect credit. Instead of implementing such current taxation, the Act provides for the deferral of subsidiary earnings and, provided that the 25% requirement is fulfilled, for a complete exemption of foreign dividends.

As a consequence of this mechanism subsidiary investment will be strongly favored in low tax jurisdictions. The dichotomy between branch, controlled subsidiary and corporate portfolio investments is striking. Indeed, the income produced by the branch is currently taxed at the domestic rate or higher whereas the income produced by controlled subsidiary is completely exempt. Portfolio income is

68. The "control and management" criterion was developed in the following cases: *De Beers Consolidated Mines Ltd.* v. *Howe*, (1906) A.C. 455; *Bullock* v. *The Unit Construction Co. Ltd.*, 38 T.L. 713; *Yamaska Steamsphip Co. Ltd.* v. *M.N.R.*, 61 D.T.C. 717. The statutory extension was introduced in the Act in 1962 though broadened in 1965, see *1952 ITA*, Sec. 139 (4a).

69. *1952 ITA*, Sec. 2, 3, 39 (1).

70. *1952 ITA*, Sec. 28 (1).

71. *1952 ITA*, Sec. 38.

granted deferral but no indirect credit. Sato and Bird present a clear summary of the situation:

> "The system in Canada prior to 1971 resulted in different after-tax profits for investments with the same before-tax rate of return, depending on the investment and the foreign rate. While branch profits were treated like domestic profits, being subjected to current taxation with a credit for foreign corporation tax, the net profits from subsidiary operations abroad in fact varied with the foreign rate because of the absence of equalizing measures in Canada. Corporate portfolio dividends were treated less favorably since no credit was granted for the foreign corporation tax. As a result the system tended to encourage subsidiary investment in low-tax countries and discourage portfolio investment, particularly in high-tax countries."[72]

The reasons for such policy and more precisely the reasons for introducing a dividend exemption are rather surprising. The original purpose of the provision is to provide an equitable and administratively simple alternative to the complexities of the gross-up and credit system. It is worth reproducing the full explanation given upon the introduction of the provision since some of the arguments advocated are still underlying the current Canadian policy.

Article 28(1)(d) was introduced in 1949. The Minister of Finance, Mr. Abbott stated the following in his budget speech:

> "There will be several amendments introduced affecting companies having business operations abroad. The more important of these will remove a complicated procedure by which corporations having controlled subsidiaries abroad are now allowed to claim a tax credit against their Canadian tax for taxes paid by these subsidiaries abroad, and in some cases by companies which are in turn subsidiaries of the foreign subsidiary. In view of the fact that most countries in which Canadian companies are now doing business abroad impose corporation taxes as heavy or heavier than the Canadian tax, the effect of the present tax credit provision is that no Canadian tax is imposed on this income. The procedure for attaining this result, however, is extremely complicated and it is proposed that the same result be achieved by an amendment which would allow dividends from such controlled foreign subsidiaries to be taken into Canadian income free of tax. This will greatly simplify one small but very complicated provision of the law at no appreciable cost in revenue."[73]

---

72. SATO and BIRD, *supra*, note 7, at 443.

73. As reported by FELTHAM, "Tax Treatment of Foreign Source Income", 20 *Conf. Ref.* Can. Tax Found. 289, 295 (Nov. 1967).

However, the exemption of foreign source dividends had implications that went far beyond the achievement of administrative simplicity. Apart from discriminating types and locations of investment and impeding the achievement of capital-export neutrality, the provision lead to abuses. Indeed, the provision was proved to favor two types of tax haven operations.

First, the provision was used by Canadians to reduce or avoid Canadian tax on income generated in Canada. The Carter Commission noticed that companies created in foreign tax havens were engaged in a series of paper transactions and were used by Canadians in order to exploit the provisions of tax treaties, take advantage of section 28 (1) (d) and consequently reduce Canadian tax liability.[74]

Secondly, data compiled by the Taxation Division provided evidence that a very substantial part of the tax free dividends reported under this section originated in foreign tax havens and were received in Canada by holding companies representing for the most part foreign ownership. As a consequence thereof, Canada itself was used as a tax haven for international business transactions.[75]

This section outlines the facts and problems existing in Canada when the Carter Commission started exploring means to achieve a tax reform. We shall examine its proposals.

3.3 THE CARTER PROPOSALS

(a) Basic Policy

The Commission considers that the taxation of foreign source income earned by Canadian residents presents two basic issues: (1) The determination of the extent to which foreign source income should be taxed as earned abroad. (2) The establishment of the form of recognition that should be given to the income taxes levied by the country of source.[76]

With respect to the first question, the Commission puts forward an equity argument and shows interest in achieving neutrality among locations of investment. Indeed, it is stated as a declaration of principle that: "Foreign income of Canadian residents should

74. *Carter Report, supra,* note 60, vol. 4 at 511.

75. *Ibid.*

76. *Id.,* at 483.

also be taxed under the comprehensive tax base in accordance with procedures which minimize tax deferment and the use of tax havens (...)"[77]

However, with respect to the second question the Commission is rather reserved in stressing the equity and neutrality standards. In describing a basic policy with regard to foreign taxes, the Report merely states that: "The treatment of foreign income of Canadian residents should include some recognition of foreign taxes levied on that income."[78]

We shall briefly analyze the system proposed before examining the reasons underlying the Commission's policy.

(b) Proposed System[79]

(i) *Domestic Level*

Under the Carter's proposals, individuals are subjected to tax under progressive rates, the top rate being of 50% reached at $100,000 a year. Corporations are taxed at a flat rate equal to the top individual's rate, namely 50%.[80]

Canadian resident shareholders are granted a full corporate tax credit upon distribution of dividends. Indeed, the proposals provide for a partial integration of corporate and personal income tax liability. Since the integration mechanism is entirely at the shareholder's level and since the top individual's rate is equal to the corporate rate, the proposed mechanism will involve a refund of taxes when the shareholder's personal rates will be under 50%.[81]

---

77. *Ibid.*

78. *Ibid.*

79. *Id.* the tax treatment of individuals is described in Vol. 3 part A and Vol. 4 part B deals with the tax treatment applicable to corporations. Vol. 4, part D at 481-537 covers the taxation of foreign source income. For technical comments on the latter aspects see J. McDONALD, *supra*, note 64, at 9-12; MOFFET et al. "International Aspects", 19 *Conf. Rep.* Can. Tax Found. 174-76, 195-99, 323-31 (Apr. 1967); FELTHAM et al. *supra*, note 73, 289-314; "Fact and Opinion", 15 *Can. Tax J.* 79-219 (1967); VINEBERG, "Royal Commission Proposals Should Revolutionize Canadian Tax System", *The J. of Taxation*, 258-61, (May 1976); C. BAILLIE, *International Taxation and the Carter Report*, 32-56 (1967).

80. Under these circumstances it is worth noticing that domestic deferral will not favor individual holders of corporate investment. On the contrary, deferral will increase the tax burden if the individual's tax rate is under 50%.

81. The dividend must be grossed-up upon reception by the amount of the corporate tax. The corporate rate being of 50%,the gross-up is equal to 100% of the dividend

(ii) *International Level*

Before outlining the Commission's proposals, we shall examine the outcome in the international setting, given the domestic setting and assuming that the concepts of international equity and capital-export neutrality are followed.

With respect to corporations, foreign source income should be currently taxed at 50% and full foreign tax credit should be granted. Since the system is provided with an integration mechanism, a credit equal to 50% of the grossed-up dividends must be extended to the shareholders, including the non-resident shareholders.

With respect to individuals, the income produced by foreign corporate investment should be subjected to the corporate rate, namely 50% and full credit should be given for the foreign taxes affecting one individual's share of income in the foreign corporation. Upon distribution, the gross-up and the 50% credit mechanism should be applied. Such measure would treat equally income from domestic and foreign corporate investments. The current taxation of branch profits would be in accordance with the tax treatment given to other domestic earnings.

However, the Commission did not present an international setting following logically its proposed domestic setting. The keystone of the Commission's approach at the international level is to provide for a deemed foreign tax rate of 30% and accordingly to grant a foreign tax credit at the same rate. The basic characteristics of the system may be outlined as follows:

All foreign source income, irrespective of the type of investment, either distributed or not, when earned during a fiscal year by a direct investor will be deemed to have been subjected to a 30% foreign tax.[82] Such income will be grossed-up by the amount of the deemed foreign tax and included in the taxpayer's tax base.

When the foreign tax rate will be in fact less than 30%, the difference between the foreign tax and a 30% tax will be paid as a special tax to the Canadian Treasury. It is important to notice that this special tax will also cover branch profits and subsidiary undistributed profits.

received. Therefore, a $100 dividend implies a $200 inclusion. Assuming a 30% personal rate the tax liability will be of $60, whereas a credit of $100 may be claimed. The taxpayer will receive a $40 refund.

82. A direct investor may be described as a Canadian resident (or his associated group) which holds a 10% or greater interest in a foreign corporation, property or business.

When the direct investor is a corporation, no Canadian tax, apart from the special tax, will be payable on its foreign source income. Upon distribution of dividends, such domestic corporation will withhold 20% of the grossed-up amount of the foreign source income. Upon reception, the shareholders will gross-up the dividend received by 100% and take a 50% credit since the equivalent of a 50% corporation tax has been paid. The credit is not extended to non-resident shareholders.

When the direct investor is an individual, his foreign source income may, in the first place be subject to the special tax. Such income will then be grossed-up by 50%, included in his tax base and taxed at his personal rate. A 30% credit is granted and any excess credit will be refunded.

As a consequence of these provisions:

— All foreign source income earned by direct investors will be taxed currently at a rate of at least 30%. Discrimination between branch and subsidiary income will be eliminated and deferral in tax havens will be minimized.

— On the other hand to the extent that the actual foreign rate is less than or equal to 30%, the corporate direct investor will benefit from a 20% margin free of tax as long as the earnings are retained in the corporation.[83]

— The limited 30% foreign tax credit may fall short of recouping the full amount of tax imposed by the source country. Under this assumption, double taxation will generate an increased tax burden on foreign source income. This is particularly true when the foreign source income reaches the individual's level.

With respect to portfolio investors the Report submits the following proposals: They will be taxed in the same manner as under the 1952 Act which means that income from all sources is taxed at the individual's rate and a direct foreign tax credit is granted. However, at his option, a portfolio investor may elect to receive the tax treatment given to direct investors.

83. Indeed the "special tax" treatment may discriminate againt domestic source income. It is understood that these provisions where proposed under the assumption that the average individual's rate was of 30% but it must be pointed out that foreign source income taxed at or under 30% in the source country will create an advantage for upper bracket shareholders when earned and retained into a domestic corporation.

This possibility of election will prevent distortions between domestic and foreign portfolio investments although domestic investment income will be privileged when the foreign tax will be higher than 30%.

(c) Reasons for Proposals and Critics

The Commission justified its proposals by insisting on the fact that the 30% deemed foreign tax provided an equality of treatment between types of foreign investments and also would reduce deferral and the use of tax havens.

With respect to the 30% limitation on the foreign tax credit, the Commission presents a long study on the concept of neutrality and states that: "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."[84] It further poses that this would require that all nations provide the same public goods, avoid tax shifting, tax income on a worldwide basis defined in a uniform manner and under the same rates, etc.[85]

After pointing out that these conditions would be very difficult to realize, the Commission stresses that it should rely on a more pragmatic basis and consider Canada's interest as a priority in spite of the fact that the achievement of international neutrality is a desirable outcome.[86]

However, in doing so the Commission would neither suggest the setting of artificial economic barriers nor favor unduly national efficiency. It is proposed that Canada should not follow a policy discouraging foreign investment by its residents in order not to provoke retaliation by foreign countries.[87]

It is interesting to notice that the avoidance of foreign retaliation seems to be an important criterion upon which the Commission relies to determine the extent to which national or world efficiency should be favored.

The deduction method being judged as likely to produce retaliation, the credit method is adopted. The 30% limitation is

84. *Carter Report, supra,* note 60, vol. 4 at 491-92.

85. *Id.*, at 492.

86. *Id.*, at 484, 496.

87. *Id.*, at 496, 506-07.

considered as capable of yielding small revenue from foreign source income without deterring foreign investment or inducing retaliation.[88]

It is further added that a flat rate credit, although arbitrary, presented the advantage of simplicity. When coupled with the deemed 30% foreign tax mechanism, it would indeed offer an adequate and simple device to deter deferral in tax havens.[89]

With respect to deferral, the indirect credit method and the United States "Subpart F" provisions were discussed by the Commission but not retained. The Commission explains: "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."[90]

It may be added that both the full and ordinary direct credit were examined but rejected. The full credit was discarded on the mere base that it involved the payment of foreign taxes by the Canadian Treasury. With respect to the ordinary credit, it was argued that such device would entitle taxpayers to offset their Canadian tax liability and therefore to enjoy the benefits of public expenditures at no cost. The Commission's opinion was that taxpayers with foreign source income should bear some of the cost.[91]

The release of the proposals dealing with the taxation of foreign source income raised more criticism than approval.

The commentators generally pointed out that the 30% limitation on the foreign tax credit created a discrimination against foreign investment since the foreign tax rates were very often higher than 30%. Such a policy imposed a heavier tax burden on taxpayers earning foreign source income, thus violating the principles of equity and international tax neutrality.[92]

Tillinghast stresses the fact that the countries member of the OECD agreed in 1963 on three methods of relief from double

88. *Id.*, at 489, 506-07.

89. *Ibid.*

90. *Id.*, at 514.

91. *Id.*, at 512-13.

92. See TILLINGHAST, "The Carter Commission Report and International Investment Transactions; Integration and Ambiguous Intentions," 22 *Nat'l. Tax J.* 79-81 (1969); MIESZKOWSKI, "Carter on the Taxation of International Income Flows," 22 *Nat'l Tax J.* 97, 100-03 (1969); MUSGRAVE, "An Evaluation of the Report," 15 *Can. Tax J.* 349, 366-69 (1967).

taxation, namely the exemption, the exemption with progression and the ordinary credit method.[93] Indeed, as far as the OECD Model Treaty represents international standards, the Carter proposals fall short from meeting them.

Tillinghast also points out that the tax treatment accorded to non-residents by the Commission assumes that: "[A] full credit for Canadian taxes will be available in the investor's home country."[94] Canada should therefore act accordingly with respect to its residents.

This theme is also emphasized by Mieszkowski who insists on the fact that Canada is heavily dependent on foreign capital, the main source of which is the United States.[95] In this respect he states that: "International neutrality is not a sacred cow but adherence to it by the United States has resulted in considerable benefits to Canada. Canada should reciprocate in full in the treatment of foreign investments abroad."[96]

Musgrave states that one of the main arguments upon which the Commission relies to justify its 30% credit proposal, namely the international market imperfections, may not support the proposed departure from neutrality since unneutralities and imperfections also exist at the domestic level. Consequently, a sound policy should promote a productive use of capital at both levels.[97]

Musgrave also pretends that the taxation of all foreign profits on an accrual basis coupled with a full credit for foreign taxes would not raise more administrative problems than those raised by the enforcement of the 30% foreign tax rule. He therefore questions the reasoning whereby the full credit approach has been rejected in part because of administrative complexities.[98]

---

93. TILLINGHAST, *supra*, note 92 at 81.

94. *Id.*, at 88.

95. Mieszkowski reports that in 1967, U.S. Nationals counted for 80% of the direct foreign investment in Canada and for about 70% of the portfolio investment. At this time, approximately 45 to 50% of the corporate equity in Canada was owned by U.S. persons. U.S. investments in Canada were of 29.4 billion while Canadian investments in the U.S. amounted to 9.3 billion; see MIESZKOWSKI, *supra*, note 92 at 101.

96. *Id.*, at 108.

97. MUSGRAVE, *supra*, note 92 at 366.

98. *Id.*, at 368.

As a whole, it may be said that the Carter Report presented a good approach towards equity and neutrality by proposing the taxation of foreign source income on a current basis, irrespective of the type of investment. However, the pursuit of a narrow concept of national interest produced a dichotomy between the domestic and foreign setting whereby foreign source income was seriously discriminated against.

3.4 THE WHITE PAPER PROPOSALS

The "Proposals for Tax Reform" released in 1969 by the Honorable E.J. Benson intend as a general objective, neither to promote nor discourage foreign investment by Canadians.[99]

This neutral proposition is, however, modified by a further statement pointing out that there is a difference between an incentive to invest in Canada and a disincentive to invest abroad and that the overall tax system may voluntarily attemp to favor domestic without deterring foreign investment.[100]

Indeed, the Canadian industry is described as being controlled to an abnormal extent by foreign ownership and consequently as suffering from a lack of Canadian capital. On the other hand, some growing Canadian companies would be required to export capital and to develop foreign markets in order to achieve appropriate economies of scale.

The Proposals attempt to fulfil these two requirements. The desired equilibrium is attained however, in a rather peculiar way. It may be said that the proposed system is more based on countervailing discriminations than on measures tending to a uniform goal.

(a) Corporate Taxpayers

With respect to foreign corporations controlled by domestic corporate parents, the Proposals present a tax treatment clearly based on capital-import neutrality. Introducing the government's

99. See *Proposals, supra,* note 61 at 72 # 6.8; for a technical analysis of the *Proposals* concerning the treatment of foreign source income see, MOFFET, MACKAY et al., "International Aspects", 22 *Conf. Rep.* Can. Tax Found. 171, 173-75, 182-87, 292, 306-07, 312-26 (1970); TAMAKI, "The White Paper: Taxation of Foreign-Source Income", 18 *Can. Tax J.* 142 (1970); SINGER et al., "Business and International Aspects of Proposed Canadian Tax Reform", *The J. of Taxation* 40, 42-43 (July 1970).

100. *Proposals, supra,* note 61, at 72 # 6.10.

policy toward CFC, the Proposals state: "Such companies would find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors."[101]

Accordingly, it is proposed to continue in a more restricted form what was provided by the 1952 Act, namely the exemption of dividends received by a Canadian corporation from a CFC. For this purpose, a Canadian corporation is deemed to control a foreign corporation when 25% or more of the foreign corporation voting shares are owned by the Canadian company.[102] In such situation of control, the Canadian corporation will be known as a direct investor.

However, this dividend exemption privilege is subject to two restrictions.

First, the dividends will be exempted provided they are released from a country with which Canada has concluded a bilateral tax convention. This measure is considered by Canada to be a good negotiation device as well as an adequate means to promote international trade and facilitate international investment.[103]

The second restriction concerns tax haven abuses. This restriction is not limited to CFC resident in a treaty country but is extended to all CFC. It is discussed below.

It must previously be mentionned that income earned by a CFC in a non-treaty country will be taxed upon distribution and the foreign taxes will be deducted from the foreign source income in such a way that an effect equivalent to the one offered by an indirect and direct credit will be obtained. Therefore, parent corporations will be able to defer corporate investment income in non-treaty countries and this privilege will not preclude the granting of a foreign tax "credit."[104]

The dividend exemption and the federal privilege outlined above are designed to enable the Canadian foreign investors to compete abroad under equal tax terms with third country investors.

---

101. *Id.*, at 72 # 6.9.

102. *Id.*, at 73 # 6.15.

103. *Ibid.*; COULOMBE, "Certain Policy Aspects of Canadian Tax Treaties", 28 *Conf. Rep.* Can. Tax Found. 290-94 (1976); on the *Proposals* and Canadian Tax Treaties see also McKIE, "Canada Tax Treaties", 22 *Conf. Rep.* Can. Tax Found. 292 (1970), substantially reprinted as "The Canadian Tax Reform Proposals and Canada's Tax Treaties", 22 *Tax Exec.* 237 (1969-70).

104. *Proposals, supra,* note 61, at 74 # 6.17.

However, such privileges may also enable Canadian taxpayers to divert or shelter property income or other "passive" income into a CFC resident in a low tax jurisdiction and to further, either repatriate same at no cost or defer tax on such income, depending upon the country of residence of the CFC.

The Proposals intend to curtail CFC abuses by taxing currently parent corporations on the income earned by their CFC when such income is not produced by active business operations.[105]

Consequently, the CFC shareholders will still enjoy the dividend exemption and the deferral privilege with respect to active business income. Furthermore, an indirect credit mechanism is granted with respect to the foreign taxes affecting the "passive" income currently taxed.[106]

This measure providing for the current taxation of "passive" income does present some similarities with the United States Subpart F provisions. While these similarities will be studied in a further section, it is worth pointing out that they do not exist by mere coincidence. Indeed, the White Paper outlines the main features of Subpart F, and concludes: "The government proposes to introduce provisions patterned generally on those in the United States. This proposal involves complicated and difficult law but the problem is serious and defies easy solution."[107]

We may also recall that the Carter Commission studied and rejected a Subpart F type mechanism for Canada on the ground that it was far too complex and ambitious for Canadian purposes.[108]

The 1969 Proposals adopt such a mechanism and in turn reject Carter's initial approach whereby all foreign source income was taxed on a current basis, irrespective of the type and location of investment.

As a consequence thereof, the taxation of UICFC is not used primarily as a means to achieve a current taxation of all foreign source income on an equity basis but rather as a means to correct abuses of a system which violates equity by providing for deferral and a dividend exemption.

---

105. *Id.*, at 6.20, 6.21.

106. *Ibid.*

107. *Id.*, at 6.21.

108. *Supra*, p. 394.

This approach leads to differentiations among locations of investment and among types of investment. Indeed, with respect to foreign direct investment, branch profits and subsidiary "passive" income are taxed currently at the rate applicable to domestic corporate earnings. On the other hand, CFC income from a non-treaty country is granted deferral and both direct and indirect credit, while CFC income from a treaty country is completely exempted.

The system presents tax measures based on capital-export neutrality, namely with respect to branch profits and subsidiary passive income and tax measures based on capital-import neutrality, namely with respect to CFC privileges of deferral and dividend exemption. This proposal obviously leads to distortions in capital flows and inequities.[109] Lower foreign rates will favor direct corporate investments particularly in a treaty country.

With respect to income produced by foreign portfolio investments undertaken by domestic corporations, the White Paper proposes taxation upon distribution and the granting of a direct credit. Furthermore, this direct credit which is applicable to foreign withholding taxes is limited to 15%.[110] These measures must be analyzed in relation to the tax treatment applicable to individuals.

(b) Individual Taxpayers

At the domestic level it is proposed that intercorporate dividends be exempted and that individual shareholders be granted a full or partial credit for dividends. Indeed, the Proposals provide for the integration of the tax imposed upon domestic corporations and their resident shareholders: Upon distribution, shareholders of closely held corporations will receive full credit for the corporate tax whereas shareholders of widely-held corporations will receive a 50% credit.[111]

Non-resident shareholders of domestic corporations are not granted the credit for dividends offered to resident shareholders. Although this policy is contrary to equity, Canada would justify this treatment on the basis of an inter-country equity principle whereby

109. See MUSGRAVE, "An Economic Appraisal," 22 *Conf. Rep.* Can. Tax Found. 308, 322-26 (1970).

110. *Propcsals, supra,* note 61 at 74 # 6.22, 77 # 6.37.

111. *Id.*, at 48-54; see also SINGER et al., "Proposed Canadian Tax Reform Has Farreaching Implications for U.S. Investors", *The J. of Taxation* 336, 338, 340-41 (June 1970).

Canada would extend the benefits of integration to non-resident shareholders only if capital-exporting countries extend a similar benefit to Canadians investing in their country.[112]

At the international level, direct business profits are taxed currently while foreign dividends are taxed upon distribution. The establishment of a domestic integrated system would require, in terms of neutrality, that individual investors be granted an indirect credit at the international level. However, only a direct credit is granted to individuals; moreover, with respect to foreign withholding taxes, this credit is limited to a maximum of 15%.[113]

As far as the integration measure is concerned, the Proposals explain that its purpose is to favor investment by individuals in domestic corporations. Consequently, it is judged that the granting at the international level of either an indirect credit or of a dividend exemption is incompatible with such policy.[114]

Therefore, foreign portfolio investments undertaken by individuals will be granted deferral and a 15% direct credit. It is proposed to apply the same treatment to corporate foreign portfolio investments in order to limit the incentive to invest abroad to CFC operations.[115]

As a consequence of these provisions, foreign investment through CFC will attract domestic corporations. However, the "passive income" provisions are not applicable to individuals. Therefore, they will be able to defer "passive income" in low rate jurisdictions.

Furthermore, it is proposed that domestic corporations "pass through" to their shareholders a credit for foreign withholding taxes up to a maximum of 15%.[116] The withholding tax being in fact borne by the ultimate shareholder. This measure would assure more equality between individuals investing in foreign corporations and those investing in domestic corporations.

The credit for withholding taxes is limited to 15% because the proposed Canadian withholding rate on dividends would be 15% and it is merely assumed that the foreign withholding taxes should

---

112. MUSGRAVE, *supra*, note 109 at 326; SATO and BIRD, *supra*, note 7 at 444.

113. *Proposals*, *supra*, note 61 at 74 # 6.22.

114. *Id.*, at 75 # 6.27.

115. *Id.*, at 74 # 6.17, 6.22; *supra*, note 110.

116. *Id.*, at 75-76.

be the same.[117] In addition, uniformity between the credit and the Canadian withholding tax permits the setting up of a simple mechanism whereby the withholding tax credit is extended to non-resident shareholders. In fact, the credit offsets the Canadian withholding tax so that the foreign shareholder receives a net dividend equal to the one received by Canadian shareholders, in spite of the fact that Canada has also imposed a withholding tax.[118]

This measure marks a step towards equity but when compared with other measures it accentuates the preference given to domestic investment.

(c) Opinions and Criticisms

The advocates of the global approach which requested Canada to adopt the Carter proposals and to extend the foreign tax credit to 50% were obviously disappointed by the White Paper's system.[119] Indeed, the Proposals do not tend to achieve neutrality between locations of investment and in fact embody different tax burdens varying with the type of investment (branch, subsidiary, portfolio), the country of investment (treaty, non-treaty) and the degree of ownership (more or less than 25%).

However, those who were attacking the Carter recommendations as pursuing a narrow concept of national interest were unable to formulate a similar criticism after the release of the White Paper. The treatment offered to Canadian foreign investors operating through CFC follows the OECD recommendations and is comparable to the treatment given by Canada's trade partners to their taxpayers.

In terms of equity, the Proposals improved the system applied under the 1952 Act by introducing the CFC "passive income" provisions and the foreign withholding tax "flow through" provisions. However, major inequities remained owing to dividend exemption, deferral and the limitation of the credit for dividends to Canadian residents.[120]

The overall system intends to favor domestic investment while being generous at the same time, with foreign investment

117. *Id.*, at 74 # 6.22, 77 # 6.37.

118. *Id.*, at 75 # 6.29.

119. See MUSGRAVE, *supra*, note 92 at 366.

120. See MUSGRAVE, *supra*, note 109 at 325.

undertaken by domestic corporations in CFC.[121] The most important point may be that such departure from equity and neutrality adequately answers Canada's economic wants. Although Canada's national interest is not as favored as under the Carter recommendations, the proposed system does not present its adverse effects with regard to Canada's trade partners' attitude. Concluding an economic appraisal, P. Musgrave states:

> "The international aspects of the tax reform proposals have particular significance for Canada owing to the open nature of the economy, mobility of resources and heavy dependance on foreign capital. The proposals seem to be consistent with Canada's national interests and judged by most economic criteria represent some improvement over the present system, although one is forced to conclude that they do not go as far as the Carter Commission in this respect."[122]

It is important for our purposes to stress the fact that the Proposals limit the taxation of UICFC to the passive income of such CFC. The Proposals further grant a dividend exemption and deferral to CFC. These measures would appear at this stage to be part of a system offering a sound solution to Canada's requirements.

In spite of its adequacy with Canada's economic situation, the White Paper received a cold reception among Canadian businessmen. The world of business was very satisfied with the 1952 Act providing for a general exemption for the dividends received from CFC. The limitation of this exemption to treaty countries and the introduction of the "passive income" provisions were the sources of their concern. Their criticisms may be summarized as follows:[123]

- The notion of "passive income" was too broad and undetermined a concept. It was therefore likely to cover items of income of Canadian based multinational corporations which were not involved in tax haven abuses.

- The revenues that would yield the application of the "passive income" provisions were estimated to 10 million or to 0.001 of the

121. It must be recalled that the achievement of this general goal is somewhat impeded by the omission of applying the "passive income" provisions to individuals controlling foreign corporations.

122. See MUSGRAVE, *supra*, note 109 at 325.

123. See inter alia, SHERMAN, "How to Kill a Mouse with an Elephant Gun", 20 *Can. Tax J.* 397 (1972); BAKER, "Planning the Form of Organization for Exports", 25 *Conf. Rep.* Can. Tax Found. 302 (1973).

forecast total income tax revenues. This amount was much lower than the administrative costs imposed on both the Revenue Department and the taxpayers by the implementation of such provisions.[124]

- As a whole, the problem of tax haven abuses had been overemphasized by the Carter Report; the application of a complex Subpart F type measure was not an appropriate remedy and would cause the migration of Canadian based companies.

- Furthermore, the limitation of the dividend exemption to treaty countries would impede the commercial activities of Canadian based companies. Canada had at the time only 16 tax conventions and the achievement of an adequate treaty network was a difficult task involving long and not necessarily rewarding negotiations.

The House of Commons and the Senate Committee studied the government policy, held hearings, examined the businessmen's concerns and reported as follows:

The House of Commons Committee denied that vast tax avoidance schemes existed through the use of foreign entities. It pointed out that a better enforcement of the existing law would resolve to a great extent all problems of tax avoidance. Accordingly it stated: "[T]he introduction of equivalent provisions to Subpart F of the United States Internal Revenue Code would be a grave error."[125]

This Committee further expressed its doubts with respect to the success of an extensive round of tax treaty negotiations and recommended that the dividend exemption be extended to all dividends distributed by a CFC.[126]

This Committee also rejected the integration proposal and gave its confidence to a separate entity approach. It considered the corporation rather than the shareholder as the investment decision entity and consequently rejected the foreign withholding tax flow through proposal except with regard to foreign shareholders.[127]

124. See *Proposals, supra*, note 61 at 96; SHERMAN, *supra*, note 123 at 397.

125. *The Standing Senate Committee on Banking, Trade and Commerce, Report on the White Paper, Proposals for Tax Reform*, 76 (Sept. 1970).

126. *Id.*, at 75.

127. *Id.*, at 77.

The Senate Committee was more reserved than the House Committee and generally agreed with the Proposals. However, it also expressed its concern with regard to the opportunity of introducing rules along the line of the Subpart F provisions.[128]

Once the Committee Reports were released, the Proposals entered the stage of the legislation-making process.

3.5 THE CURRENT SYSTEM

The 1971 Tax Reform Legislation was introduced by the Budget Speech of 18 June 1971 which was followed by the presentation of Bill C-259. In spite of the Hearings and Committee Reports, the Bill retained substantially the system proposed by the White Paper with regard to the taxation of CFC income. It rejected however, both the integration proposal and the withholding tax flow through mechanism.[129]

The Bill became law on 1 January 1972. However, it was decided to postpone the enforcement of the provisions applicable to CFC until 1 January 1976 in order to permit the Canadian negotiators to expand the treaty network and also because certain provisions needed to be refined or made more precise by regulations.

Indeed, modifications and refinements were announced in the Budget Speech of 8 May 1972, 6 May and 18 November 1974,and the final regulations were issued on 21 October 1976.

The current Act is still fundamentally based on the 1969 Proposals and our discussion of the White Paper is to a great extent applicable to the existing law.

The characteristics of the present Income Tax Act may be summarized as follows:[130]

128. *House of Commons, Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform*, 84-89 (Oct. 70).

129. On the Tax Reform Bill see E.J. BENSON, *Summary of Tax Reform Legislation*, 55-58 (1971); Revenu National Impôt, *Guide de l'Impôt sur les Corporations, La Réforme Fiscale*, 89-95 (1971); WINGFIELD, LEES et al., "International Aspects", 23 *Conf. Rep.* Can. Tax Found. 158-200, 279-306 (1971).

130. On the current law see SIMON et al., "International Taxation and the 1974 Budget", 26 *Conf. Rep.* Can. Tax Found. 225-62 (1974); SHORT et al., "Foreign Affiliates Regulations", 27 Conf. Rep. Can. Tax Found. 834-92 (1975); IFA, 1975 *Special Seminar on the New Treaties and the FAPI Regulations*, 23-65; BROWN,

(a) Individual Taxpayer

Canadian residents are taxed on their worldwide income. All income is taxed "as earned" except for the income produced by corporate investment which is, as a general principle taxed upon distribution.[131]

Upon reception of a dividend from a Canadian corporation, the individual shareholder must gross-up the dividend by an amount equal to 33 1/3% of its value, include the grossed-up amount in its taxable income, compute his tax liability and deduct from the tax payable a credit equal to the amount by which the dividend was first grossed-up.[132] The Act does not provide for any flow through of the foreign withholding tax credit granted to the Canadian corporation.

It must be pointed out that the Budget Speech delivered on March 31, 1977 announced that for the fiscal years following 1977, the rate of the gross-up would be increased from 33 1/3% to 50%.

The 33 1/3% dividend credit was not referred to by the Canadian government as an integration measure but rather as a means to encourage investment in domestic corporations. If the credit is increased to 50% Canada will definitely adopt a partial integration system. Neither the Act nor the budget provides for an extension of the credit for dividends to non-resident shareholders. Neither is the tax credit granted to corporations for foreign withholding taxes, extended to non-residents.

At the international level, the individual is granted a direct tax credit. This credit is limited by the Canadian tax applicable to the foreign source income.[133] Consequently individuals interested in foreign corporations may defer the payment of the Canadian tax applicable to their foreign source income and obtain a credit for the foreign withholding taxes upon repatriation.

However there is an exception to the rule outlined hereabove: If the foreign corporation is controlled by an individual, he will have to

---

"International Tax Planning", 24 *Can. Tax J.* 144-52, 241-48, 372-79, 494-504 (1976); GOODLET, "Canada's Approach to Foreign Affiliate Earnings", 28 *Tax Exec.* 151 (1975-76); R. FRIESEN and D. TIMBRELL, *Canadian Taxation of Income Arising in Non-Resident Corporations and Trusts*, (1975); DART, "The Foreign Affiliates Regulations", 28 *Conf. Rep.* Can. Tax Found. 104-30 (1976).

131. *1972 ITA*, Sec. 2(1), 12(1) (j), 82(1) (b), 90.

132. *1972 ITA*, Sec. 12(1) (j), 82(1) (b), 121.

133. *1972 ITA*, Sec. 126.

include in his taxable income, on a current basis, the "passive income" earned by the CFC.[134]

Under the Act a CFC is referred to as a controlled foreign affiliate. Such a corporation is a foreign affiliate of the taxpayer which is, at that time, controlled directly or indirectly in any manner whatever, by the taxpayer or by the taxpayer and not more than four other persons resident in Canada, or by a related group of which the taxpayer is a member.[135]

Moreover, a foreign affiliate is defined as a non-resident corporation in which a taxpayer resident in Canada owns an equity percentage of not less than 10%.[136]

The "passive income" is referred to as Foreign Accrual Property Income (FAPI). The FAPI will be taxed currently under the individual's personal rate. Furthermore, the individual will be granted an indirect credit for the underlying foreign taxes affecting such income.[137]

It is worth pointing out that the taxpayer will be taxed currently in respect of the FAPI earned by a controlled foreign affiliate only when such income will be greater than $5,000. Otherwise, the FAPI will be taxed when distributed as a dividend.[137a]

Since the rules related to the taxation of FAPI are identical whether they are applied to corporations or individuals, futher rules will be explained below.

It is important to notice that the current Act, by applying the FAPI rules to individuals, corrected a shortcoming of the White Paper. However, individuals undertaking foreign portfolio investments will not be covered by such rules.

(b) Corporate taxpayer

A Canadian resident corporation is either a corporation managed in Canada or in general terms incorporated in Canada after April 26, 1965.[138] Canadian resident corporations are taxed on

---

134. *1972 ITA*, Sec. 91. See BRADLEY, "The Individual and FAPI", IFA, *supra*, note 120 at 31-41.

135. *1972 ITA*, Sec. 95(1) (a).

136. *1972 ITA*, Sec. 95(1) (d).

137. *1972 ITA*, Sec. 91(4).

137a. *1972 ITA*, Sec. 95(1) (e).

138. *1972 ITA*, Sec. 250(4). See also note 68.

their worldwide income at a basic rate of 46%.[139] At the domestic level intercorporate dividends are exempt from tax.[140]

At the international level branch profits are currently taxed whereas subsidiary profits may be subject to different treatment.

A first distinction ought to be made between a non-resident corporation and a foreign affiliate. A foreign affiliate is considered in relationship with a taxpayer, which means that a foreign corporation may be a taxpayer's foreign affiliate. The qualification criterion is the 10% of equity percentage as it has been explained above. A taxpayer owning less than an equity percentage of 10% will be deemed a portfolio investor in a non-resident corporation.

It must be noticed that the notion of equity percentage refers to both a direct ownership of shares in a foreign corporation and an indirect ownership in a foreign corporation held through other corporations.[141]

When a Canadian corporation receives a dividend from a foreign affiliate, it will be entitled to exclude that portion of the dividend which is received from the exempt surplus of the foreign affiliate.[142] The exempt surplus comprises, among other elements, the income earned from an active business carried on in a treaty country.[143]

The Canadian corporation will also be allowed to obtain a credit for the underlying foreign taxes affecting any portion of the dividend paid out of the taxable surplus of the foreign affiliate.[144] This surplus comprises, in part, earnings from active business undertaken in non-treaty countries and FAPI.[145]

When a Canadian corporation receives a dividend from a non-resident corporation, such dividend will be fully taxed and the credit will be limited to the taxes withheld in the source country.[146]

---

139. *1972 ITA*, Sec. 123.

140. *1972 ITA*, Sec. 112.

141. *1972 ITA*, Sec. 95(4) (a) (b).

142. *1972 ITA*, Sec. 113(1) (a), R:5907 (1) (d).

143. *1972 ITA*, R:5907(1) (d). On surplus accounts see DART, "Foreign Affiliates - Surplus Accounts and Reorganization Provisions", in SHORT et al., *supra*, note 130 at 859-75; DART, *supra*, note 130 at 6-39.

144. *1972 ITA*, Sec. 113(1)(b)(c). See SHERMAN, "Tax Treatment of Dividends Received from Foreign Affiliates", in SIMON et al, *supra*, note 130 at 253-62.

145. *1972 ITA*, R:5907(1) (k).

146. *1972 ITA*, Sec. 126.

When the foreign affiliate is a controlled foreign affiliate of the Canadian corporation, FAPI will be deemed to be received currently by such corporation and taxed accordingly.[147] Upon deemed reception, the parent corporation will be entitled to claim an indirect credit for the underlying foreign taxes affecting such FAPI and for the withholding taxes levied upon distribution of dividends paid out of the same FAPI.[148]

The taxable share of the Canadian Corporation in the FAPI of its controlled affiliate is computed on the basis that each share issued by the foreign affiliate bears an amount of FAPI equal to the total FAPI earned in the given fiscal year divided by the number of issued shares. Therefore, each share held by the parent corporation will be related to the inclusion of a given amount of FAPI.[149]

Furthermore, the amount of FAPI attributable to each share will increase the adjusted cost base of the share in question.[150] The purpose of this provision is to entitle the parent corporation to dispose of the share and to realize the value of the retained earnings of the affiliate, which are already included in its income, with no further tax effect.

When a dividend is received from the taxable surplus of the controlled foreign affiliate, such dividend will be taxed only on the amount which is in excess of the FAPI previously attributed.[150a] Furthermore, the adjusted cost base of the shares giving a right to this dividend will be reduced by the amount of the dividend attributable to each share to the extent of the amount by which the adjusted cost base was previously increased.[151]

The Foreign Accrual Property Income of a foreign affiliate may basically be described as its income for the year from property and from business other than active business.[152] It also comprises the

---

147. *1972 ITA*, Sec. 91(1). The Canadian taxpayer will be taxed on its FAPI to the extent that such amount is in excess of $5,000. *1972 ITA*, Sec. 95(1) (e).

148. *1972 ITA*, Sec. 91(4). See FRISEN and TIMBRELL, *supra*, note 130 at 55-57.

149. *1972 ITA*, Sec. 95(1) (e), R:5904(1). The Act and Regulations provide for adjustments when the foreign affiliate has issued more than one class of shares. See BROWN, *supra*, note 130 at 495-96.

150. *1972 ITA*, Sec. 53(1) (d), 92(1) (a).

150a. *1972 ITA*, Sec. 91(5).

151. *1972 ITA*, Sec. 53(2) (b), 92(1) (b).

152. *1972 ITA*, Sec. 95(1) (b). See HAUERMAN, "The Tax Implications of Controlled Foreign Affiliates Under the Canadian Foreign Accrual Property Income Rules", in

taxable portion of the capital gains realized by the foreign affiliate which are not attributable to the disposition of active business assets or shares of other foreign affiliates under certain permitted reorganizations.[153] There must also be included in FAPI certain service income deductible by the parent corporation in the computation of its business income.[154]

Certain items of income are expressly excluded from FAPI.[155] We may insist on the following: Income from an active business or which is incident to an active business; inter-affiliate dividends; service income giving rise to a Canadian deduction but which is attributable to the transportation of persons or goods or to the purchase or sale of goods; the exempt portion of realized capital gains.

As a whole the FAPI provisions aim at curtailing tax haven abuses by taxing currently passive income diverted into controlled foreign affiliates. However, unlike the White Paper, the current Act presents a more restrictive approach. Following the criticisms made about the broadness of the notion of "passive income" the Act rather includes in FAPI earnings from business, other than an active business,and further outlines specific items of income which must be included or excluded from FAPI.

Unfortunately "active business income" is neither defined in the Act nor in the regulations. The Revenue Department claimed that a flexible notion of "active business" is crucial to an adequate enforcement of the law and therefore the taxpayer must rely on the criteria drawn from case histories.[156]

The Revenue Department did however outline these criteria as guidelines in two of its Interpretation Bulletins:[157] As important

SHORT et al., *supra*, note 130 at 852-53; ČUMYN, "Foreign Accrual Property Income Under the 1974 Spring Budget", in SIMON et al., *supra*, note 130 at 240-53.

153. *1972 ITA*, Sec. 95(2).

154. *1972 ITA*, Sec. 95(3).

155. *1972 ITA*, Sec. 95(2) (3).

156. With respect to the Revenu Department, see *infra*, note 157. With respect to case histories, see *Centennial Shopping Centre* v. *M.N.R.*, (1974) C.T.C. 2255; *The Queen* v. *Rockmore Investments Ltd.*, (1976) C.T.C. 291; *ESG Holdings Ltd.* v. *The Queen*, (1976) C.T.C. 295. By analogy see also *Dominion Bridge Company Limited* v. *The Queen*, (1975) C.T.C. 263, 554.

157. See Interpretation Bulletins, IT-72R2, *Meaning of "Active Business"*, May 20 (1975); IT-73R2, *Meaning of "Income from an Active Business"*, March 10 (1975).

criteria we may mention that a corporation involved in active business will have an independant office and an independent bookkeeping system. Its activities will require the expenditure of time and labour by its employees and the quantity and quality of such expenditure will be determinant of the amount of profits realized by the company.

(c) Over-all Effects

We may summarize this section on the Canadian current system by pointing out that a parallel may be easily drawn with the White Paper Proposals.

The system retained the treaty country distinction with respect to the dividend exemption. It also retained the privilege of deferral and the granting of an indirect credit to foreign affiliates operating in non-treaty countries.[158]

These favorable measures with regard to foreign affiliates may be contrasted with the current taxation applicable to foreign branch profits. It may also be compared to the treatment given to foreign portfolio income where no indirect credit is provided for in spite of the adoption of an integrated system at the domestic level.

Such an international setting leads to inequities and unneutralities similar to the ones discussed under the White Paper analysis. Branch and portfolio investment are discriminated against, vis-a-vis foreign investment through foreign affiliates.

At the domestic level, the system does not present any improvement along the line of equity. On the contrary, the refusal to extend the benefits of integration to non-resident shareholders and the rejection of the mechanism providing for the extension of the withholding tax credit may have worsened the situation.

The combined effect of the credit for dividend with the treatment given to foreign portfolio investment favors domestic rather than foreign investment. This is particularly true since the FAPI provisions cover the income of foreign affiliates controlled by individuals and since the credit for dividends may be increased to 50%.

However, this Canadian system favoring domestic investment also opened a channel toward foreign investment and this channel follows the path of treaty negotiations.

158. It is worth pointing out that the ownership requirement is now of 10% whereas it was of 25% under the White Paper.

From the 16 conventions that Canada had at the time of the Proposals, 26 are now in force and another 10 new treaties are under negotiation. In 1969, 70 treaties were regarded as an adequate network of conventions.[159]

Did Canada overestimate its negotiation capacities? Is the actual number of treaties sufficient to generate adequate international transactions?

The Canadian government would probably answer that its policy is successful. It would stress the merits of a bilateral rather than a unilateral approach. The former would provide the investors with some certainty against tax system changes. It may facilitate their operations by reducing filing and other tax requirements.[160]

Tax treaties would further complete unilateral relief mechanism, favor exchange of information, create a good climate for commercial transactions, etc. In short, it would permit the setting up of a tax system which would be both more controlled and more flexible at the international level.[161]

The advocates of the unilateral tax system would stress the complexity of a system based on several different treaties. They would further point out the difficulties entailed in negotiations especially when structural differences separate the tax systems involved.

We do not intend to close this debate at this stage. We shall follow this discussion on the Canadian dividend exemption and treaty policy after achieving a condensed analysis of the United States approach to the taxation of foreign source income.

IV. THE UNITED STATES APPROACH

4.1 BASIC RULES

The Sixteenth Amendment of the American Constitution authorizes the Congress "[T]o pay and collect taxes on incomes,

---

159. See PETERSON, "Canada's New Tax Treaties: Personal Service and Other Income, and Special Provisions", 28 *Conf. Rep.* Can. Tax Found. 327-38 (1976). The list of treaty countries for the dividend exemption purpose is provided by *1972 ITA*, R:5907(11).

160. See COULOMBE, *supra*, note 103 at 290-303. Gerard Coulombe addressed the Canadian Tax Foundation as Assistant Director, Personal and International Tax Division of the Canadian Department of Finance.

161. *Ibid.*

from whatever source derived". Section 61 of the 1954 Internal Revenue Code basically calls for an inclusion into the tax base of "[A]ll income from whatever source derived."[162] Section 1 and 11 of the IRC further give one the impression that all individuals and corporations whatsoever are subject to United States tax.

However, more scrutiny will entitle one to find out that the United States tax system is based on two jurisdictional connections namely the personal and the "ad rem" jurisdiction.

With respect to the personal jurisdiction, individuals, either citizens or residents,will be taxed on their income from all sources.[163] Corporations known as domestic corporations (which comprise the corporations created or organized in the United States under federal or state law) will have their worldwide income subject to tax.[164] It is important to notice that the location of the seat-of-management of a corporation is not used as a test in order to determine the United States personal jurisdiction on corporations.

With respect to the "ad rem" jurisdiction, non-resident aliens and corporations other than domestic corporations will be taxed only on income derived from sources in the United States.[165]

The taxpayers taxed under the personal jurisdiction and taxed on a worldwide basis are referred to as United States persons. The IRC recognizes the fact that these persons may be taxed on their foreign source income by both the country of source and the United States and provides for foreign tax relief.

A United States person may either deduct from his tax base the foreign income taxes paid on foreign source income or elect to credit the foreign taxes against his United States liability on the foreign source income.[166]

We may therefore say that the United States' initial approach is along the lines of equity and neutrality since basically all United

---

162. The *1954 Internal Revenue Code* will hereinafter be referred to as *IRC*.

163. *IRC* § 1. The Term resident includes alien resident. The Code does not define neither citizen nor resident. However, a geographical definition of the United States is given in *IRC* § 7701(a) (g). Moreover, the courts consistently accept the notion of residence provided by Regs. § 1.871-2 (G).

164. The term "domestic" when applied to corporations is defined in *IRC* § 770(a) (4).

165. The geographical source of the income is determined by *IRC* § 861-864.

166. *IRC* § 164(a) (3); 901(a).

States persons are taxed on their income from all sources and since a credit is granted for foreign taxes.

As a first departure from neutrality we may point out that the credit granted is an ordinary credit and therefore it will not prevent double taxation when the source country tax liability is higher than that of the United States.[167]

The United States approach embodies a second departure from neutrality. Indeed, its system of taxation is a separate entity system. Consequently, an individual taxpayer earning income through a corporation will bear both the corporate and his personal income tax, whereas an individual taxpayer earning the same income directly will bear only his personal tax liability.[168]

However, when the individual's personal rate is higher than the corporate rate, the individual may take advantage of the system by earning income through a corporation and by leaving such income in the corporation funds. The individual will, in this manner, reduce his tax liability.

At the international level the application of the equity rule would call for the extension of the system provided for at the domestic level. Consequently, the individual earning income through a foreign corporation should be entitled to defer the payment of his personal U.S. taxes after the imposition upon the income of a foreign corporate tax equal to the domestic corporate tax.[169] The United States does not equalize in this manner the domestic and foreign corporate rates and the individual is entitled to deferral upon application of the foreign corporate rate. As a consequence thereof, the individual may take advantage of this non-neutral measure and defer the payment of U.S. tax in foreign corporations upon which no or a low corporate tax may be applicable.

With respect to domestic corporations the system provides for the application of a uniform 48% corporate tax rate.[170] The system also provides to a large extent for the exemption of intercorporate dividends.[171]

---

167. See *IRC* § 904.

168. This statement assumes that the shareholder bears the corporate tax.

169. Equity would also call for the granting of a full foreign tax credit. See discussion *supra*, on pp. 380-81, 382.

170. *IRC* § 11.

171. *IRC* § 243-47.

Since domestic income is currently taxed at a uniform rate of 48%, equity and neutrality would call for the current taxation, at an identical rate,of all foreign source income. However, in that respect the system also departs from equity and neutrality and provides for the current taxation of branch profits on the one hand and for the taxation upon distribution of subsidiary profits on the other hand.

Therefore, domestic corporations are entitled to take advantage of rate differentials at the international level. Assuming that a foreign country offers a lower corporate rate, a domestic corporation will find an advantage in earning foreign source income through a foreign corporation resident in this jurisdiction and in deferring the payment of U.S. taxes by the means of this corporation.

As a consequence thereof, subsidiary investment will be privileged, foreign investment will receive an incentive, low rate jurisdictions will attract capital flows, repatriation of foreign source income will be deterred and what is more, the payment of U.S. taxes may be avoided.

4.2 HISTORICAL BACKGROUND

These problems linked to the structure of the system did not call for attention until the U.S. corporations started to export goods and capital.[172]

Shortly after the World War II very few domestic corporations were involved in foreign market transactions. However, by the late 1950's several corporations had undertaken business operations abroad.

At that time several corporations had also incorporated foreign subsidiaries in low rate jurisdictions and intangible rights, licences and franchises or stock of non-U.S. corporations were transferred to such foreign entities. These corporations were also used as offshore trading vehicles: parent corporations would sell goods to foreign subsidiary for purpose of resale reasons. Resale income, as well as royalty and dividend income were foreign source incomes and therefore not currently subject to U.S. tax.

In 1960, this diversion of income towards tax haven jurisdictions troubled the U.S. Treasury Officials who considered such practice as a true abuse of U.S. laws.

---

172. For historical background, see O'CONNOR, "Subpart F Provisions of the Internal Revenue Code" in "International Aspects II", 22 *Conf. Rep.* Can. Tax Found. 326, 326-29 (1970); HAMMER, "The Controlled Foreign Corporation Provisions of the U.S. Code — An Overview," 18 *Can. Tax J.* 171, 172-73. (1970).

It must be pointed out that tax haven operations undertaken by individuals had concerned the U.S. Congress several years before. Indeed, in 1937 the foreign personal holding company provisions were enacted and further incorporated in the 1939 Code.[173]

The purpose of these provisions was primarily to curtail the abuse made of the deferral privilege in low tax jurisdictions. Indeed, several citizens and residents had been able to transfer their securities to a foreign holding company and therefore to avoid U.S. taxation.[174]

The solution adopted was to tax on a current basis the United States shareholders of foreign personal holding companies on their allocable share of the undistributed income of such companies.

A company is deemed to be a foreign personal holding company if at least 50% of its gross income is foreign personal company income and if more than 50% of its stock value is owned directly or indirectly by not more than five citizens or residents of the United States.[175]

Foreign personal holding company income consists of "passive income" such as dividends, interests, royalties, annuities, capital gains, etc.[176]

In 1960 a very similar problem with respect to parent corporations was under study in the U.S. Treasury.

In his tax message to Congress on April 20, 1961, the President raised the issue. He indicated that since the post-war reconstruction had been completed, there no longer existed policy reasons to favor foreign investment in economically advanced areas. He noted that the deferral privilege induced U.S. firms to invest abroad basically for tax purposes. Moreover, such investments upset an efficient allocation of resources, it had adverse balance of payment effects and deprived the U.S. of revenue. He proposed a complete abolition of tax deferral except for investments in developing countries but also recommended the abolition of tax haven operations anywhere in the world.[177]

---

173. *IRC.* § 551-57.

174. See World Tax Series, *Taxation of the United States*, 774 # 9A/6. (1963).

175. *IRC* § 552.

176. *IRC* § 553.

177. President's Message to Congress, 87th Cong., 1st Sess., HR. Doc. No. 140 (April 20, 1961) at 6-8 reported in *U.S. 90th Congress, House, Committee on Ways and Means, Legislative History of the Revenue Act of 1962*, vol. 1, at 146-48 (1967).

He stated:

> "If we are seeking to curb tax havens, if we recognize that the stimulus of tax deferral is no longer needed for investment in the developed countries, and if we are to emphasize investment in this country in order to stimulate our economy and our plant modernization, as well as our balance of payments deficit, we can no longer afford existing tax treatment of foreign income."[178]

Following the President's message, the Secretary of the Treasury Dillon addressed the House Ways and Means Committee. He stressed the importance of eliminating the tax factor in the investor's choice between domestic and foreign investment. He pointed out how the abolition of deferral would curtail tax haven operations but also how it would improve the standing of the tax system in terms of equity and neutrality.[179]

The Committee held hearings and the appearances indicated a strong opposition against a complete abolition of tax deferral. The major arguments may be summarized as follows:[180]

- Tax haven abuses could be prevented by enforcing mechanisms presently provided by the law without the necessity of new legislation.

- The current taxation of undistributed income at the U.S. rate would impose a heavier tax burden on U.S. foreign investors than on local investors. Under these circumstances, the American investors would not be able to compete adequately in foreign markets and U.S. enterprises now manufacturing abroad would probably have to give up some of their markets.

- Foreign risks such as political instability, expropriation, exchange restrictions and run-away inflation are other factors which call for an equal treatment between local corporations and subsidiaries controlled by U.S. parents.

- The proposals were an inadequate means to solve problems of balance of payment.

---

178. *Id.*, at 7.

179. Statement by Hon. Douglas Dillon, Secretary of the Treasury, before the Committee on Ways and Means of the House of Representatives, 87 Cong., 1st Sess., H.R. Doc. No. 140 at 23-26, 30, also reported in *U.S. 90th Congress, supra*, note 177, Vol. 1, at 163-66, 170.

180. *Hearings Before the Committee on Ways and Means of the House of Representatives*, 87th Cong., 1st Sess., Vol. 4, pp. 3578-3590, see also a "Digest of these Hearings", in *U.S. 90th Congress, supra*, note 177, Vol. 1, at 464-76.

As a result of these hearings the Committee was faced with a dilemma: On one side it had foreign investors claiming for capital-import neutrality and advocating that equal treatment in the source country was crucial to the survival of U.S. foreign enterprise abroad. On the other side, it had the Presidential Message stressing that "equal treatment" abroad had given birth to tax avoidance. An adequate solution to this problem would be based on equity, neutrality and a better allocation of resources. This solution would be the elimination of deferral. Furthermore, such elimination would achieve capital-export neutrality and favor domestic investment. This outcome was favorable to the U.S. since it was suffering from problems of balance of payments.

The dilemma was solved by a compromise. The Committee appeared to have been sensitive to the businessmen's requests and did not completely abolish deferral. However, it attacked the abuses of deferral and tax avoidance problems by proposing the current taxation of the subsidiary income which was not related to a legitimate trade or business:

> "Your Committee has also concluded that U.S. tax should be imposed currently on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business unless, in accord with the policy enunciated by the President, it is invested in business in less developed countries. Because of this your Committee's bill taxes to U.S. shareholders investment-type income not invested in less developed countries and also income which may arise from the active conduct of a trade or business if the income is not reinvested in the same business (outside the United States) or in a less developed country."[181]

The Committee on Finance of the Senate further held its hearings and issued a Report.[182] It may be said that in general the Senate Committee softened the attack on tax haven devices undertaken by the House Committee. Among other limitations and exceptions, we may mention that this Committee provided for the minimum distribution schedule and the export trade corporation provisions.[183]

181. *Report of the Committee on Ways and Means, House of Representatives,* to accompany H.R. 10650, 87th Cong., 2d Sess. No. 1447 at 58 (March 16, 1962) also reported in *U.S. 90th Congress, supra,* note 177, Vol. 1, at 1192.

182. *Report of the Committee on Finance, United States Senate,* to accompany H.R. 10650, 87th Cong., 2d. Sess. No. 1881 (Aug. 15, 1962), also reported in *U.S. 90th Congress, supra,* note 177, Vol. 2, at 2353.

183. The minimum distribution provision has since been repealed. See *Tax Reduction Act 1975,* P.L. 94-12.

These anti-tax haven recommendations were enacted by Congress as part of the Revenue Act of 1962. They were integrated to the Internal Revenue Code as the Subparts F and G of the part dealing with income from sources outside the United States.[184]

We shall now outline the main features of Subpart F as they stand today while pointing out the significant modifications which occurred since 1962.

4.3 PARTIAL ELIMINATION OF DEFERRAL

The key to Subpart F provisions revolves around two factors: the control of the foreign corporation and the type of income of the foreign corporation.

As a general rule, a United States person owning at least 10% interest in a CFC on the last day of such corporation's taxable year, will be required to include into his tax base his pro rata share of certain undistributed income of the corporation.[185]

A CFC is a foreign corporation of which more than 50% of the voting power is owned (or is considered as owned under the attribution rules of section 958) by United States shareholders on any day during the taxable year of such foreign corporation.[186]

Section 958 basically outlines rules which permit the determination of stock ownership when this stock is owned directly, indirectly or in a constructive manner.[187]

With respect to ownership, it is important to notice that only United States shareholders are subject to current taxation and that those owning less than 10% of the total voting power are taxable only upon distribution, even though the foreign corporation is a CFC.

184. *IRC* § 951-971. For a technical analysis of Subpart F, *see:* World Tax Series, *supra*, note 174; O'CONNOR, *supra*, note 172; HAMMER, *supra*, note 172; HOEFS and BUNGE, "Tax Considerations Involved in International Business under the 1962 Revenue Act", *J. of Taxation* 295 (Nov. 1963); FISHER, "Proposed Regs, on Subpart F Income Reflect Cautious Treasury Approach", *J. of Taxation* 372 (June 1963); WILCOX, "Operations Abroad Through Foreign Subsidiaries", *N.Y. Univ. 21st Ann. Inst. on Fed. Taxation* 905, (1963).

185. *IRC* § 951(a).

186. *IRC* § 957 (a), 958, 318.

187. For the purpose of determining the 50% control test or the 10% ownership test the attribution rules of section 318 will apply, although subject to some modifications. However, for the purpose of imposing the tax, section 318 does not apply.

It must also be borne in mind that the shareholders are taxed on their pro rata share of the currently taxed income. Also, this income is reduced by any dividends received previously by the current or by a previous shareholder out of the currently taxable fund of the CFC for a given fiscal year.[188]

To the extent that the 50% test is met, the United States shareholder will be taxed as if he had received a dividend, although the income attributed to him may have "hopscotched" over intervening corporations.[189]

An indirect credit is granted to the U.S. shareholder with respect to all foreign taxes paid by the CFC. This credit is limited by the U.S. tax liability applicable to the income received.[190]

Furthermore, in order to reflect any imputed inclusion in his gross income the shareholder is required to increase the basis of each of his shares by the amount attributable to such shares. Further distributions will decrease the basis of same.[191]

Subpart F will cover various items of income which may be outlined as follows:

- Income from insurance of U.S. risk will be covered by the provision in order to prevent the avoidance of underwriting gains by domestic life insurance companies.[192] These companies may do so either by reinsuring abroad or by placing the initial policy with a controlled foreign insurance company.

- Subpart F income also includes foreign personal company income,with certain modifications however.

- The provision is also concerned with income from selling or servicing by subsidiaries which had been divorced from the manufacturing activities of a related corporation in order to be taxed at a lower rate.[193]

---

188. *IRC* § 959.

189. See World Tax Series, *supra*, note 174 at 1049.

190. *IRC* § 960, 902; When a CFC is controlled by an individual he may elect to be treated as a corporation with respect to taxation under Subpart F. The individual will be entitled to an indirect credit under this provision. See *IRC* § 962.

191. *IRC* § 961.

192. *IRC* § 953.

193. *IRC* § 954.

- Amount of illegal bribes and income earned in violation of international boycotts are also covered by the provision.[194]

In addition to these items of income, generally referred to as Subpart F income, the Code provides for the taxation on a current basis of another category of income.

Indeed, under certain circumstances income from increase in investments in U.S. property is considered as a means of repatriating foreign source income without tax consequences and is therefore taxed currently.[195]

As a whole, the Subpart F provisions approach the taxation of tax haven income in a rather restrictive manner. It taxes enumerated and exhaustively listed items of income tending to avoid broad provisions.

It must be mentioned that the existing Subpart F presents a more rigid control of tax haven operations than the one provided by the 1962 provisions.

We may mention that under the original Subpart F when a CFC had aggregated foreign base company income (holding company, plus sales, plus service income) which represented less than 30% of its gross income in a given year, no portion of its foreign base company income was subject to current tax. Under the present code, the 30% criterion has been reduced to 10%.[196]

Previously, if a certain minimum distribution was made by a CFC to its U.S. parent, the Subpart F income of this CFC was exempt from current taxation. This relief provision has been repealed.[197]

Furthermore, an exception with regard to income derived from the operation of shipping and airline industries has been tightened. This income was completely exempted from current taxation; it is now subject to such taxation, unless reinvested in the same operations.[198]

---

194. *IRC* § 952.

195. *IRC* § 956.

196. *IRC* § 954 (b) (3). The provision was amended by the *Tax Reduction Act 1975*, P.L. 94-12 § 602 (c) (d) (e).

197. *Tax Reduction Act 1975*, P.L. 94-12 § 602 (a).

198. *IRC* § 954 (f), P.L. 94-12 § 602 (d).

Another exception related to foreign personal company operating in less developed countries has been eliminated.[199]

Under the current system a CFC may find a partial relief from the Subpart F provisions if it qualifies as an Export Trade Corporation.[200] Moreover, a complete relief may be granted if a CFC is capable of establishing that neither its creation nor its operations have a significant tax reduction purpose.[201]

We may summarize the United States approach to the taxation of UICFC by pointing out that in 1962 a complete abolition of deferral was proposed,in part to eliminate tax haven abuses but also for neutrality and equity purposes.

A compromise was adopted and deferral was eliminated where it was found that its granting had led to abuses and tax avoidance. Legislation was enacted under which income earned through tax haven operations was subject to taxation on a current basis.

However, some relief provisions were repealed and some exceptions were abolished. The capital-import neutrality policy adopted vis-a-vis legitimate business operations was consequently narrowed.

The United States separate entity system is based on the taxation of income from all sources. The credit method is adopted as a foreign tax relief rather than the exemption method. The over-all system therefore tends towards capital-export neutrality and the adoption of the Subpart F provisions is consistent with this tendency.

However, deferral is still present in the system and for this reason the system is somewhat ambivalent. By granting deferral to foreign investors it features a departure from capital-export neutrality.

This departure may be explained by policy reasons, by a desire to favor the expansion of U.S. based companies to foreign markets. It may also be that such policy no longer answers the economic wants of the country. Now that U.S. multinational companies are firmly implanted in foreign countries and now that their home country has balance of payments problems another policy, closer to capital-export neutrality, may be considered.

---

199. *Tax Reduction Act 1975*, P.L. 94-12 § 602 (c) (d).

200. *IRC* § 970.

201. *IRC* § 954 (b) (4).

This issue involving a proposition of complete abolition of deferral is examined in the following section.

V CONCLUSION: GUIDELINES

The term "guidelines" does not refer to general rules broadly applicable to the taxation of UICFC but rather to consequences that we will attempt to draw from the present analysis.

5.1 ELEMENT OF COMPARISON

(a) Technical Aspects

The Canadian FAPI regulations were designed along the lines of the Subpart F provisions. Their purpose is fundamentally the same, namely to prevent tax avoidance through tax haven operations although the respective technical approaches are some what different.

While Subpart F provides for the taxation on a current basis of specific items of income precisely defined under the Code and the Regulations, the FAPI rules are founded on a more global approach.

The main target of the FAPI provisions is not a series of items of income but rather a broader and more vague element of income, namely business income other than active business income.

The same remark may be applicable to the notion of "control". While the United States provides for a precise "more than 50%" rule, Canada refers to a notion of "controlled, directly or indirectly in any manner whatever".[202]

As a result thereof, the Canadian approach may permit more extensive coverage of tax haven operations but it obviously leaves the taxpayer uncertain with respect to "border line" transactions.

The systems also present technical disparities, the most important of which is probably related to the indirect credit mechanism. The Canadian system is not providing for an indirect credit mechanism as such,where foreign taxes offset domestic taxes, but rather for a deduction method whereby foreign taxes and relevant tax factors are deducted from foreign source income.

---

202. *1972 ITA*, Sec. 95(1) (a), *IRC* § 957.

The difference is worth mentioning but any further analysis would merely prove that the results are similar under both systems. The Canadian mechanism was designed this way in order to cope with an integration system where different corporate tax rates are involved.

Another, technical aspect worth mentioning is that both countries created side by side two systems achieving the same goals and likely to interact if not overlap when dealing with foreign taxes and attribution of income.

Various cases of economical double taxation were pointed out when the Canadian Bill C-259 was released.[203] Some of these problems are now solved in a satisfying manner.

For example, Canada had to modify its attribution of income rule which was based on the "participating percentage" formula. Under certain circumstances, the participating percentage could be higher than the equity percentage which could lead to the taxation of more than 100% of a foreign affiliate is income. Indeed, a foreign affiliate controlled by a Canadian parent and also involving United States shareholders could have the "same" income attributed to the Canadian shareholders under the FAPI regulations and upon a further distribution taxed as dividends in the hands of the U.S. shareholders.

Canada modified its attribution of income rule and the current rule is based on a "pro rata" share of earnings formula, similar to the one provided by the IRC.

Other problems will need further consideration. Let us assume, for example, that a Canadian corporation is controlled by a U.S. parent. In turn, this Canadian corporation holds all the shares of a third country subsidiary earning income from tax haven operations.

This income will be taxed in the United States as Subpart F income and in Canada as FAPI. The Canadian tax imposed on the Canadian corporation is not considered as a foreign creditable tax for U.S. purposes. Similarly, the U.S. tax is not creditable in Canada.

This economical double taxation will need to be avoided by negotiation between Canada and the United States.

---

203. See TILLINGHAST, "Canadian Tax Reform and International Double Taxation: A View from the United States", 21 *Can. Tax J.* 472, 477-79 (1973), TILLINGHAST, "New Canadian Tax Law Creates Double Taxation to U.S. and Canadian Taxpayers", *The J. of Taxation* 278 (May 1974).

This type of problem will become more significant if the United States completely abolishes deferral. It will have to be dealt with in treaty negotiation involving several trade partners of the United States.

(b) Policy Aspects

Our analysis of the Canadian system led us to the conclusion that the Canadian policymakers promoted a system where domestic investment was generally favored.

However, the same system also opened a channel toward foreign investments through CFC by exempting CFC income in treaty countries and by granting the right to deferral and to an indirect credit in non-treaty countries. The FAPI regulations intended to limit these privileges to active business income.

In order to achieve such an outcome, we demonstrated that in both domestic and international settings, departures from neutrality and equity were embodied and that the system presented both capital-exporting and capital-importing features.

It was pointed out, however, that these departures were in accordance with the Canadian economic requirements. In general, Canada needed domestic investment, but had reached a stage in economic growth, where Canadian based companies also sought expansion towards foreign markets.

The general rationale was to adopt a system basically presenting capital-export neutrality features in order to favor domestic investment and also capital-import neutrality features in order to favor foreign investment.

The dilemma was to introduce capital-import neutrality means such as the exemption method and a right to deferral while also trusting to curtail tax haven abuses, to achieve a proper allocation of resources and to favor world efficiency.

The policymarkers suggested that under such circumstances, a treaty approach appeared as being a sound manner to achieve their goals.

It was held that a bilateral approach may permit the channeling of capital flows towards precise and desirable targets. A controlled allocation of resources may further be achieved by favouring foreign investment in treaty countries and inter-country equity could accordingly be improved. The FAPI regulations would insure that all foreign investments would be dynamic ones.

It is, therefore, suggested that Canada follows a sound policy be linking the dividend exemption to treaty countries and by retaining its right to apply FAPI regulations to same.[204]

With respect to the United States the situation is very different.

Unlike the Canadian structure, the United States tax structure is based on a separate entity system which permits, as it was suggested by our model, to approach in a simple manner the problems raised by the taxation of foreign source income.

Our model adopted a separate entity system; it provided that equity and capital-export neutrality could be met, with respect to corporations, by taxing currently all foreign source income and by adopting a full foreign tax credit. With respect to individuals, equity could be achieved by granting at the international level a right to deferral similar to the one provided at the domestic level.

The United States is closer to this model than Canada, albeit the U.S. systems presents some departures: (1) individuals are granted the right to deferral at the international level in relation to the application of the foreign corporate rate rather than the domestic corporate rate. (2) In general, foreign source income earned by domestic corporations is granted deferral if earned through a subsidiary. (3) The credit system is an ordinary rather than a full credit system.

This approach will favor individuals earning foreign source income through a foreign corporation since they may benefit from a lower corporate rate and therefore defer at a lower cost. This approach also favors domestic corporations which earn foreign source income through foreign subsidiaries when compared to domestic corporations earning domestic income or branch profits.

However, unlike Canada, the United States is not concerned as to whether individuals should be granted an indirect credit at the international level or as to whether a credit for dividends should be extended to non-resident shareholders. These problems are raised by the adoption of an integrated system.

Canada in terms of equity would have been required to grant the indirect credit and to extend the dividend credit mentioned above. It did not meet these requirements. The United States because of its separate entity approach is not, in terms of equity, required to grant

204. See HAUSMAN, "Canada's New Tax Treaties: The Investment of Income from Property: Capital Gains, Dividends, Interest and Royalties", 28 *Conf. Rep.* Can. Tax Found. 319-27 (1976).

neither one nor the other credit. In this regard the United States' approach may be more equitable than the Canadian system.

Furthermore, at the international level, the United States' approach relies on a credit system whereas the Canadian system embodies both exemption and credit systems. To that extent the United States' system achieves capital-export neutrality and international equity to a greater extent than Canada does.

In the United States' system the remaining exception to the achievement of capital-export neutrality and international equity is deferral. The abolition of deferral in the United States would bring its system very close to our model.

The question at stake is as to whether this departure from equity and neutrality is desirable or not for the United States.

We may briefly recall the arguments involved:[205]

The opponents of deferral would argue that deferral is an incentive to foreign investment as opposed to domestic investment and a disincentive to repatriation of foreign source income. This effect is contrary to the United States' economic requirements which would need domestic rather than foreign investments.

Furthermore, deferral represents a loss of revenue for the United States since foreign source income tends not to be repatriated.

The abolition of deferral would favor domestic growth, and would achieve a better tax system. The achievement of a better system would be particularly significant in terms of equity among taxpayers, neutrality and simplicity.

In relation to the simplification of the system, to the extent that the Domestic International Sales Corporations (DISC) were created to counterbalance deferral of foreign source income, such corporations could be eliminated. Indeed, the DISC provisions permit a deferral of export income which is to some extent similar to the deferral privilege granted to foreign subsidiaries.

---

205. See *U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations*, Depart. of Treasury, at 16-80 (1976); *Recommendations of the Task Force on Foreign Source Income*, Committee on Ways and Means U.S. House of Representatives, 95th Cong., 1st Sess. at 45-49 (March 8, 1977); SURREY, McDANIEL, PECHMAN, *Elimination of Tax Deferral for U.S. Multinational Corporations in Federal Tax Reform for 1976*, at 77-92 (1976).

The proponents of deferral would argue that domestic investment is not a substitute for foreign investment and that the abolition of deferral would not necessarily improve domestic investment.

They would add that deferral creates jobs in the U.S. and favors economic growth since foreign subsidiaries are involved in exportation of U.S. goods transactions.

The politico-economic situation in source countries requires that foreign investors be treated under equal tax terms with local investors and investors from third countries.

The abolition of deferral would provoke some retaliation measures by foreign governments, which would for instance raise their tax rates to the U.S. level, impede distribution of dividends by exchange regulations, etc.

Finally, the abolition of deferral would not lead to a substantial increase in U.S. Revenue.

This debate may be difficult to solve in an absolute way and the answer remains a matter of choice and policy.

It may be said: (1) As far as the betterness of the tax system is concerned in terms of equity, neutrality and simplicity, deferral must be eliminated. (2) In terms of economic growth and promotion of domestic investment, deferral may have some beneficial effect but its abolition would probably have the same effect. (3) The United States would have a good opportunity to achieve capital-export neutrality and it is unlikely that foreign countries would retaliate to such measure. Adjustments could be made by treaties.

5.2 INTERDEPENDENCE

Following from argument (3) outlined above it may be said that in presence of rate differentials, unilateral measures may achieve international tax equity and capital-export neutrality. However, it would need to be completed by treaty in order to reach an optimal allocation of resources and to promote world efficiency.

Indeed distortions of capital flows resulting from rate differentials may be diminished by tax conventions and inter-country equity would therefore be improved. To this extent countries are interdependent among themselves.

It follows that unilateral and bilateral measures should be

embodied in a tax system and a combination of these measures should regulate the taxation of foreign source income.

Therefore:

- A sound tax system would achieve international equity by taxing currently all foreign source income, including UICFC. It would further improve world efficiency by treaty. It is thought that the United States should follow this line.

- To the extent that a current taxation of foreign source income from all sources may not be achieved for reasons of national welfare, world efficiency and inter-country equity should be safeguarded as much as possible through treaties. It is thought that Canada should follow this line.