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The Recent Tax Incentive for U.S. Corporations to Invest Short-term Funds Abroad

During 1961 and 1962, U.S. parent corporations having subsidiaries or branches in Canada had a powerful tax incentive to earn additional income abroad for their own account.[1/] Much of the outflow of U.S. short-term capital during the past two years, but especially during 1961, may have been due to this tax incentive instead of to the higher level of short-term interest rates existing abroad.[2/] This paper attempts to spell out the nature of this tax incentive, and also to make some tentative estimate of the capital outflow that it may have stimulated.

Nature of the tax incentive

In recent years, U.S. corporations have been allowed to take a "tax credit" (against their tax liability to the U.S. Treasury) for taxes paid abroad by their foreign subsidiaries and branches, so long as these taxes did not exceed 52 per cent of the income derived from these affiliates. In those cases where foreign taxes paid by subsidiaries or branches exceeded 52 per cent of subsidiary or branch income, the parent corporation found itself with an "excess tax credit". This credit could not be applied against income earned in the United States, but it could be applied -- at least until recently -- against additional foreign income earned in the name of the parent corporation and taxed at a relatively low (perhaps zero) rate abroad. Such additional income was completely free from

1/ The phrases "income earned abroad" or "foreign income" are used in this paper to mean earnings from foreign subsidiaries and branches and, also, interest and dividends earned on U.S. corporate investments abroad; the phrases are not used to mean export receipts of corporations located in the United States.

2/ Oscar L. Altman has commented on this development in a recently published study, "Canadian Markets for U.S. Dollars", IMF Staff Papers, November 1962. This paper is mainly an elaboration of his discussion. I am very grateful for Mr. Altman's help on a number of points and also for the help of Mr. Richard Pfister of the Treasury Department and Mr. Samuel Pizer of the Department of Commerce.

U.S. taxes until the ratio of all foreign taxes to all foreign income was reduced to 52 per cent. The most convenient way for the parent corporation to generate such income was probably through the purchase of foreign money-market assets or through the placement of time deposits (denominated in either foreign currencies or U.S. dollars) with foreign banks.

The following example indicates how the incentive might have worked in a specific case. Suppose that a U.S. firm had a single foreign subsidiary which earned an annual profit of $100,000 and was taxed at a rate of 60 per cent by the country in which it is located. The subsidiary's after-tax income would then be $40,000. Suppose, also, that the subsidiary paid half of this amount in dividends to the parent company during the year. In this case, the Treasury would have deemed that the parent company had paid taxes abroad on its foreign earnings of $12,000 (=20/100 ($60,000)).[3/] But the maximum credit which the Treasury would have allowed the parent company to claim against its tax liability to the United States would have been $10,400 (=.52 x $20,000). Accordingly, the parent corporation would have found itself with an "excess tax credit" of $1,600 which it could have applied only against additional income earned abroad. Such additional foreign income -- up to the point where it reduced the tax rate paid abroad to 52 per cent -- would not have increased the corporation's tax liability

3/ "In the case of a foreign subsidiary, the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income." See Revenue Act of 1962: Report of the Committee on Finance, United States Senate to Accompany H.R. 10650 (87th Cong., 2nd Sess., Report No. 1881), August 16, 1962, p. 66.

to the U.S. Treasury. If no foreign taxes had to be paid on this additional income, the parent company would have been motivated to earn abroad an additional \$3,077.[4]

Whether a parent company could mop up an excess tax credit originating in one foreign country through income earned in a second foreign country depended on the company's prior choice of tax options. Beginning in 1961, U.S. corporations were allowed, for tax purposes, to consolidate all of their foreign earnings and foreign taxes or to allocate them on a country-by-country basis (the latter procedure was mandatory before 1961). On the country-by-country option, an excess tax credit arising from subsidiary or branch operations in a particular foreign country could only be mopped up by generating additional income in the name of the parent firm in that same country. On the consolidated option, an excess foreign tax credit could be applied against additional earnings by the parent firm anywhere outside the United States.

Specifics of the Canadian case

At the end of 1960, Canada increased its withholding tax on dividends sent abroad by foreign (e.g., U. S.) subsidiaries from 5 to 15 per cent and at the same time imposed a 15 per cent surtax on profits of branches of foreign companies operating in Canada if these profits were not reinvested in certain Canadian assets. The tax on dividend remittances was imposed on top of existing Dominion and provincial taxes which, for corporations chartered in Ontario and Quebec, amounted to 52 per cent of corporate income. The surtax on branch earnings was imposed on top of a 50 per cent Dominion income tax. As a result of these

4/ Let X=desired additional foreign income which is assumed to be free of foreign taxes. Then X is found from the following equation: $12,000/(20,000 + X) = .52$

actions by the Canadian Government, parent corporations in the United States earning income through Canadian branches or receiving remittances from Canadian subsidiaries found themselves with substantial excess tax credits that could be applied against additional foreign income.

The total amount of these excess credits -- or at least their potential upper limit -- can be estimated on the basis of U.S. corporate earnings received from Canadian affiliates as reported by the Department of Commerce. In each of the last two years, these earnings totalled around $300 million.[5/] The potential excess tax credits that might have been generated by such earnings could have been as large as $50 million.[6/]

To mop up this amount of excess tax credits, U.S. corporations would have needed to generate untaxed foreign income for their head-office accounts of around $95 million.[7/] The volume of short-term investments necessary to

5/ U.S. balance-of-payments figures state that income from "direct investments in Canada" totalled $409 million in 1961 and $266 million in the first three quarters of 1962. If the usual pattern of large fourth quarter remittances occurs, we might expect the total figure for 1962 to be around $415 million. These figures overstate subsidiary dividend remissions and branch earnings, however, because they include certain dividend payments to private holders of shares in Canadian companies. According to the Department of Commerce, a reasonable estimate of subsidiary and branch earnings would probably be $300 million in each of the past two years.

6/ The ratio of excess foreign tax credits to branch and dividend receipts from Canadian affiliates was 17.6 per cent for subsidiaries chartered in Quebec and Ontario and for branches located in all Canadian provinces, assuming that the branches remitted all of their earnings to their head-office. (See Appendices 1 and 3) The ratio was 15.3 per cent for subsidiaries chartered in Canadian provinces other than Quebec and Ontario. (See Appendix 2)

To get an over-all estimate of annual potential tax credits in 1961 and 1962, it seemed reasonable to multiply $300 million by the middle figure of 16.5 per cent. The product is $49.5 million.

7/ 49.5/52 = 95.2.

generate such earnings would have depended, of course, on the average yield obtainable on such investments. If the average yield had been 4 per cent, U.S. corporations having Canadian subsidiaries and branches would have needed to hold -- on the average -- foreign investments of $2.4 billion;[8/] a lower average yield would give an even larger magnitude. The actual external portfolio investments of U.S. parent corporations at the end of 1960 were certainly well below this level so that when Canada revised her tax laws an incentive was created for a substantial capital outflow.

The adverse impact of this incentive on the U.S. balance-of-payments for the years 1961 and 1962 was softened, however, by two considerations. In the first place, corporations desiring to generate additional foreign income could have used an "in-and-out" technique. For example, a corporation motivated to earn an additional $4 million of foreign income during 1961 might have done so by placing $457 million abroad for 3 months at 3.5 per cent instead of $100 million abroad for one year at 4.0 per cent (assuming no tax paid to a foreign government on this extra income). If a corporation chose the first alternative, it would have had no additional investments abroad at the end of the year, and the balance of payments figure for net capital flow during 1961 as a whole would have been unaffected.

A second qualification is that a corporation with a Canadian affiliate may have had subsidiaries or branches in other countries where the average tax rate was below 52 per cent. If such a parent corporation had chosen to consolidate all of its foreign income in reckoning its tax liability to the U.S. Treasury,

8/ 95 ÷ .04 = 2,375

much or all of the excess tax credit resulting from taxes paid in Canada by its Canadian subsidiary could have been "applied against" the income of subsidiaries in third countries. Such a procedure might have completely erased or greatly reduced the parent corporation's incentive to earn additional income abroad.

Despite the qualifications just noted, holdings of foreign liquid assets by U.S. corporations at the end of 1960 were probably well below the level they desired to hold in 1961 and 1962 as a result of the increase in the Canadian withholding tax. Accordingly, the incentive for many large U. S. corporations to export short-term capital in 1961 and 1962 was probably much stronger than simple interest arbitrage calculations would show. For even if the before-tax yield on short-term investments in Canada and in the U.S. had been equal, the after-tax return on a short-term investment in Canada would have been, for many large U.S. corporations, roughly twice as large as on a comparable investment in this country.

The recent build-up in U.S. time deposits with Canadian banks

Among the available alternatives for "soaking up" tax credits, time deposits with Canadian banks denominated in U.S. dollars were particularly suitable investments: they involved no exchange risk, they had attractive before-tax yields, the interest received was free from Canadian withholding tax (unlike interest on Canadian Treasury bills), and finally, such deposits may have furthered "relations" between a Canadian subsidiary and the Canadian bank receiving a time deposit from the parent corporation.

In fact, short-term U.S. corporate claims in Canada, payable in U.S. dollars, rose by $400 million in 1961 and by a further $170 million in the first 9 months of 1962. A recent breakdown of the composition of these claims reported

to the U.S. Treasury supports the hypothesis that nearly all of this $600 million increase represented enlarged U.S. dollar deposits with Canadian banks.

Of course it is unreasonable to attribute all of this increase to tax considerations. Much of it may be due to the efforts of Canadian banks to attract U.S. corporate funds by offering time deposit rates well in excess of comparable yields in this country. Canadian banks are known to have been able to place such funds profitably in either the broker's market in New York or in the Euro-dollar market.

In view of the weakness of the Canadian dollar during 1961 and the first half of 1962, one might also suppose that a significant part of the time deposit build-up in Canadian banks by U.S. corporations represented speculation against the Canadian dollar. But such speculation could only occur if Canadian dollars were, in some sense, the "home currency" of the holders of the U.S. dollar deposits. This was obviously not so for the parent corporations themselves, although conceivably their increased U.S. dollar deposits in Canada could have represented speculative or hedged positions (against the possibility of a further depreciation of the Canadian dollar) on behalf of their Canadian subsidiaries. This hypothesis is contradicted, however, by the further rise in U.S. corporate deposits in Canada during the second half of 1962 when the Canadian Government's stabilization program and international assistance removed fears that the Canadian dollar would be devalued further.

The new tax law

The Revenue Act of 1962 ended the special tax incentive to earn interest or dividend income abroad.[9] The incentive "expires" for each particular parent corporation at the beginning of its first new "taxable year" after October 16, 1962; for most corporations, this date is believed to be January 1, 1963. Other things being equal, therefore, we might expect to see some reflux of short-term funds from Canada this year.

But even though the tax incentive may have been responsible for substantial short-term outflows in 1961 (and to a lesser extent in 1962), its removal may fail to reverse these outflows. Having been induced to place funds abroad initially by a special tax incentive, U.S. corporations may keep their funds abroad if they believe that foreign yields (especially yields paid by

9/ The Act does this by the simple expedient of denying parent corporations the right to consolidate interest income earned abroad in their own name with income earned abroad by subsidiaries or branches. For specific details, see Revenue Act of 1962: Report of the Committee on Finance United States Senate to Accompany H.R. 10650 (87th Cong., 2nd Sess., Report No. 1881), August 16, 1962, pp. 72-74.

Several other provisions in the act also affect the treatment of foreign income of domestic corporations. A "gross-up provision" requires domestic corporations receiving dividends from foreign subsidiaries to include taxes deemed to have been paid abroad on these dividends as part of their taxable income (unless the subsidiary is considered to be a "less developed country corporation"). A second provision is designed to eliminate tax havens; this is done by making certain types of foreign subsidiary income fully taxable whether or not this income is distributed to the parent corporation.

Neither of these provisions would appear to affect the incentive to export short-term funds. By making it less profitable to hold funds abroad, however, they might encourage some greater rate of dividend transfers from abroad, thereby improving our balance of payments in the short run.

Canadian banks for time deposits) are sufficiently attractive even without a tax sweetener.[10/]

10/ Moreover, the act still leaves U.S. corporations having Canadian subsidiaries with an incentive to mop up their excess tax credits. Since they are prevented from doing this by acquiring interest-yielding liquid assets abroad in their own name, parent corporations may be stimulated to "artificially increase" the earnings of their subsidiaries in countries where corporation taxes are relatively low. If parent corporations choose the consolidated tax option, they can apply the excess tax credits generated by Canadian subsidiaries against the tax liabilities created by additional earnings of subsidiaries in third countries. In some cases, therefore, additional transfers to subsidiaries in third countries (recorded in our balance-of-payments figures as direct investment abroad) may occur as a result of the recent change in the law.

Appendix I

Sample calculation of "excess foreign tax credit" in 1961 and 1962 for a U.S. parent corporation having a Canadian subsidiary subject to Canadian income tax of 52 per cent and dividend remittance tax of 15 per cent:

	Thousands of U.S. dollars
Profits of subsidiary	100
Canadian income tax	52
Assumed dividends transmitted	48
Withholding tax on dividends	7.2
Dividends received by parent corporations	40.8
Tentative U.S. tax at 52 per cent 11/ (.52 x 48)	25
Potential credit for foreign tax paid by subsidiary 12/ $52\left(\frac{48}{100}\right) + 7.2\left(\frac{48}{48}\right) =$	32.2
Excess foreign tax credit 32.2 - 25.0	7.2

Excess foreign tax credit as proportion of dividends received by the parent firm $= \frac{7.2}{40.8} = 17.6\%$ 13/

11/ Under the interpretation of the Treasury Department, dividends remitted by a subsidiary were considered to be "foreign income" of the parent corporation on a before-withholding-tax basis.

12/ "In the case of a foreign subsidiary the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income." See Revenue Act of 1962: Report of the Committee on Finance, United States Senate to Accompany H.R. 10650 (87th Cong., 2nd Sess., Report No. 1881), August 16, 1962, p. 66.

There are two foreign taxes involved in this situation -- the 52 per cent Canadian income tax and the 15 per cent withholding tax on dividends transmitted. The relevant proportion by which the first is multiplied is 48/100; for the second, it is 48/48, since the withholding tax is applied to income that is completely included in the U.S. tax base.

13/ This same percentage result holds even if the subsidiary remits only a fraction of its after-tax income.

Appendix II

Sample calculation of "excess foreign tax credit" in 1961 and 1962 for a U.S. parent corporation having a Canadian subsidiary subject to Canadian income tax of 50 per cent and dividend remittance tax of 15 per cent:

	Thousands of U.S. dollars
Profits of subsidiary	100
Canadian income tax	50
Assumed dividends transmitted	50
Withholding tax on dividends	7.5
Dividends received by parent corporation	42.5
Tentative U.S. tax at 52 per cent	26
Potential credit for foreign tax paid by subsidiary $\frac{50}{100}$ 50 + 7.5 =	32.5
Excess foreign tax credit	6.5

Excess foreign tax credit as proportion of dividends received by the parent firm $= \frac{6.5}{42.5} =$ 15.3% 14/

14/ This same percentage result holds even if the subsidiary remits only a fraction of its after-tax income.

Appendix III

Sample calculation of excess tax credit in 1961 and 1962 for a U.S. corporation having a Canadian branch:

	Thousands of U.S. dollars
Profits of the branch	100
Dominion corporation tax	50
Earnings transmitted to head-office	50
Branch profits tax on remitted income (.15 x 50)	7.5
Income received by head-office	42.5
Tentative U.S. tax at 52 per cent	52
Potential credit for foreign taxes paid by branch	57.5
Excess foreign tax credit	7.5

Excess foreign tax credit as a proportion of income received by the head-office $= \frac{7.5}{42.5} = 17.6\%$ 15/

15/ This ratio would work out to only 8.2 per cent if the branch reinvested half of its after-tax income in certain specified assets in Canada.