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The Treasury Transfer Effect

Are Canada's Corporate Tax Cuts Shifting Billions to the U. S. Treasury?

By Erin Weir

Executive Summary

The U.S. government taxes American corporations on a worldwide basis. Profits repatriated from other countries are subject to the U.S. federal corporate tax rate minus a credit for taxes already paid to foreign governments. Earlier this year, President Obama announced more rigorous enforcement of this policy.

American corporations account for about one-third of the profits subject to Canada's general corporate tax rate. If Canadian federal plus provincial corporate taxes equal or exceed the U.S. federal rate, these corporations do not owe American tax on their Canadian profits.

However, the federal government and some provincial governments are now cutting Canada's combined general rate from 36% to 25%, far below the 35% U.S. federal rate. This lower corporate tax rate will not help Canada attract more investment from American corporations, which will have to pay the rate difference back to Washington. Planned federal and provincial corporate tax cuts will transfer between $4 billion and $6 billion of annual revenue from Canadian governments to the U.S. treasury.

Commentators of all stripes once acknowledged this strong rationale for keeping Canada's corporate tax rate at least equal to the U.S. federal rate. Unfortunately, it has been essentially absent from the public debate about recent corporate tax cuts.

Finance Canada has deflected concerns about the treasury transfer effect by arguing that loopholes allow American corporations to avoid facing U.S. tax on their Canadian profits. But Obama plans to close these loopholes. U.S. Internal Revenue Service statistics appear to contradict Finance Canada's further claim that American corporations will have enough foreign tax credits to meet their U.S. tax obligations despite much lower Canadian corporate taxes.

Canadian federal and provincial governments should enact a combined corporate tax rate of at least 35% to retain revenue that will otherwise be transferred to the American federal treasury. Canada could meet this threshold while staying below the U.S. combined federal-state corporate tax rate, which averages 40%.

Introduction

In May 2009, President Barack Obama unveiled proposals to strengthen U.S. taxation of profits generated abroad by American corporations.[1] This initiative not only provides a general contrast to Canada's relentless drive for ever lower corporate taxes, but also has specific implications for the Canadian subsidiaries of American corporations.

Obama's stated goal, based on a major election promise, is to remove any federal tax incentives for American companies to invest and create jobs abroad rather than in the U.S. He seeks to achieve this goal by rigorously enforcing the longstanding American requirement that U.S.-based corporations pay a tax rate on their foreign facilities at least equal to the American federal corporate tax rate.

Current Canadian policy is to attract investment and jobs by cutting corporate tax rates below the U.S. and other Group-of-Seven countries.[2] This policy clearly runs afoul of Obama's policy.

An important critique of corporate tax cuts has been that, even if they make already profitable assets more lucrative, they will not necessarily induce greater investment in new assets.[3] If American corporations must pay the U.S. federal tax rate on their Canadian profits, then a lower Canadian tax rate will not make their existing Canadian assets more lucrative, let alone induce them to undertake greater investments in Canada.

For these corporations, the only effect of deep federal and provincial corporate tax cuts will be to transfer some of their tax payments from Canadian governments to the U.S. treasury. When Canada's scheduled corporate tax cuts are fully implemented, this transfer could cost between $4 billion and $6 billion annually in lost Canadian tax revenue.

The Treasury Transfer Effect

The U.S. has always taxed its corporations on a worldwide basis. When American corporations repatriate profits generated in other countries, they are taxed at the American federal rate of 35% minus a credit for foreign corporate tax payments.

This system has an important implication for countries like Canada. If our combined federal-provincial corporate tax rate equals or exceeds the U.S. federal corporate tax rate, then Canadian tax payments will provide a large enough credit to fully satisfy the U.S. tax obligations of American corporations operating here. But if our rate falls below the U.S. rate, then these corporations will have to pay the difference back to Washington. To retain corporate tax revenues, Canada must at least match the U.S. federal rate.

The significance of this implication depends on how much profit U.S. corporations generate in Canada. In 2006, the most recent year for which *Corporations Returns Act* figures are available, U.S. corporations had operating profits of $41.8 billion in Canada, 24% of total corporate profits.[4]

Since an appreciable portion of profits generated by Canadian corporations are subject to the lower "small business" tax rate, American corporations account for around 30% of profits subject to the general corporate tax rate.[5] Japan also taxes its corporations on a worldwide basis and has a higher corporate tax rate than the U.S. Therefore, more than 30% of the revenue lost by cutting Canada's corporate tax rate below the U.S. federal rate will simply flow to foreign treasuries.

Reductions of Canada's general corporate tax rate are aimed particularly at foreign corporations, which are more likely than Canadian corporations to be internationally mobile.[6] In 2006, U.S. corporations accounted for 55% of operating profits generated by foreign corporations in Canada. Japanese corporations account for a further portion of Canada's corporate profits.[7] Therefore, most of the profits generated in Canada by foreign corporations are insensitive to Canadian corporate tax cuts below the U.S. federal rate.

The Apparent Consensus

The last two Alternative Federal Budgets and other CCPA publications have cited the treasury transfer effect as an argument against corporate tax cuts.[8] The Canadian Labour Congress has made the same point in a letter to the editor, as well as in presentations to the House of Commons Finance Committee.[9]

A wide range of other commentators used to agree. In 1991, Andrew Coyne wrote in *Canadian Business*

Table 1: Statutory Corporate Income Tax Rates in Canada and the U.S., 2000–2013[16]

Year	Canadian Federal	American Federal	Canadian Federal + Ontario	American Federal + State	Total Difference	Treasury Transfer
2000	29.1 %	35.0 %	44.6 %	40.0 %	(4.6 %)	-
2001	28.1 %	35.0 %	42.1 %	40.0 %	(2.1 %)	-
2002	26.1 %	35.0 %	38.6 %	40.0 %	1.4 %	-
2003	24.1 %	35.0 %	36.6 %	40.0 %	3.4 %	-
2004	22.1 %	35.0 %	36.1 %	40.0 %	3.9 %	-
2005	22.1 %	35.0 %	36.1 %	40.0 %	3.9 %	-
2006	22.1 %	35.0 %	36.1 %	40.0 %	3.9 %	-
2007	22.1 %	35.0 %	36.1 %	40.0 %	3.9 %	-
2008	19.5 %	35.0 %	33.5 %	40.0 %	6.5 %	1.5 %
2009	19.0 %	35.0 %	33.0 %	40.0 %	7.0 %	2.0 %
2010	18.0 %	35.0 %	30.0 %	40.0 %	10.0 %	5.0 %
2011	16.5 %	35.0 %	28.0 %	40.0 %	12.0 %	7.0 %
2012	15.0 %	35.0 %	26.0 %	40.0 %	14.0 %	9.0 %
2013	15.0 %	35.0 %	25.0 %	40.0 %	15.0 %	10.0 %

Notes: The Canadian rates include the 1.1% federal surtax until its elimination in 2008. "Total Difference" is the U.S. federal plus state rate minus the Canadian federal plus Ontario rate. "Treasury Transfer" is the amount by which the U.S. federal rate exceeds the Canadian federal plus Ontario rate.

magazine, "The government doesn't want to let rates get to lower here than in the U.S. Why? Because U.S. firms get credited for the tax they pay in Canada against their tax payable at home. If they pay less tax to Ottawa, it just increases the tax they owe to Washington. In effect, we'd only be transferring revenues to Uncle Sam."[10]

In 1997, the Government of Canada's Technical Committee on Business Taxation reported that some "foreign governments permit their taxpayers to credit Canadian corporate income and withholding taxes against the foreign government's taxes... If Canada did not assess corporate income taxes, foreign investors and the treasuries of foreign governments would be among the main beneficiaries."[11]

Robin Boadway, Canada's most cited public finance professor, went further in commenting on this report: "To the extent that the foreign government gives a tax credit on taxes paid abroad, domestic taxes can be increased costlessly: an increase in domestic taxes simply reduces foreign taxes one-for-one, [which] implies that corporate taxes should be levied up to the point where the possibilities for such crediting become exhausted."[12]

In 2007, *The Globe and Mail* reported, "Experts warn there are diminishing returns for lowering rates far below U.S. levels. That's because U.S. governments will end up collecting any difference in rates from American companies operating in Canada."[13]

Canadian Corporate Tax Cuts

Despite this previous consensus that it does not make sense to cut Canada's corporate taxes below the U.S. level, Canadian governments are doing exactly that. The U.S. applies its federal corporate income tax rate of 35% on a worldwide basis. (State corporate income tax rates do not apply on a worldwide basis.)

Canada's 2000 federal budget announced a schedule of corporate tax cuts ending with a 22.1% federal rate in 2004. Where provincial corporate tax rates were at least 13%, credits for total Canadian taxes should have been large enough to meet U.S. tax obligations (35%) on profits repatriated from Canada. Provincial governments that maintained corporate tax rates below 13% risked transferring revenues to the American treasury. The Ontario government's 2003 *Fiscal Responsibility Act* raised its corporate tax rate from 12.5% to 14% in 2004, narrowly avoiding the treasury transfer effect in Canada's largest province.

Further federal corporate tax cuts introduced by the Liberal government in 2005 and enacted by the new Conservative government in 2006 scheduled a 19% rate by 2010. The 2007 Economic Statement accelerated these cuts, enacted a 15% federal rate by 2012, and urged provincial governments to slash their rates to 10%.[14]

Today, Canada's federal rate is 19%. In Nova Scotia and Prince Edward Island, provincial rates of 16% are sufficient to match the 35% U.S. rate. In every other province, there is already a risk of redirecting corporate tax payments to Washington.

With a 15% federal rate, all combined federal-provincial corporate tax rates will fall short of the American federal rate. The governments of Ontario, British Columbia and New Brunswick recently aggravated this problem by announcing provincial corporate tax rates of 10%. Alberta already had a 10% corporate tax rate.

In these provinces, which account for more than two-thirds of Canadian corporate profits, the gap between the U.S. federal rate and the Canadian federal-provincial rate will be ten percentage points. Where provincial governments maintain corporate tax rates above 10%, the transfer of tax revenue to the U.S. treasury will be smaller.

An important assumption underlying these calculations is that the U.S. will maintain a 35% federal corporate tax rate going forward. While one cannot completely rule out the possibility of a future U.S. federal corporate tax cut, no such reduction has been enacted since 1986. Indeed, the last time this rate changed was an increase from 34% to 35% in 1993.[15]

Even when Republicans have since controlled both Congress and the White House, they have not cut the general corporate tax rate. The U.S. instead enacted temporary and targeted tax measures, such as bonus depreciation, to promote business investment.

Finance Canada's Defence

Most conservative commentators, even those who once acknowledged the treasury transfer effect, have simply ignored it in applauding Canada's sweeping corporate tax cuts. However, at least one Canadian academic journal recently printed an article engaging the issue.[17] Notably, the federal Department of Finance explicitly addressed the treasury transfer effect in its 2008 Tax Expenditures and Evaluations (released on Friday, January 2, 2009, for maximum exposure):[18]

> Under the "treasury transfer effect," the revenue forgone by Canada could simply reduce the amount that the home country allows as a credit for foreign (i.e., Canadian) taxes, thereby increasing taxes payable in the home country. Such an outcome would result in a revenue loss for Canada without any favourable impact on investment. This is a potentially important concern with respect to the U.S., since it supplies about half of Canada's inbound FDI [foreign direct investment].

But the document went on to downplay the issue: "Given current institutional arrangements, however, the transfer of tax revenue to the U.S. treasury should not now be considered a serious constraint on Canada's choice of statutory rate." Finance Canada supported this conclusion with five specific claims:

- Profits generated in Canada are not subject to American tax until they are repatriated to the U.S. Such profits could be reinvested in Canada for extended periods before repatriation.

- "U.S. MNEs [multinational enterprises] are also able to use tax-planning techniques to indirectly repatriate income from low-tax jurisdictions without incurring additional U.S. tax."

- "In 2004, U.S. MNEs were allowed a one-time, 85% tax-free repatriation of dividends from controlled foreign corporations...firms may be adjusting the expected value of the repatriation tax for the probability that such an event will occur again."

- "U.S. MNEs are able to pool incomes from high- and low-tax jurisdictions when calculating additional U.S. taxes payable upon repatriation of dividends, so a low rate in Canada would not necessarily result in a treasury transfer."

- "The allocation of expenses incurred by the U.S. parent to foreign subsidiaries" and withholding taxes produce foreign tax credits greater than Canada's statutory corporate tax rate.

President Obama's proposed corporate tax reforms weaken Finance Canada's first three claims. Under current rules, American corporations may immediately deduct expenses associated with a foreign investment in filing U.S. taxes, even if they do not repatriate the profits from that investment for years. But Obama's reforms make it far less attractive for American corporations to delay repatriating profits "by requiring a company to defer any deductions—such as for interest expenses associated with untaxed overseas investment—until the company repatriates its earnings back home [to the U.S.]"[19]

Some American corporations have avoided U.S. tax on foreign profits by exploiting "check-the-box regulations" instituted in 1997.[20] Again, Obama proposes to change these regulations to stop tax-avoidance.[21]

The President's announcement signals that he intends to ensure that American corporations actually pay U.S. tax on profits collected abroad. This revelation sharply reduces the probability of another U.S. tax-holiday on repatriated profits. If the expected value of U.S. tax obligations on repatriated profits is now extremely close to 35%, then the expected gain from a Canadian corporate tax rate below 35% must be very close to zero.

Internal Revenue Service Statistics

Finance Canada's last two claims can be evaluated using U.S. government data on corporations with credits for foreign tax payments. American corporations receive a credit for all foreign tax payments on profits repatriated from all foreign countries. A U.S. corporation with profits from a high-tax country and Canada could have foreign tax credits worth more than 35% of its repatriated profits. But it cannot receive a U.S. tax refund for foreign credits over and above the amount needed to meet its U.S. tax obligations.

In this situation, a Canadian tax cut would simply use up the excess credits rather than increase the corporation's U.S. tax payments. As a result, the corporation would retain more profits after tax and might be inclined to invest more in Canada.

But how common is this situation? If the value of all foreign tax credits typically exceeded 35% of all repatriated profits, then one might infer that many U.S. corporations have excess foreign credits. In fact, this global percentage has been just over 25% in every year for which data are available online (1992 through 2004).[22]

As a whole, corporate America does not have excess foreign credits. For the vast majority of U.S. corporations with worldwide operations, lower Canadian corporate taxes do not increase after-tax profits or make Canada a more attractive place to invest.

Indeed, the fact that most such corporations have insufficient foreign credits to meet their U.S. tax obligations may provide an opportunity to transfer revenue from the American treasury to Canada. If federal and provincial governments set their combined corporate tax rates above 35%, they would create excess credits on Canadian profits. American multinationals could use those credits to meet tax obligations on profits from countries with lower corporate taxes. In this case, higher Canadian corporate taxes would have no effect on after-tax profits.

However, other U.S. corporations have their foreign investments heavily or exclusively concentrated in Canada. For them, the relevant issue is not the global balance between foreign tax credits and foreign profits, but the Canadian balance. One would assume that a Canadian corporate tax rate of at least 35% would be required to meet all U.S. tax obligations on profits repatriated from Canada.

Finance Canada asserts that this "threshold rate" is probably below 35%, but does not offer a numerical estimate. American corporate tax rules require that some expenses incurred in the U.S. to support foreign operations be counted against foreign income. The Government of Canada levies "a 5% withholding tax on dividends arising from direct investment repatriated to the U.S."[23]

Both factors modestly reduce the value of profits upon repatriation. A Canadian corporate tax rate applied to the initial profits will loom somewhat larger as a percentage of the reduced profits received in the U.S. In theory, a Canadian corporate tax rate below 35% could still generate enough foreign tax credits to satisfy all tax obligations created by the 35% U.S. federal rate.

Table 2: U.S. Corporate Profits and Tax Credits from Canada, 2001—2004 ($ millions)[24]

	Profits Repatriated from Canada	35% of Profits	Tax Credits from Canada	Possible Treasury Transfer
2001	$11,784	$4,124	$4,067	$ 57
2002	$15,052	$5,268	$4,747	$ 521
2003	$22,124	$7,743	$6,321	$1,422
2004	$28,318	$9,911	$8,262	$1,649*

***** Because of the U.S. tax holiday on dividends repatriated in 2004, that year's actual treasury transfer would have been much less.

In practice, there are other differences between American and Canadian definitions of taxable profits. Finance Canada presents no empirical evidence that effective tax rates on repatriated profits are lower in the U.S. than in Canada.

Again, the most relevant source of data is presumably the Internal Revenue Service. From 2001 through 2004, the most recent years for which figures are available, credits for all Canadian taxes have fallen below 35% of repatriated profits.

The fact that this shortfall occurred even while Canada's statutory corporate tax rate exceeded 35% implies that, on the whole, the U.S. may define corporate profits more broadly than Canada for tax purposes. In other words, federal and provincial governments may need to maintain a combined statutory corporate tax rate above 35% to fully meet U.S. tax obligations on repatriated profits.

Not surprisingly, as Canadian corporate tax rates declined between 2001 and 2004, the possible treasury transfer increased. However, even annual figures exceeding $1 billion are just the tip of the iceberg.

Cost Estimate

The Government of Canada's stated objective of cutting combined federal-provincial corporate taxes from 36%, the rate in effect from 2004 through 2007, to 25% will push Canada further below the U.S. threshold. Finance Canada estimates that the federal portion of this cut will cost $14 billion annually.[25] If all provincial governments comply with this plan, their revenue losses would bring the national total to around $20 billion annually.[26]

As noted above, American corporations account for approximately 30% of profits subject to Canada's general corporate tax rate. Therefore, proposed federal and provincial corporate tax cuts will transfer about $6 billion annually to the U.S. treasury.

Of course, this estimate reflects Finance Canada's assumptions about the future growth of corporate profits. What if pre-tax profits only return to 2006 levels? As noted above, U.S. corporations collected profits of more than $40 billion in Canada that year. The treasury transfer will equal about 10% of those profits—the 35% U.S. federal tax rate minus Canada's 25% combined federal-provincial rate. These more cautious assumptions suggest an annual transfer of $4 billion from Canadian governments to the U.S. treasury.

There is also a further transfer to the Japanese government, which taxes Japanese corporations on a worldwide basis. Canadian governments can ill afford such revenue losses, particularly given concerns about the prospect of ongoing budget deficits.

Conclusion

The obvious policy implication is that Canada should enact a combined federal-provincial tax rate of at least 35% to minimize these treasury transfers. This threshold could be reached through a higher federal corporate tax rate, higher provincial rates, or some combination of the two. A logical first step would be for both orders of government to cancel corporate tax cuts scheduled in future years.

A 35% federal-provincial corporate tax rate would still be appreciably lower than the combined U.S. rate because 47 states and the District of Columbia

apply additional corporate taxes over and above the 35% federal rate.[27] Ontario's last provincial budget notes that, "Compared to the U.S. Great Lakes states — Ontario's key competitors for jobs and investment — Ontario's combined rate [of 25%] would be 15 percentage points lower."[28]

With a combined rate of 35%, Ontario would still be 5 percentage points below these "key competitors." For American corporations that must always pay at least 35%, the tax advantage of investing in Ontario would be 5% of profits under either scenario.

While a reasonable working assumption is that Canada needs a 35% statutory corporate tax rate to match the 35% U.S. federal rate, further research would be useful in identifying the threshold more precisely. Internal Revenue Service figures suggest that some profits from Canada may have been paid to the U.S. treasury even before Canada's rate fell below 35%. Given different definitions of taxable income, Canada may need a tax rate somewhat above 35% to fully satisfy the tax obligations created by the 35% American rate.

Canada's optimal corporate tax rate is likely above the floor defined by the U.S. federal rate. Given a general rate just high enough to meet American tax obligations, any Canadian tax incentives would simply cause a treasury transfer. Targeted tax measures, such as accelerated Capital Cost Allowances (CCA), will only affect after-tax profits and hence investment decisions if Canada's federal-provincial taxes are somewhat higher than American federal taxes to begin with.

Of course, a related point is relevant even for corporations that are not taxed on a worldwide basis. The value of tax deductions is always proportional to the tax rate. Corporate tax cuts are self-defeating to the extent that they make corporate tax incentives less effective in promoting investment. In 2004, a little-known Finance Canada study noted that "reducing the statutory rate of corporate income tax [is] less cost-effective" because it "lowers the value of the CCA tax benefit."[29] While the treasury transfer effect is an important consideration, it is not the only reason to conclude that deep federal and provincial corporate tax cuts are misguided.

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Notes

1. U.S. Department of the Treasury, "Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas," press release and backgrounder, May 4, 2009.

2. Finance Canada first presented the explicit goal of "establishing the lowest tax rate on new investment in the G-7" in *Advantage Canada — Building a Strong Economy for Canadians*, November 23, 2006.

3. See, for example, Andrew Jackson and Erin Weir, "The Conservative Tax Record," in *The Harper Record*, edited by Teresa Healy (Ottawa: CCPA, 2008), pages 57–69.

4. Statistics Canada, *Corporations Returns Act* (Catalogue no. 61–220-X), March 3, 2009, page 58 (Table 24).

5. Estimated from ibid.; Finance Canada, *Budget 2009*, page 220 (table 4.5); and Finance Canada, *Tax Expenditures and Evaluations 2008*, January 2, 2009, page 27 (table 2).

6. Finance Canada, *Tax Expenditures and Evaluations 2006*, March 1, 2007, page 42.

7. Statistics Canada, *Corporations Returns Act*, page 58 (Table 24). Unfortunately, these figures do not separate Japanese corporations from other non-U.S. and non-European foreign corporations.

8. CCPA, *Alternative Federal Budget 2008*, February 25, 2008, page 23; CCPA, *Alternative Federal Budget 2009*, January 23, 2009, page 27; Jackson and Weir, "Conservative Tax Record," page 60.

9. Erin Weir, "Our loss U.S. gain?," *National Post*, May 26, 2007, page FP15; Canadian Labour Congress, "Winning the Race to the Bottom: A Critical Appraisal of Corporate Tax Cuts," submission to the House

of Commons Finance Committee 2007 Pre-Budget Consultations, August 2007, pages 5–6.

10. Andrew Coyne, "Corporate Tax Reform," *Canadian Business*, 1991, available at http://andrewcoyne.com/essays/

11. *Report of the Technical Committee on Business Taxation* (Ottawa: Government of Canada, 1997), page 2.8.

12. Robin Boadway, "The Economic Rationale for Integration," in *Business Tax Reform* (Toronto: Canadian Tax Foundation, 1998), page 21:5.

13. Steven Chase, "Lower corporate taxes? Not likely Business groups don't foresee any tax reductions in March 19 budget," *Globe and Mail*, March 8, 2007, page B5.

14. Finance Canada, *Economic Statement*, October 30, 2007, pages 73–77.

15. Internal Revenue Service, "Corporation Income Tax Brackets and Rates, 1909–2002," available at http://www.irs.gov/pub/irs-soi/02corate.pdf

16. Ibid., page 75; Ontario Ministry of Finance, *2009 Ontario Budget Papers*, March 26, 2009, page 117; KPMG International, *KPMG's Corporate and Indirect Tax Rate Survey 2008*, pages 10–13.

17. George Zodrow, "Corporate Taxation in Canada," *Canadian Tax Journal*, Vol. 56, No. 2 (2008), pages 430–440.

18. Finance Canada, *Tax Expenditures 2008*, pages 47–48.

19. Department of the Treasury, "Leveling the Playing Field."

20. Zodrow, "Corporate Taxation," pages 431 and 440.

21. Department of the Treasury, "Leveling the Playing Field."

22. Internal Revenue Service, "Table 3.--U.S. Corporation Income Tax Returns with a Foreign Tax Credit: Foreign Income, Deductions, and Taxes Reported on Form 1118, by Selected Country to Which Foreign Taxes Were Paid," available at http://www.irs.gov/taxstats/index.html

23. Finance Canada, *Tax Expenditures 2008*, page 48.

24. Ibid.

25. Finance Canada, *Canada's Economic Action Plan: Budget 2009*, January 27, 2009, page 255 (table A2.2). Finance estimates that all business tax cuts since 2006 will cost $14.9 billion when fully implemented in 2013–14. However, about $1 billion of this total is the cost of cutting the small business rate as opposed to the general rate.

26. Ontario Finance officials indicate that cutting Ontario corporate taxes to 10% will cost $2.3 billion when fully implemented in 2014–15. The *2009 Budget Papers*, page 134, only project this cost through 2012–13.

27. The three states with no state corporate income tax are Nevada, Washington and Wyoming.

28. Ontario, *2009 Budget Papers*, page 118.

29. Finance Canada, *Tax Expenditures and Evaluations 2004*, November 4, 2004, page 73.

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