

APPENDIX A

Eliminating Artificial Tax Incentives To Capital Movements Arising Out Of Foreign Tax Credit Computation⁹

Last summer Canada revised its tax laws to provide a 57½% effective rate of Canadian tax applicable to income going to United States corporations operating in branch or subsidiary form in Canada. This Canadian tax rate in excess of the U.S. 52% rate has highlighted the operation of the existing method for computing the foreign tax credit as an artificial inducement to the outflow of short-term U.S. capital. This is harmful to our monetary stability and to our balance of payments position.

Under existing rules, a U.S. company deriving income from business abroad through a branch or a subsidiary may have an unused foreign tax credit where the foreign rate of tax on the income exceeds the U.S. rate. If, however, additional foreign source investment income can be generated which is subjected to a foreign tax rate lower than the U.S. rate, the two kinds of income can be lumped together under the existing foreign tax credit rules. In this way the U.S. tax on the income from such investment funds can be completely eliminated by the excess credit from the tax on the business income of the company.

For example, the 57½% effective rate of Canadian tax applicable to income going to U.S. corporations operating in branch or subsidiary form in Canada leaves an excess credit of 5½% over the U.S. 52% rate. The Canadian rate of tax on interest income flowing to such corporations is only 15%. Consequently, some of these U.S. corporations have transferred to Canada short-term funds, such as bank deposits, which ordinarily would be held in the United States. Since the excess credit from the business income will eliminate the U.S. tax on the interest income, the effect is to leave that income taxable at only a 15% Canadian rate, as compared with the 52% U.S. rate that would apply if the funds were held in the United States. Thus the existence of this situation serves as an artificial inducement to the movement of U.S. capital abroad.

In my report to the President on the balance of payments, transmitted to the Congress on March 28, 1962, I recommended that this situation be corrected. I suggest that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income. In this way a foreign tax credit will be allowed against investment income only for the actual foreign taxes paid on such income. This will result in the same tax rate being paid with respect to short-term investment income of U.S. companies whether it is earned at home or abroad. We believe that this is an effective and fair way to correct this tax-induced disruptive monetary situation. A more detailed explanation of this recommendation and the proposed statutory language is submitted as exhibit III E.

⁹ Excerpt from testimony of Secretary Dillon at Hearings before Senate Finance Committee on the Revenue Act of 1962 (Part 1, pages 103 and 104).