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The Impact on Canada-US. Business of Diverging Corporate Tax Rates

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A superior line of thought

DAVIES

CANADA-U.S. TAX PRACTICE

A Cross-Border View

The Impact on Canada-U.S. Business of Diverging Corporate Tax Rates

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OVERVIEW

Debate rages in both Canada and the United States over corporate tax rates. This column examines the debate in the context of the effects that the recent divergence of the rates in favour of Canada is having and the impact future changes may have. There are two key questions: (1) do lower Canadian rates draw more U.S. investment? and (2) do lower Canadian rates skew intercompany prices, resulting in greater profits in Canada?

BACKGROUND AND CURRENT CONTROVERSY

Historically, there has been rough parity between Canadian and U.S. corporate tax rates,[1] although structural differences between the federal-subpolitical corporate tax systems of the two countries create difficulty in making comparisons that are *both* simple and accurate.[2] Significant recent tax cuts in Canada — at both the federal and provincial levels — without corresponding changes in the United States[3] now suggest, in some cases, that U.S. corporate tax rates are nearly double those in Canada.

In Canada, the abated rate[4] this year is 16.5% — down 1.5 percentage points from the 18% rate last year — and is scheduled to be further reduced to 15% for 2012 and subsequent years. Moreover, most provinces (including Ontario, Canada's largest) will have a 10% add-on rate by mid-2013, resulting in an aggregate effective Canadian corporate tax rate of 25%. In New Brunswick, which is phasing in an 8% rate, the aggregate will be 23%, which is *less* than half the all-in effective U.S. federal, New York State, and New York City rate applicable to each dollar of income earned by a corporation in Manhattan.[5]

Will these rates and this disparity continue?

In the past few months, an almost unheard-of political controversy has arisen in Canada over the tax rate cuts. The opposition parties are now threatening to bring down the minority Conservative Government of Prime Minister Stephen Harper unless he takes steps (in his Spring budget, due on March 22, 2011) to enact a return to an 18% tax rate.[6]

Meanwhile pressure has been building in the United States to redress the perceived damage to the

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[1] Shoven and Whalley, *Canada-U.S. Tax Comparisons*, NBER (1992).

[2] In the United States, state corporate tax rates may range from nil to about 10% and (excluding those cities that also levy a corporate tax on income) the net burden of state corporate taxes may not be very material, particularly because state corporate taxes are deductible in computing U.S. federal taxable income. If we assume that the U.S. federal rate is 35% and that the average U.S. state corporate rate is 7%, after the deduction the real cost of the state tax is, roughly, 4.5%. Put differently, the state rate (7%) effectively reduces the U.S. federal rate to about 32.5% (of pre-tax profit), with an overall effective combined U.S. federal and state corporate rate of 39.5%. The state tax component therefore constitutes only some 18% of the overall effective rate (7/39.5 = 18%). In Canada there is a totally different approach, resulting in totally different results with respect to the numbers. There is a nominal federal rate of tax, which in 2011 is 26.5% and is set to become 25% in 2012. However, where a corporation carries on business regularly in a province (through a domestically defined "permanent establishment"), the federal rate is reduced by 10 percentage points (so that the net federal rate would be 16.5% this year and 15% in 2012 and thereafter) in order to leave room for provincial tax rates, most of which by 2012 will be roughly 10%, with the combined rate (of approximately 26.5% this year and 25% next year and thereafter) applying to a common taxable income base. Here it can be seen that the provinces take roughly 40% of corporate tax (10% of the 25%) — a far cry from the average in the United States — and that is why it is not particularly accurate or representative to compare the U.S. net federal rate of, say, 32.5%, which represents generally between 80%–85% of the overall corporate tax rate, and the Canadian net federal rate (16.5% this year and 15% thereafter), which represents only 60% of the Canadian combined tax rate.

[3] At the state level, Illinois has just raised its rates.

[4] The "abated rate" is the federal rate reduced by 10 percentage points to leave room for provincial taxes.

[5] The New York State and City corporate income tax rates are each some 9%, which are deductible for purposes of determining U.S. federal taxable income (subject to the 34%–35% federal rate) yielding a combined rate of some 47%.

[6] *See* Jackson, "United Opposition Calls for Rollback of Canadian Corporate Tax Cuts," *Tax Analysts* (2/14/11) (Doc. No. 2011-2936). The article states that:

> Canada's opposition parties. . . united on February 9 to push the ruling Conservative Party to roll back corporate tax cuts that the opposition says are too costly and are of a benefit to only a small portion of Canadian corporations. . . . The Liberal Motion [of February 9] calls on Prime Minister Stephen Harper's Conservative government to return the federal corporate tax rate to its 2010 level of 18 percent as part of the March budget. The rate was lowered to 16.5 percent as of January 1, and is scheduled to decrease again to 15 percent in 2012. Harper has said that the business community unanimously supports the cuts as necessary for promot-

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U.S. economy resulting from the United States having the second highest corporate tax rate among industrialized countries (second to Japan). The latest pressure, of course, arose in President Obama's State of the Union address, where he called for a substantial cut in the U.S. corporate income tax rate. To that end, the chairman of the Ways and Means Committee, Rep. Dave Camp, has proposed to cut the U.S. federal tax rate for both corporations and individuals to 25%, and to reduce or eliminate certain deductions.[7] To the surprise of some observers, and to the pleasure of the U.S. business community, President Obama suggested that the U.S. corporate rate should be reduced, funded by elimination of corporate tax preferences that would level the playing field for all U.S. industries. The President's subsequently released proposed 2012 Budget would remove certain preferences available mainly to the U.S. energy industry and would reduce deductions and tax credits available to U.S. multinational corporations. However, those proposals were not related to any reduction in the U.S. corporate income tax rate.

Will these opposing initiatives result in a material reduction in the tax disparity that is currently in favour of Canada so as to materially reduce the possible incentives to invest in and shift income to Canada?

INCENTIVE TO INVEST IN CANADA?

It is common knowledge that a country's corporate tax rate does not necessarily tell everything about the overall tax burden for companies that operate there. There may be, for example, unfriendly depreciation rules, not to mention capital taxes, franchise taxes, payroll taxes, etc. But it is also common knowledge that a country's corporate tax rate can have a powerful, symbolic and visceral influence on whether a country retains existing business or attracts new investment. Such an influence can obviously have salutary effects on the economy. In November 2009, there were headline stories in Canada[8] about OECD reports that Canada was, in fact, faring poorly in an international comparative survey concerning corporate tax rates, having the fifth highest (at 33%) among the roughly 120 countries surveyed.

As already noted, that stigma is changing as a result of a conscious and focused effort by the Canadian federal government, and now by many of the provinces, to reverse that profile in the global marketplace and make Canada's corporate tax rate position highly competitive.[9]

Support for this initiative has not been uniform and there are those who would have Canada, in a retrograde initiative, change directions, scrap the phasing-in of the lower rates described above, and, instead, increase them.[10]

The underlying concern of such observers is that lower Canadian tax rates will not actually encourage investment, but instead, the benefit of the cuts will "flow not to enterprises operating in Canada but to foreign governments,"[11] and in particular to the United States.[12] The ostensible problem is that the U.S. tax system (including Code §902 and the U.S. high corporate tax rate) operates to give the impression that Canadian tax cuts become additional taxes paid to the U.S. when Canadian subsidiaries distribute their profits to U.S. parent companies. However, that is not what actually happens.

The U.S. system would have such effects *if* Canadian subsidiaries regularly paid dividends to their U.S. parent companies;[13] however, U.S. parent companies do not cause their foreign subsidiaries to pay dividends that would produce U.S. tax currently. Instead, they either have their foreign subsidiaries reinvest their profits outside the United States or otherwise use those profits without paying material U.S. tax.

The accuracy of that contention (and its undesirable effect of depriving the U.S. economy of the benefits of directly repatriated foreign subsidiary profits) led to the enactment six years ago of a temporary low tax rate (approximately 5%) on repatriated foreign profits

ing growth, according to a February 10 CTV.ca report. The Conservatives also say the tax cuts will generate thousands of new jobs, a claim that has been challenged by the Liberals.... Despite projections by Finance Minister Jim Flaherty that as many as 110,000 companies would benefit from the tax cuts, independent analysts have cautioned that only a handful of companies would be in a position to actually take advantage of them because many Canadian companies are still booking losses as a result of the recent financial crisis, thereby avoiding tax in the short term.

[7] *See* McKinnon, "Tax Plan Aims for 25% Cap," *Wall Street J.* (3/17/11).

[8] *See, e.g.*, Tait, Canwest News Service, "Corporate Taxes Here Among the Highest," *The Montreal Gazette* (11/13/09), p. B6.

[9] As noted above, by 2012 or 2013 corporations operating in Alberta, Ontario, and several other provinces will pay a combined federal/provincial rate of 25%, those in Quebec 27%, and those in New Brunswick 23%, the lowest combined corporate tax rate in North America. A corporation operating in New Brunswick will pay *half* the combined rate imposed on a corporation operating in New York City. In 2011 the rates in oil-rich Alberta and Canada's two largest provinces, Ontario and Quebec, will be, respectively, 26.5%, 28% (as of July 1), and 28.4%.

[10] *See* Weir (United Steelworkers Union of Canada economic spokesperson), "Corporate Tax Cuts Would Hurt Canada," *FP* 13 (11/19/09). For a response, *see* Boidman, "Two Fatal Flaws in Steelworkers Tax Arguments," *FP* 23 (11/21/09); and for two sequels, *see* Boidman and Weir, "Corporate Tax Debate," *FP* 19 (11/28/09). Weir would increase the Canadian rate roughly 40% — to 35% from the planned 2012 target of 25%.

[11] Weir, fn. 9, above.

[12] Mr. Weir also (erroneously) complained about the relationship with Japan. *See* fn. 14, below.

[13] Under U.S. Code §§78 and 902, a U.S. parent receiving, say, a dividend of $75 from a Canadian subsidiary, arising from pretax profits of $100 reduced by Canadian corporate taxes of $25, would include in income the grossed-up dividend (that is, backed up to the underlying income of the Canadian company before the Canadian taxes) and apply the U.S. corporate rate of, say, 35% for a tax of $35. Then under Code §902 the U.S. parent would credit the Canadian taxes of $25 and, therefore, pay net $10 to the U.S. government. (This example ignores withholding tax.)

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(in Code §965). That repatriation holiday led to some $312 billion of foreign profits being repatriated by 843 U.S. Fortune 1000 companies, according to the IRS's Spring 2008 *Statistics of Income Bulletin*.[14] Absent that enactment of the low rate, that $312 billion of profit presumably would have never been brought into the U.S. tax net. Thus, there is no reason to think that the substantial tax savings U.S. companies will enjoy in Canada will ever increase revenues of the U.S. Treasury because a Canadian subsidiary generally will not distribute Canadian profits to its U.S. parent if that would give rise to any material amount of U.S. tax.[15]

A concern was also expressed that the Obama interest expense deferral proposal would see Canadian tax cuts end up in U.S. government coffers. That sentiment also appears invalid because such a deferral would simply punish U.S. parent corporations by increasing U.S. tax on U.S.-source profit, rather than force accelerated payments of dividends from Canada. *In the real world*, according to informed U.S. observers, the Obama approach would lead to a massive "push down" of U.S. parent-level borrowings to their foreign subsidiaries.

It is therefore logical to conclude that the current corporate tax rate arbitrage in favour of Canada provides an incentive for increased U.S. business investment in Canada.

DISINCENTIVE TO INVEST IN THE UNITED STATES?

On the surface, the tax rate gap may also provide a disincentive for Canadians to carry on business in the United States through U.S. subsidiaries or permanent establishments (within the meaning of the Canada-U.S. Income Tax Treaty). As noted above, however, while the corporate tax rate may have a strong visceral influence, there may be other tax-related rules that mitigate this effect and attract Canadian investors.

A simple example is a Canadian-based real estate organization, which in Canada cannot defer taxes on selling Canadian property in the context of a "like-kind exchange." But a U.S. subsidiary with sufficient size and more than five full-time employees operating in the U.S. real estate sector could use Canada's deferral regime and achieve tax deferral or exclusion in Canada as well. This result may occur due to an exception to the Canadian foreign accrual property income (FAPI) attribution regime, which is similar to the U.S. "Subpart F" rules. If income qualifies as active business-exempt surplus, the Canadian parent never pays tax on the subsidiary's profits.[16]

There will, of course, be other situations where advantageous U.S. rules will offset or mitigate the negative effects of the adverse U.S. corporate tax rate and incentivize Canadians to invest in the United States. Thus, in many cases, a Canadian investor can still obtain a better tax result in the U.S. than in Canada. As but one example, a Canadian investor in a partnership in the United States may often deduct, for U.S. tax purposes, losses that exceed the investor's investment in the partnership, and those losses can be used to offset income from other U.S. operations of the Canadian investor.[17] Such a result would not be possible in Canada.

EFFECT ON CANADA-U.S. INTERCOMPANY TRANSACTIONS

The second important consequence of the tax rate gap is the incentive it ostensibly raises for Canada-U.S. groups to minimize intercompany prices for northbound transfers of goods or services or licensing of intangibles, and the corollary incentive to maximize intercompany prices for southbound transfers or licences. Such pricing assists in shifting profits to Canada where they are subject to the lower Canadian corporate tax rates.

To what extent will U.S. transfer pricing law facilitate such bias? In principle, because both countries regulate intercompany pricing on the basis of the arm's-length principle, the answer should be: none at all.[18]

However, two factors could provide some flexibility. First, the July 2009 final Code §482 "Services

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[14] *See also* the IRS's Spring 2008 *Statistics of Income Bulletin*; "Camp Open to Repatriation Holiday, Warns Congress Must Move Carefully," *BNA Daily Tax Real Time* (2/11/11) ("House Ways and Means Committee Chairman Dave Camp (R-Mich.) said Feb. 10 that he is open to the idea of offering companies a tax incentive to bring overseas earnings back into the United States, but said any legislation would need to be constructed carefully to ensure that the money is used for U.S. investment"); Shreve & Pierson, "No Repatriation Holiday Without Tax Reform, Geithner Says," *Tax Analysts* (2/10/11) ("Treasury Secretary Timothy Geithner February 9 said the White House will not support a tax holiday for repatriated corporate dividends outside a broader tax reform effort but also will not offer a detailed proposal for corporate tax reform in President Obama's fiscal 2012 budget"); and "Geithner Says No Corporate Tax Reform, Repatriation in FY 2012 Budget," *BNA Daily Tax Report* (2/10/11).

[15] Mr. Weir's contention respecting Japan (*see* fn. 11, above) was also fatally flawed in that he was apparently not aware of the fact that that country has changed its tax system and, in principle, no longer imposes tax on foreign subsidiary profits repatriated to Japanese parent companies. (Five percent of a dividend is still included in computing taxable income, but this is seen as simply a recovery of expenses incurred by the Japanese parent company to manage its investment in its foreign subsidiary.)

[16] See in general §§90 to 95 of the Income Tax Act for the rules with respect to "foreign affiliates," "controlled foreign affiliates," "FAPI," and the component thereof known as an "investment business," as well as §113 dealing with the receipt of dividends out of "exempt surplus" and Part 5900 of the Income Tax Regulations for, *inter alia*, the rules and definitions respecting "exempt surplus" and its constituent parts, such as "exempt earnings."

[17] *But see* Code §§465 (at-risk rules) and 469 (passive loss limitations).

[18] Indeed, recent cases in the United States (*Xilinx Inc. v. Comr.*, 9th Circuit, Nos. 06-74246 and 69 (3/22/10), and *Veritas Software Corp. v. Comr.*, 133 T.C. No. 14) and in Canada (*GlaxoSmithKline v. The Queen*, 2008 DTC 3957 (TCC), *GlaxoSmithKline Inc. v. Canada*, 2010 FCA 201, *General Electric Capital*

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Regs" have maintained some room for charging services at cost (under the "Services Cost Method" or "SCM"), thus preventing companies from realizing a profit margin on some parent company services performed for a subsidiary. However, the SCM tool may be largely illusionary in that it does not apply to services of high value, or those of a sophisticated or front-line nature,[19] nor to any that are considered "core" to the success of the business of either party.[20]

Second, in Canada-U.S. transfer pricing disputes, the Canada Revenue Agency (CRA) has generally been more aggressive than the IRS in pushing its views. Moreover, with the IRS often more focused on CFCs in low-tax countries, rather than those in high-tax countries, there can be flexibility for taxpayers to push the envelope.

Thus, with the unfolding allure of the substantial corporate tax rate differential, a predilection to pushing the pricing envelope toward optimizing Canadian corporate profits may take hold. And if it does, presumably the IRS, not CRA, will bring a jaundiced eye to examining Canada-U.S. pricing of any transfers, including guarantees.[21] There are detailed U.S. transfer pricing rules in the Code §482 regulations, but the Canadian application of the arm's-length principle in ITA §247 is unadorned by any statutory or regulatory rules (although augmented by an uncertain role for the OECD Guidelines). As a practical matter, one must also deal with CRA's non-binding views and audit practice, and the combined effect of the approaches set out in Information Circular 87-2R (International Transfer Pricing) and in the OECD Guidelines.

If the clear tax rate arbitrage in favour of reducing U.S. income and increasing Canadian income increases prices for southbound guarantees, for example, the indirect result should be more disputes with the IRS and fewer with CRA. However, this is not an easy matter to forecast and assess. Furthermore, it would appear that the opposite trend was witnessed in the past.

RELATED CONSIDERATIONS

Comparative marginal tax rates are not the same as comparative effective tax rates, but data on the latter are hard to come by. Meanwhile, there is anecdotal support for the United States being the less receptive tax regime generally. Indeed, U.S. readers of this column will be familiar with ways in which U.S. multinationals are subjected in the United States to the most complex and challenging tax environment as compared to other foreign multinationals. It may be worthwhile to develop objective metrics to compare these and other tax systems "apples to apples."

Meanwhile, recent U.S. tax legislation (e.g., on foreign tax credit "splitters" and covered asset acquisitions) and President Obama's international tax proposals in his proposed 2012 Budget (e.g., to average rates under the indirect foreign tax credit and to defer deductions on interest paid to acquire or carry foreign affiliates with deferred profits) would only make matters worse for U.S. multinationals.

The U.S. corporate tax system may be close to the breaking point, and seems vastly in need of reform. It is unfortunate that any reform effort must occur in an atmosphere where maintaining tax revenue is the starting point.

POSTSCRIPT

The March 22 Canadian federal budget, referred to above, was tabled after the foregoing was written and, as expected, did not propose rollback of the corporate tax cuts discussed above. Opposition parties immediately signaled, however, that they would topple the minority Conservative government over the budget, and a general election is expected in May. That means the story respecting Canadian corporate tax rates may not yet be fully told.

Canada, Inc. v. The Queen, 2009 TCC 563 (Tax Court of Canada), and *The Queen v. General Electric Capital Canada, Inc.* (2010) FCA 344 (Federal Court of Appeal)) show, in our view, the hegemony of facts and circumstances in applying the arm's-length principle. As was written in Boidman, "Pricing Canada-U.S. Guarantees After GE Capital: Still Evolving," 19 *Tax Mgmt. Transfer Pricing Report* 1042 (2/10/11), at p. 1048, "This obvious but often overlooked canon of transfer pricing law has been clearly recognized and articulated by the Canadian courts in two decisions almost 50 years apart," as well as by two senior U.S. Treasury representatives almost 20 years apart. In 1992, James Mogle, then International Tax Counsel with the U.S. Treasury, referred to this notion in announcing (in September of that year) that the January 1992 proposal to make the comparable profits method mandatory where there are no exact comparables was being withdrawn. Last March, Associate International Tax Counsel David Ernick also referred to the notion in commenting on the September 2009 OECD announcements respecting Chapters I–III of the OECD transfer pricing guidelines. In the context of this article, the comments of Justice Robert Hogan's decision in *GE* are particularly apt. In paragraph 273 he states, 'In the final analysis, transfer pricing is largely a question of fact and circumstances coupled with a high dose of common sense.' " (Citations omitted.) *See also* the IRS's AODs in *Veritas* and *Xilinx*.

[19] The SCM method does not apply if the same services are rendered at a mark-up of greater than 7% to third parties. As well, it does not apply to manufacturing, production, extraction, constructing, reselling, distributing, research development engineering, financial transactions (including guarantees), and insurance and re-insurance. For a detailed discussion of the effect in Canada of the July 2009 final services regulations, *see* Boidman, "The Implications in and for Canada of the Final §482 Services Regulations," 61 *The Tax Executive* 445 (Nov.-Dec. 2009).

[20] This involves the "business judgment rule," under Regs. §1.482-9(b)(5), which requires (in order that the SCM may be applied) that the taxpayer "reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more trades or businesses of the controlled group. . . ." The reasonableness of the conclusion will be assessed on "all the facts and circumstances."

[21] For a related discussion, *see* Boidman, fn. 17, above.

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