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U.S. DIRECT FOREIGN INVESTMENT IN MANUFACTURING AND THE TAXATION OF U.S. BUSINESS ABROAD

CONGRESSIONAL RESEARCH SERVICE

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AND THE TAXATION OF U.S. BUSINESS ABROAD

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U.S. DIRECT FOREIGN INVESTMENT IN MANUFACTURING AND THE TAXATION OF U.S. BUSINESS ABROAD

I. AMERICAN BUSINESS ABROAD: An Orientation to the Magnitudes of Direct Foreign Investment

Direct Foreign Investment is generally defined as investment leading to the ownership of real capital goods -- plants, machinery, land, offices, etc., -- in foreign countries, or the acquisition of sufficient equity in foreign corporations to put the American "parent" corporation in a position to exercise significant managerial control. Direct foreign investment thus includes only a portion of the capital flows recorded in the balance-of-payments. Excluded are portfolio investments which imply no managerial control, as well as all forms of "short-term" financial claims and liabilities, i.e., those maturing within a year.

The growth of U.S. direct foreign investment over the past two decades has raised a number of serious issues for American foreign economic policy, and for various host countries fearful for their economic independence. A brief examination of the data of direct foreign investment may be helpful for an appreciation of the magnitude of the phenomenon. Table 1 draws together some aggregate figures for the past twenty years. It records the book value, at yearend, of cumulative direct foreign investment assets owned by American residents, at five-year intervals since 1950. In rounded numbers, the value of America's direct foreign investment assets has risen from $11.8 billion in 1950 to about $86 billion in 1971. These figures include all forms of direct investment. The extractive industries, mining and petroleum, comprise a large portion of direct investment. The percentage flowing into manufacturing industries, however, has risen from around 33% to 41% of the total. (An interesting example of the shift to manufacturing is Venezuela, in which total American direct investment assets have declined since 1965, while the manufacturing portion thereof has more than doubled.)

Table 1:

Cumulative Value of U.S. Foreign Direct Investment Assets

(Book value at yearend, in $ million)

	1950		1955		1960	
	Total	Manufacturing	Total	Manufacturing	Total	Manufacturing
TOTAL	11,804	3,845	19,313	6,349	32,744	11,152
Canada	3,564	1,881	6,494	2,841	11,198	4,827
U.K.	804	535	1,426	946	3,194	2,164
Germany	202	121	332	191	1,006	638
France	285	161	376	210	741	402
Australia	198	95	498	240	856	476
Brazil	627	270	1,115	565	953	515
Mexico	399	118	607	274	795	391
Belgium	65	35	134	78	231	146
Italy	63	19	157	47	384	170
Japan	19	5	128	13	254	91
Netherlands	84	23	162	38	283	80
Argentina	354	146	447	230	472	213
Venezuela	981	24	1,428	60	2,569	180
Switzerland	25	10	41	17	254	91
South Africa	140	45	259	86	286	108

Table 1 (Continued)

	1965		1970		1971 *	
	Total	Manufac-turing	Total	Manufac-turing	Total	Manufac-turing
TOTAL	49,328	19,339	78,178	32,261	86,001	35,475
Canada	15,223	6,872	22,790	10,059	24,030	10,537
U.K.	5,123	3,306	7,996	4,977	8,941	5,421
Germany	2,431	1,555	4,597	2,828	5,214	3,307
France	1,609	1,076	2,590	1,868	3,013	2,167
Australia	1,679	893	3,304	1,704	3,704	1,846
Brazil	1,074	723	1,847	1,247	2,045	1,409
Mexico	1,182	756	1,786	1,199	1,840	1,272
Belgium	596	372	1,529	852	1,815	1,015
Italy	982	451	1,550	824	1,860	1,001
Japan	675	275	1,483	749	1,818	959
Netherlands	686	270	1,508	804	1,672	870
Argentina	992	617	1,281	771	1,350	813
Venezuela	2,705	246	2,704	462	2,698	516
Switzerland	1,120	177	1,777	459	1,884	509
South Africa	529	237	868	438	964	489

* Preliminary Data.

Source: Yearly articles on U.S. Foreign Investment in Survey of Current Business. Later tables are also based on these articles.

Table 1 continues with a breakdown of this data for the fifteen leading recipients of U.S. capital in the manufacturing enterprises, as of 1971. (The only major recipients of all kinds of U.S. direct investment excluded from this list, because they have received but miniscule investment in manufacturing, are Panama and Middle Eastern countries.)

Table 2 records the size of the change, from yearend to yearend, in cumulative direct investment assets.

Table 2

(First column is the total, the second that in manufacturing industries)

	1960		1961		1962		1963		1964		1965	
In $ billion, rounded	Tot.	Man.	Tot.	Man.	Tot.	Man.	Tot.	Man.	Tot.	Man.	Tot.	Man.
Changes in U.S. Direct Invest.Assets	2.97	1.46	2.84	0.78	2.48	1.67	3.46	1.69	3.7	2.0	5.0	2.4
Net Capital Outflow	1.69	0.8	1.60	0.46	1.55	0.68	1.97	0.77	2.3	1.0	3.5	1.5
Reinvested Earnings	1.26	0.63	1.10	0.43	1.20	0.52	1.51	0.85	1.4	0.9	1.5	0.9

	1966		1967		1968		1969		1970		1971	
Changes in U.S. Direct Investment Assets	5.3	2.7	4.7	2.1	5.5	2.2	6.0	3.1	7.1	2.7	7.8	3.2
Net Capital Outflow	3.6	1.6	3.1	1.2	3.2	1.0	3.3	1.2	4.4	1.3	4.8	1.5
Reinvested Earnings	1.7	1.0	1.6	0.8	2.2	1.3	2.6	1.9	2.9	1.5	3.1	1.8

This yearly growth stems from two sources: from new capital sent abroad by American business, and from reinvestment of the earnings of foreign subsidiaries

and branches. 1/ Table 2 discloses that, for direct investment as a whole, the larger share derives from new capital outflows, with the share of reinvested earnings fluctuating between about 25% and 40%. In manufacturing investment, however, neither source has steady dominance. During the 1960's, capital movements slightly outweighed reinvested earnings in the early years, but the order is reversed in the later years. On the whole there has been rough equality between the two sources.

Whereas capital outflows are deficits in the balance-of-payments, and reinvested earnings are potential credits unclaimed, both carry the promise of future earnings. This promise has long been yielding high returns to American business. Table 3 measures these returns over the last decade. "Earnings from Direct Foreign Investment" is the total, in billions of dollars, accruing to American business, after deduction of foreign taxes, in the form of branch profits, dividends, interest, and reinvested earnings. After 1960 data is also available on the royalties and fees flowing to American business by virtue of its overseas operations. Together these comprise the most complete measure of the full return on foreign investment.

1/ The addition of the figures for net capital outflow and reinvested earnings does not always precisely equal the growth of direct investment assets. Slight discrepancy is introduced by rounding the figures, and by having to rely, in the case of the manufacturing data, on preliminary estimates. Differences may also be due to an accounting problem. When a U.S. resident liquidates his equity in a foreign enterprise, the U.S. investment position changes by the amount of the book value of that equity, but the capital repatriated will be the amount actually realized from the liquidation.

Table 3

($ billion)	Earnings from Direct Foreign Investment	+	Royalties and Fees	=	TOTAL	-	Rein-vested	=	Repa-triated
1960 Total	3.60	+	(no data)	=	3.60	-	1.26	=	2.34
Manufacturing	1.18	+	(no data)	=	1.18	-	0.63	=	0.55
1961 Total	3.80	+	0.45	=	4.25	-	1.10	=	3.15
Manufacturing	1.14	+	0.24	=	1.38	-	0.43	=	0.95
1962 Total	4.25	+	0.55	=	4.80	-	1.20	=	3.60
Manufacturing	1.26	+	0.30	=	1.56	-	0.52	=	1.04
1963 Total	4.64	+	0.66	=	5.30	-	1.51	=	3.79
Manufacturing	1.50	+	0.37	=	1.87	-	0.85	=	1.02
1964 Total	5.0	+	1.0	=	6.0	-	1.4	=	4.6
Manufacturing	1.8	+	0.5	=	2.3	-	0.9	=	1.4
1965 Total	5.5	+	0.9	=	6.4	-	1.5	=	4.9
Manufacturing	2.9	+	0.6	=	3.5	-	0.9	=	2.6
1966 Total	5.8	+	1.0	=	6.8	-	1.7	=	5.1
Manufacturing	2.1	+	0.7	=	2.8	-	1.0	=	1.8
1967 Total	6.1	+	1.1	=	7.2	-	1.6	=	5.6
Manufacturing	2.9	+	0.7	=	3.6	-	0.8	=	2.8
1968 Total	7.2	+	1.2	=	8.4	-	2.2	=	6.2
Manufacturing	2.5	+	0.8	=	3.3	-	1.3	=	2.0
1969 Total	8.3	+	1.7	=	10.0	-	2.6	=	7.4
Manufacturing	3.3	+	0.9	=	4.2	-	1.9	=	2.3
1970 Total	8.9	+	1.9	=	10.8	-	2.9	=	7.9
Manufacturing	3.4	+	1.0	=	4.4	-	1.5	=	2.9
1971 Total	10.4	+	2.2	=	12.6	-	3.1	=	9.5
Manufacturing	3.7	+	1.1	=	4.8	-	1.8	=	3.0

Over the past decade American business has enjoyed an unbroken yearly increase in its return on foreign investment. By subtracting from that total return the amount reinvested abroad each year, we obtain the total of profits repatriated to this country. The amount repatriated almost uniformly exceeds that reinvested, in the aggregate and in the manufacturing sector, with, however, a noticeable tendency for a higher percentage to be reinvested out of manufacturing than out of total profits.

To calculate return as a percentage of investment, we may take the total return, including royalties and fees, and calculate its ratio to the total of cumulative direct foreign investment assets at the beginning of the year:

Table 4

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Total Returns as % of Total Investment Assets	13.3	13.8	14.2	14.7	14.4	13.7	13.1	14.1	15.3	15.3	16.1

These rates of return are probably an understatement of the benefits American business derives from its foreign investments. Additional benefits include imports from foreign subsidiaries at prices lower than the competitive market price, and increased exports. Demand for the latter stems not just from foreign subsidiaries, but also from other sectors of the foreign economy whose income has been increased by American investment.

To conclude this summary, we may examine the magnitudes of foreign investment in terms of balance-of-payments accounting. These figures do not precisely measure the "impact" of direct foreign investment on the balance-of-payments, because other items, particularly exports and imports, are significantly affected by capital movements. Investments abroad generate not just future income for the

investing company, but, indeed, some future "induced" increase in demand for exports from other sectors of the American economy.

Ignoring these uncertain consequences, we can still see that, on face value alone, direct foreign investment is a significant source of credits in the balance-of-payments. Table 5 records the repatriated earnings for each year, and deducts from them the net capital outflows of that year. The difference has consistently represented a large credit item in the balance-of-payments. With the single exception of 1960, this holds true, in the years examined, for manufacturing investment as well as total investment.

II. The Taxation of American Business Abroad

The two primary forms of direct investment are the establishment, by an American business, of a branch office overseas, and the ownership, in whole or in large part, of the stock of a company incorporated under the laws of the host country. The following account generally disregards distinctions among the types of incorporation possible under the laws of various countries. This distinction may be important for specific business operations, but it would unnecessarily complicate any broad cross-country comparisons. A distinction must be made, however, between the taxation of a resident [1/] corporation and the treatment of the local branch of a non-resident corporation. The former distributes its profits to its shareholders in the form of dividends, the latter as a direct transfer of funds within a single corporate structure. Taxation of the two types of profits may differ. These two types of earnings, branch earnings and

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1/ "Resident" will always refer to a company incorporated under the laws of the country in which it is located, without regard to the degree of foreign ownership, or of foreign control over its operations.

Table 5:

Direct Foreign Investment in the Balance-of-Payments Accounts

	Repatriated Earnings	-	Capital Outflows	=	Credit (+)
1960 Total	2.34	-	1.69	=	+0.65
Manufacturing	0.55	-	0.80	=	-0.25
1961 Total	3.15	-	1.60	=	+1.55
Manufacturing	0.95	-	0.46	=	+0.49
1962 Total	3.60	-	1.55	=	+2.05
Manufacturing	1.04	-	0.68	=	+0.36
1963 Total	3.79	-	1.97	=	+1.82
Manufacturing	1.02	-	0.77	=	+0.25
1964 Total	4.6	-	2.3	=	+2.3
Manufacturing	1.4	-	1.0	=	+0.4
1965 Total	4.9	-	3.5	=	+1.4
Manufacturing	2.6	-	1.5	=	+1.1
1966 Total	5.1	-	3.6	=	+1.5
Manufacturing	1.8	-	1.6	=	+0.2
1967 Total	5.6	-	3.1	=	+2.5
Manufacturing	2.8	-	1.2	=	+1.6
1968 Total	6.2	-	3.2	=	+3.0
Manufacturing	2.0	-	1.0	=	+1.0
1969 Total	7.4	-	3.3	=	+4.1
Manufacturing	2.3	-	1.2	=	+1.1
1970 Total	7.9	-	4.4	=	+3.5
Manufacturing	2.9	-	1.3	=	+1.6
1971 Total	9.5	-	4.8	=	+4.7
Manufacturing	3.0	-	1.5	=	+1.5

dividends, constitute the bulk of profits reaped by American business through their overseas operations, and then repatriated to the United States. A comprehensive breakdown of the total return on foreign investment would include three other significant categories: reinvested earnings, royalties and fees, and interest on loan capital from the parent to the subsidiary. Reinvested earnings loom very large, comparable in magnitude with dividends and interest:

Table 6

Returns on U.S. Foreign Investment, by Type of Earning, ($ billion, rounded) After Deduction of Foreign Taxes

	Branch Earnings	Dividends	Reinvested Earnings	Royalties & Fees	Interest
1969	2.6	2.6	2.6	1.7	0.5
1970	2.5	3.0	2.9	1.9	0.6
1971	3.1	3.5	3.1	2.2	0.6

Reinvested earnings make a large contribution to the increase in America's direct foreign investment assets. The tax burden they bear must properly be distinguished from the taxation of dividends and branch earnings. The tax treatment of the two remaining categories, however, will not be closely scrutinized. Royalties and fees from a foreign subsidiary to its American corporate parent represent a significant item in the total measure of return on foreign investment. Its rate of increase over the past decade exceeds that of the other kinds of return. (Prior to 1961, however, data on royalties and fees were not recorded in the Survey of Current Business' yearly analysis of the U.S. international investment positions.) From the point of view of taxation, the significance of royalties and fees is that they are generally deductible from the taxable income of the subsidiary. They represent, there-

fore, a method by which a subsidiary might transfer income to its parent corporation under the guise of business expenses, thereby avoiding some of the taxation levied on profits. Royalties and fees do not escape withholding taxes, though the rates may differ from those applicable to dividends.

Interest paid on loan capital comprises the final category of return on direct foreign investment. It is also generally deductible as an expense item by the foreign subsidiary, though some countries levy a withholding charge of about 10% on it. The major items for tax analysis remain, therefore, the general taxation of corporate income, taking account of the distinction between reinvested and distributed profits, the additional taxation of dividends, and the treatment of branch profits. Additional forms of taxation, such as local business taxes, capital transaction taxes, net assets taxes, sales taxes, and surcharges will be mentioned only where they seem particularly important.

Taxation of corporate profits and of dividends poses the standard problem of double taxation. The corporation pays a substantial tax on its yearly profits, and the shareholder also pays a tax, usually withheld at the source, on the dividends he receives. Since both taxes fall on the same bundle of profits, it is double taxed. In their treatment of this problem most corporate tax systems adopt one of three general approaches, which may be called the classical, dual rate, or imputation (credit) systems. In all three systems, taxes are levied on both corporate profits and on the dividends distributed from them. The classical system provides no relief from this double burden. In the dual rate system, relief is provided by taxing corporate profits to be distributed as dividends at a lower rate than the tax on retained profits. In the imputation system, a single rate for taxation of both

distributed and retained corporate profits is maintained, but shareholders are granted a credit against their own total income tax liability, the credit being some proportion of the taxes paid by the corporation on its profits. (Any particular system may, of course, represent a hybrid of these principles.) The system in force in a given country is important for a comparison between the foreign tax treatment of profits earned by American business and the foreign country's taxation of its indigenous business. In the classical system the two stand on equal ground. In the dual rate system the foreign investor potentially enjoys an advantage. (See Germany.) In the imputation system, the indigenous enterprise is potentially favored, unless special provisions are adopted to restore equality of treatment. (See France.)

The tax systems of the fifteen largest recipients of American manufacturing investment will be described, not only in terms of corporate tax rates, but also in terms of the double taxation issue, the withholding of taxes on dividends to nonresidents, and the taxation of branch earnings, should it differ from that of resident corporate earnings. The income of the branch office of nonresident companies is usually taxed on the same basis as the income of a resident company, the only difference arising with the imposition of withholding taxes on subsidiary dividends and the absence of an equivalent imposition on branch profits. (See country descriptions for exceptions.)

In addition to the double taxation resulting from a given country's taxing of both profits and dividends, the problem of international double taxation is posed by the tax claims of the country in which profits are earned and the country to which they are repatriated. This problem is partially met by double taxation treaties, and, for American business, is almost wholly removed by the foreign tax credit provisions of the U.S. tax code, and by the deferral of taxes until income is actually repatriated. By

applying these principles we can calculate the total tax burden on American foreign investment, as well as its repartition among the claimants. (Discussion of its features is reserved for the conclusion.) The following country descriptions and summary tables are reduced, where possible, to the greatest simplicity.

CANADA

In 1972 Canada completed a major reform of its tax system. It instituted a version of the imputation system, with the intention that there be no difference in the tax burden on income received as dividends and on that earned directly by the individual.

There is a single rate of 50% on corporate profits, to be reduced by one percentage point each year until 1976. There is a special reduction for "small businesses." They are taxed at only a 25% rate on the first $50,000 of their profits, until they have accumulated and retained a total of $400,000, after which they nominally cease being "small businesses." (They may, however, prolong their small business status by increasing their distribution of dividends.) This small business reduction is available only to Canadian-controlled corporations. If control should pass to non-residents, the tax savings incurred by virtue of the small business reduction must be repaid.

Taxes are withheld on dividends at a 15% rate, to be increased to 25% in 1976, unless reduced by international treaties. (The present treaty rate on dividends to U.S. shareholders is 15%). Dividends paid by companies with "a degree of Canadian control" (defined as 25% share ownership) are granted five percentage points reduction in the normal withholding rate, be it the statutory or the treaty rate.

Shareholders are granted a tax credit, against their personal income tax, for dividends received. The computation of this credit is complex, the rate varying with provincial tax rates, but an average figure for the credit due a shareholder would be around 35% of dividends received.

Special tax rates apply to the dividend income of corporations. These taxes are, however, refunded, in part or in whole, when the recipient corporation passes on those dividends to its own shareholders. The effect of these refunds, combined with the credit given individual shareholders, is to render the ultimate tax rate on distributed profits the equivalent of the individual shareholder's personal income tax rate.

UNITED KINGDOM

The British corporate income tax is the only significant tax imposed on corporations. Its current rate is 40%.

There is a 38.75% withholding tax on dividends to individuals. The individual pays his full income tax on gross dividends, but receives full credit for the taxes withheld. He receives, however, no credit for the tax on corporate profits paid by the distributing corporation. Dividends from a subsidiary to a parent corporation are generally exempt from withholding tax, and are exempt from corporate income tax in the hands of the parent. Dividends distributed to non-resident corporations are subject to withholding taxes, but the rate is usually greatly modified by tax treaty. The U.S.-U.K. tax treaty reduces the withholding rate on dividends paid to individual and corporate residents of the U.S. to a maximum of 15%.

This system has been in effect since 1965, when it replaced a much more complicated one. A reform of this system has, moreover, been proposed by the Chancellor of the Exchequer. It would make the British system somewhat similar

to the credit system now in force in France. No information as to new tax rates could be found.

GERMANY

Corporations resident in Germany are taxed on their undistributed income at a rate of 51%. The tax on distributed profits is 15%. Foreign corporations which operate in Germany through a branch, not through a subsidiary incorporated under German law, are taxed on the income attributable to the operations of that branch. Since a branch, not being a separate corporation, distributes no dividends to its head office, the dual rate system applicable to corporations is replaced by a flat rate of 49% on the earnings attributable to the branch.

Three other significant taxes face the corporation resident in Germany. A Net Assets Tax, at 1% of assessed value, is levied on the worldwide net worth of German corporations, as well as on certain assets held in Germany by non-resident corporations. It is not deductible for purposes of the corporation income tax. In addition, a local business tax is imposed on all business enterprises, at a rate of approximately 15% of the business' income. The local business tax is deductible from net income for purposes of the national corporate profits tax. Finally, there is a capital transaction tax, at 2.5%, payable by the corporation, levied on any increase of its capital. This applies to sales of newly issued shares by a German corporation, and to any transfer of capital from a foreign parent to its unincorporated branch in Germany.

Dividends to individuals are subject to a withholding tax of 25%, which is fully creditable against personal income tax. Dividends received by corporations are exempt from corporate income tax if the recipient corporation owns at least 25% of the stock of the distributing corporation. This creates, in conjunction with the dual rates, a potential tax loophole. A subsidiary pays only

15% income tax on the profits it distributes to its parent corporation, which are then exempt from the parent's corporate income tax, provided the parent owns at least 25% of the subsidiary's stock. If those dividends are not passed on to the parent corporation's own shareholders, they must be subjected to an additional 36% tax -- precisely the difference between the 15% paid on them by the subsidiary in which they originated, and the 51% that subsidiary would have had to pay on them if it had retained instead of distributing them.

This system creates a tax advantage for non-resident corporations controlling German subsidiaries because the additional tax of 36% cannot be imposed on the income of a non-resident corporation. It has proven very advantageous for non-resident corporations intending to reinvest the earnings of their German subsidiaries. Instead of leaving the profits to be taxed at the high rate for retained earnings, it could distribute them as dividends to a holding company in a tax haven country, thus subjecting them only to the 15% tax on distributed earnings and escaping the 36% supplementary tax, then send them back as new capital from the holding company to the German subsidiary. The logical means by which to close this tax advantage would be to increase the withholding rate for dividends distributed to non-resident corporations until it equaled the 36% supplementary tax on German companies. This would, however, severely penalize non-resident corporations simply repatriating their profits with no intentions of reinvesting them via tax haven holding companies. The German-American treaty on double taxation sets the withholding rate on dividends to Americans at a maximum of 15%, except on dividends re-invested in German subsidiary, to which the standard 25% rate applies. This reduces, but does not remove, the tax advantage described above.

FRANCE

France subjects most corporate profits, whether distributed or not, to a 50% tax rate. Certain long-term capital gains, provided they are not distributed, benefit from a reduced rate of 10%.

There is no withholding tax on dividends distributed to residents of France. The nominal rate of withholding tax on dividends to non-residents is 25%, unless modified by tax treaty. The U.S.-French treaty reduces this to 5% for dividends paid by a French subsidiary to an American parent corporation. Individual U.S. recipients are subject to a withholding rate of 15%. The net profits of a branch of an American corporation are also subject, in addition to corporate income tax, to a 15% withholding tax, whether such profits are repatriated or not.

An article of the French tax law enables the tax authorities to adjust, for purposes of calculating the appropriate tax base, the profits of a French company under foreign control. The French authorities suspect that the subsidiary of a foreign firm may indirectly divert to its foreign parent the profits earned, in fact, by the subsidiary. Various intercorporate business practices are designed to accomplish this diversion so that profits are transferred without being declared as dividends, and the profits reported by the subsidiary for tax purposes are artificially deflated. When the French authorities can present convincing evidence of such practices, they are permitted to levy corporate taxes on the amount of profits they calculate the subsidiary would have earned and reported in the absence of diversion.

Since there is no withholding on dividends to residents, the problem of double taxation arises when dividends received are included in the recipient's taxable income. To mitigate this problem the French grant a credit ("avoir fiscal") against the recipient's income tax liability equal to 50% of the

corporate profits tax already paid with respect to those dividends. The French did not, however, want recipients to benefit from this credit in cases in which their dividends stem from corporate profits which had escaped the normal 50% rate, as certain kinds of long-term capital gains are able to do, or which had been earned five years prior to distribution. In these instances, therefore, an additional tax (the "precompte"), designed to nullify the advantages of the credit to shareholders, is imposed on corporate profits.

In contrast to Belgium, which grants the kind of tax credit characteristic of the imputation system only to individuals, France extends it to both individual and corporate shareholders. Almost all dividends received by a French corporation are, however, exempt from corporate income tax, so the tax credit received on their behalf cannot immediately be utilized. But if the dividends are eventually passed on to the parent corporation's own shareholders, they are subjected to the additional tax (precompte) mentioned above. If they are distributed within five years of the time the present corporation received them, the shareholder credit granted to the parent corporation on their behalf, which it could not previously utilize, can now be used to offset the "precompte" tax. The parent corporation is not, in other words, taxed for serving as a conduit for dividends from its subsidiary to its own shareholders, provided the connection is not unduly postponed. And the individual shareholder to whom they are ultimately distributed receives, on their behalf, the standard credit.

Non-resident shareholders are generally entitled, by the terms of tax treaties, to receive the same tax credit awarded to residents. It is, of course, of no benefit unless the non-resident recipient pays an income tax in France. The Franco-American tax treaty stipulates, therefore, that in such cases France will make a cash payment to the non-resident shareholder in the amount of the tax credit due him. Thus the only discrimination in favor of French enterprises

inherent in the French tax system is the incentive to resident shareholders to invest in resident corporations, since they receive no tax credit on dividends from non-resident corporations.

AUSTRALIA

Corporate tax rates are changed from time to time. The following rates were those in effect in 1971. They differ according to whether a company is "public" or "private." A public company is one whose shares (or the shares of its parent) are quoted on the stock exchange, and 75% of which are held by more than 20 persons. Private companies are formed to obtain the advantage of limited liability for small companies closely akin to partnerships, and for subsidiaries of other companies. American corporations establishing an Australian subsidiary often find it the more convenient form.

The public corporation resident in Australia was taxed at a single rate, 47.5% of taxable income. A non-resident public corporation, usually represented by a branch office, is taxed on the income accruing to it from its operations in Australia. On the first $10,000 (Australian $) of income it pays only 42.5%, provided those earnings are distributed as dividends. Undistributed income under $10,000, and all income in excess of $10,000, bears the 47.5% rate. The private form of incorporation would offer its shareholders the possibility of avoiding the higher personal income tax rates by not distributing its earnings. To avoid this, Australian tax law defines what it considers a "sufficient" distribution, generally around 65% of after-tax profits, and subjects any shortfall to an additional 50% tax on undistributed income.

Dividends received, by corporations or individuals, are included in their taxable income. Individuals receive <u>no</u> credit against their personal income tax

in compensation for the original tax borne by the company paying the dividend. Resident corporations receiving dividends are, however, granted a rebate which, in effect, virtually eliminates the taxation of the dividend. This avoids the successive imposition of taxes on dividends passed through intermediary corporations standing between the ultimate shareholders and the company originally earning the profits giving rise to the dividend. (This principle is somewhat modified in the case of private companies.) Dividends to non-resident corporation do not enjoy this relief. Except where reduced by tax treaty, taxes are withheld at a 30% rate on dividends to non-residents, individual and corporate, with no form of credit or rebate. The U.S.-Australian treaty generally reduces this to 15%. Interest paid to non-residents is subject to a 10% withholding rate. Withholding on dividends and interest payments represents the final tax levy, i.e., dividends or interest received by a non-resident, on which taxes have been withheld, are excluded from the calculation of any income tax payable in Australia.

The only other taxes on corporate income are the payroll tax, levied at 3.5%, and a receipts tax of 1¢ per $10. There is no capital gains tax.

The major investment incentive has been a deduction from taxable income, in addition to normal depreciation, of 20% of the cost of new plants and equipment in manufacturing or primary production. This allowance was rescinded in 1971, however, for new investment in manufacturing. The major incentive to promote exports was a tax rebate, calculated as 42.5% of certain types of expenditures, such as advertising and market research, deemed to foster exports.

BRAZIL (Rates as of 1970)

There is a single tax, at a rate of 30%, on the profits of normal industrial and commercial enterprises. In calculating taxable profits, dividends from subsidiaries are excluded, as is the income attributable to the export of manufactured goods -- a significant export incentive. Royalties and fees paid to a foreign parent corporation, however, are not deductible. (Those paid to resident corporations are deductible, within limits.) Accelerated depreciation may be allowed as an investment incentive.

Withholding rates on dividends vary. Dividends distributed to unidentified shareholders are subject to 15% withholding if the distributing company qualifies as a publicly owned or "open capital" company, 25% otherwise. Identified resident recipients have the option of having taxes withheld at these rates, and excluding dividends received from their personal taxable income, or having no taxes withheld and including dividends in their income, which is taxed on a graduated scale. Dividends distributed to non-resident individuals and corporations are normally subject to 25% withholding, with the qualification that the rate may be increased by 20% if the tax authorities deem the activities generating the income not to be in the interest of the national economy. Branch profits are also subject to 25% withholding, in addition to the regular profits tax. This may be reduced to 15%, however, if they are reinvested in plant expansion. There appear to be no credits or rebates, to residents or non-residents, to mitigate double taxation. The nominal rate on corporate profits is, however, significantly lower than the rates of corporate taxation in countries which attempt to mitigate double taxation.

There is no capital gains tax. There is a Federal excise tax on all goods or products imported or produced in Brazil, with few exceptions, but it is passed on to the purchaser by addition to the sales price. A sales tax, normally around 17%, is payable upon "the physical movement" of merchandise. (The precise meaning of this tax is unclear.)

MEXICO

There is no distinction between retained and distributed corporate profits, all corporate income being subjected to a single national tax, but at a graduated rate. Sample rates are:

Taxable Income	Effective Rate on Lower Limit
38,000 - 50,000 Pesos	about 10%
86,000 - 100,000	15%
200,000 - 300,000	20%
400,000 - 500,000	26%
over 500,000	42%

(as of 1971, the par value was $1 = 12.5 pesos)

These rates are somewhat misleading. The actual taxable income, due to the addition of a variety of nondeductible expenses, is likely to be significantly higher than the profits shown on the company's books. (For example, only 60% of expenses for advertising and publicity are deductible.) Profits are also subjected to a compulsory profit-sharing scheme, at an effective rate of about 13% of profits after taxes. These factors can typically raise the actual tax plus profit-sharing burden on corporate income to around 60% of before-tax profits.

The other significant taxes on corporate income are the gross receipts tax and the withholding tax on dividends. Though it varies somewhat with locality, the standard rate for the tax on gross receipts is 3%. It is, in effect, a sales

tax, but is generally borne by the seller and not passed directly to the buyer.

Taxes on dividends to all shareholders, individual and corporate, resident and non-resident, are withheld at rates of 15, 17.5, or 20%, depending on the amount of dividends received by the shareholder from the distributing corporation during the year. The higher rate applies to dividends exceeding 270,000 pesos. (No taxes are withheld on dividends reinvested, within 30 days, in the distributing company.) A resident corporation receiving dividends from another Mexican company may exclude them from its taxable income. The taxes withheld on intercorporate dividends will either be refunded, or the recipient will receive credit for them against its own tax liability. Intercorporate dividends, therefore, escape taxation as dividends. (They have already, of course, been taxed as part of the distributing corporation's income.) Dividends distributed to individual shareholders must bear the withholding tax without credit to the individual recipient, but he may exclude them from his taxable income. There is no credit to shareholders to compensate for corporate profits taxation.

BELGIUM

Although Belgium operates primarily on the imputation principle, it taxes retained and distributed profits at slightly different rates. The nominal rate on distributed profits is 30%. Retained earnings are taxed at diversified rates, each rate being applied not to aggregate income, but to that income within its bracket:

less than 1,000,000 Belgium franks:	25%
1,000,000 - 1,250,000 Belgium franks:	50%
1,250,000 - 5,000,000 Belgium franks:	30%
over 5,000,000 Belgium franks:	35%

These nominal rates are increased by a municipal surcharge of 6%, and, for corporations with taxable income exceeding Bfrs. 3,000,000, a national surcharge of 10%. The surcharges raise the effective rate on distributed income to about 35%. If we take a rate of 35% to represent the single most adequate approximation of the nominal tax on retained income, the surcharges would increase it to an effective rate of about 40%. A second surcharge of 10%, intended to harmonize Belgium's traditionally low corporate tax rates with those of her EEC neighbors, is pending.

The withholding rate on dividends to residents is 20%, but only 10% on dividends to non-residents. Whereas individuals include dividends in their taxable income, but are given credit for the withholding tax already paid on them, corporations are permitted to exclude from their taxable income most of the dividends they receive from subsidiaries. The recipient corporation enjoys no relief, however, from the double taxation represented by the combination of withholding and distributed profits tax paid by its subsidiary. Individuals do enjoy such relief. Unlike corporations, they must include the gross amount of dividends received in their taxable income, but they are allowed credit against their personal income tax, not only for the full amount of the withholding tax, but also for 50% of the distributed profits tax paid on those dividends by the corporation.

Under the dual rate system, of which Germany was an example, non-resident corporations enjoy a potential tax advantage. (See discussion on Germany). Under the imputation system, however, the non-resident

shareholder enjoys no advantage. If the non-resident shareholder is a corporation, the dividends it receives from its Belgian subsidiary are taxed, within Belgium, to approximately the same degree as dividends received by a resident parent corporation from a subsidiary. This tax burden consists primarily of the withholding tax and the distributed profits tax paid by the subsidiary. Equality of treatment is not absolute, however, because the dividends received by the Belgian parent firm from its domestic subsidiary are not completely exempt from the parent firm's own income tax. The parent firm is allowed to exclude 95% (or, in some cases, 90%) of dividends received from the calculation of that income to be taxed at the nominal 30% rate on distributed profits. If the dividends from its subsidiary are retained by the parent corporation, however, so that, if not exempted, they would be subject to the higher rate for retained earnings, the parent corporation must pay on them an income tax rate equal to the difference between the rates on distributed and retained earnings, i.e., about 5%. Against this tax it receives no credit for the withholding tax. Since non-resident corporations pay only the withholding tax, but no Belgian income tax, on dividends received from Belgian subsidiaries, they enjoy, by comparison with the resident corporation, which cannot exclude all its dividends from its taxable income, a slight advantage. This advantage, however, will likely vanish when the non-resident corporation faces its own tax authorities with their own designs on its dividends. (See discussion on U.S. foreign tax credit.)

The resident individual shareholder, however, does enjoy a very distinct tax advantage in comparison with the non-resident individual shareholder. The tax credit received by the individual shareholder in compensation for the distributed profits tax paid by his corporation, being creditable against personal

income tax, is of no benefit to the non-resident shareholder whose income is not subject to Belgian taxation. The latter enjoys no relief from double taxation. The relief granted the resident shareholder is, furthermore, available only for dividends received from resident corporations, so the imputation system operates to create an incentive for Belgians to invest in Belgian, rather than foreign, enterprises.

ITALY

Italy enjoys a simplified new corporate tax system, effective Jan. 1, 1973. Corporations are subject to two taxes: the corporate income tax, at a rate of 25% on both distributed and retained earnings, and local income tax, which varies with locality, but carries an average rate of around 12%. Dividends distributed to resident shareholders, individual and corporate, are subject to a 10% withholding tax. The gross amount of dividends received by a resident shareholder, individual or corporate, is part of the recipient's income, and is taxed without credit for the corporate profits tax already paid by the distributing company. Full credit, however, is given for the 10% withholding tax. Since the dividends received by non-resident shareholders cannot be subjected to the Italian income tax, the nominal withholding rate on dividends to non-residents is increased to 30%. The U.S.-Italian Double Taxation Treaty, however, reduced this rate to a maximum of 15% on dividends to U.S. shareholders, and to only 5% if the American recipient is a corporation controlling at least 95% of the stock of its Italian subsidiary.

JAPAN

Japan operates a dual rate system with respect to corporate taxation, but also grants credits to individual shareholders. The basic rate on retained corporate profits is 35%, with 26% for distributed profits. Small companies

(capitalized at less than 100 million yen) enjoy a reduction from 35% to 28% in the rate on retained profits for the first 3 million yen taxable income, but no reduction thereafter. The rate on distributed dividends for small companies falls from 26% to 22% for the first 3 million yen, with no reduction beyond that.

American business in Japan has often been in the form of "family corporations," defined as corporations in which more than 50% of the stock is owned by three people, 60% by four people, etc. For "family corporations" there is a surtax on undistributed earnings exceeding 30% of taxable income. The rates are graduated -- 10, 15, 20% -- depending on the amount of undistributed earnings. The tax authorities have the right to disregard the reported income of "family corporations" and make their own assessment of the proper amount of additional tax.

The low rate of national taxation of corporate profits is misleading, since Japanese firms must pay two other forms of income tax: the "Enterprise Tax" and the "Municipal Inhabitants" tax, which flow to local government. The combination of these with the national tax produces a total effective rate of taxation on corporate profits of about 47% for retained earnings, and 36% for distributed profits.

Special tax credits are available to foreign-owned as well as domestic corporations in several instances: when they improve their debt-equity ratio, merge with other companies, or increase expenditures on "research and experimentation" relative to manufacturing and technology. In the latter case, the tax credit is 25% of the increment of "research and experimental" expenses in any accounting period, as compared with such expenses in the previous period. There are, in addition, special provisions for exporting firms to obtain accelerated depreciation. The amount of additional depreciation can be computed by

multiplying the ordinary depreciation available by the ratio of export sales to total revenue in a given accounting period. This rate is further increased by an additional 30 to 60% if the firm records increases in its export revenue.

The rate for withholding taxes is 15% on dividends to corporations, and 15 or 20% on dividends to individuals. Individuals include gross dividends received in their taxable income, but receive credit for the taxes withheld on them. Japan taxes distributed profits at a lower rate than retained profits, but she also grants, in addition to credit for taxes withheld, a special credit to individual shareholders, equal to 15% of dividends received. Corporations do not receive this special credit, but they escape double taxation of dividends from subsidiaries by receiving full credit for the taxes withheld on them and by excluding most of them from their own taxable income. In effect, therefore, the only effective taxation of dividends distributed by subsidiaries to resident parent corporations is the original distributed profits tax. Non-resident recipients, however, paying no income tax in Japan, have no way to utilize the credit granted for the withholding tax, and must therefore bear some double taxation. In contrast to the Franco-American tax agreement, the Japanese-American tax treaties contain no provisions by which this credit against income tax can be transformed into a cash payment to the non-resident who cannot utilize a tax credit.

THE NETHERLANDS

The Netherlands subjects its corporations to a uniform income tax rate, levied on retained and distributed profits alike, of 46%. There is a slight reduction for corporations with small incomes, and a general increase of around 4% from a temporary surcharge imposed in 1972. There are no other major taxes on corporations.

Gross dividends received by individual shareholders are subject to the personal income tax, with no credit for the taxes paid by the distributing corporation on its profits. But dividends received by a parent corporation from a subsidiary in which it owns more than 5% of the stock are fully exempt from the parent corporation's income tax. There is a 25% withholding tax on dividends, creditable against income tax. The U.S.-Netherlands tax treaty reduces this rate to a maximum of 15% for dividends distributed to U.S. residents, and to 5% for dividends to U.S. corporations holding at least 25% of the voting stock in the Dutch company.

ARGENTINA (As of 1970)

Corporate taxes are levied at the single rate of 33%. Dividends are excluded from corporate taxable income, as are royalties and fees remitted abroad. (There is, however, a 41% withholding tax on royalties and fees.)

Taxes are withheld on dividends remitted abroad at a 12% rate. This represents the final levy on dividends, i.e., they may be excluded from the calculation of any income tax payable by the recipient to Argentina. No withholding taxes are required for dividends to resident shareholders, corporate or individual, nor are these dividends included by the recipients in their own taxable income. Double taxation is avoided, in other words, by not taxing dividends, which seems rather remarkable in light of the relatively low rate of corporate profits taxation. Only foreign shareholders bear the burden of double taxation, enhanced in this instance by the 41% withholding tax on royalties and fees and a 10% withholding rate on interest payments. (Interest on loans to finance the importation of machinery and equipment is, however, exempt.)

Branch profits bear the normal 33% rate of taxation, and, in addition, the 12% withholding tax on all profits remitted to the head office.

There are several other kinds of local taxes: a sales tax ranging from 10% to 20%, a 10% capital gains tax, a turnover tax of 1.1% of gross sales, and a so-called "substitute inheritance tax." The latter is a tax assessable on the financial year-end <u>net</u> worth of corporations, i.e., the excess of assets over liabilities, at a rate of 1.5%. These other forms of taxation are apparently designed to compensate for the relatively low corporate profits tax rate.

<u>VENEZUELA</u> (As of 1969)

There is no distinction between retained and distributed profits, all corporate profits being taxed on a graduated scale:

For portion between:	Rate:
0 and 100,000 bolivares	15%
100,000 and 1,400,000 bolivares	25%
1,400,000 and 3,800,000 bolivares	30%
3,800,000 and 6,400,000 bolivares	35%
6,400,000 and 10,000,000 bolivares	40%
10,000,000 and 20,000,000 bolivares	45%
20,000,000 and 28,000,000 bolivares	47.5%
28,000,000 and above bolivares	50.0%

(as of 1971, the exchange rate was approximately 4.50 bolivares = $1.00)

Dividends received by resident corporations are generally exempt from tax. Dividends received by resident individuals are included in their taxable income, but double taxation is substantially reduced or eliminated by granting them a tax

credit equivalent to 40% of the effective tax rate in the previous year of the company from which the dividends originate. Thus the only effective tax on dividends is the tax withheld from dividends distributed to non-residents, individual and corporate. This withholding rate is normally 15%, except for dividends to the holders of bearer shares who do not report their ownership to the company, for which the rate is 30%.

Branches of non-resident corporations are subject to the ordinary income tax on the graduated scale. An additional 15% is levied on income after deduction of the ordinary profits tax. This additional imposition is the equivalent, for branches, of the 15% tax on dividends from subsidiaries.

Although other kinds of taxes facing the manufacturing [1/] corporation in Venezuela are not significant, it should be noted that profit sharing, at a level of 10% of profits,is a legal requirement.

There are tax credits available for new investment, up to 12% of their cost. Credits are also allowed for increased export sales, at a rate of 0.25% of taxable income for each 1% increase in exports.

SWITZERLAND

A simple summation of corporate taxation in Switzerland is not possible. The major portion of taxes is levied by local government, with considerable variation in effective rates among the 25 cantons, and even among communes and parishes within each canton. They also differ in other matters, such as

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1/ Tax rates and other conditions are somewhat different for the mining and hydrocarbon industries.

permissible deductions, provisions for carrying forward losses, and even periods of assessment. Instead of calculating national averages, we will single out two of the more important cantons, Zurich and Geneva. (Strictly speaking, the sample rates given below were valid only for the cities of Zurich and Geneva, and only in 1969. Rates are often changed annually at the local level.)

Tax authorities assume a liberal attitude toward allowing all reasonable business expenditures as deductions from taxable income. Having determined assessable income, a complex procedure is applied to determine a "basic rate" of income taxation. The ratio of profits to total invested capital is multiplied by a coefficient, which can vary among cantons, to produce the basic rate, subject to given minimum and maximum rates. The theory is that this yield ratio should provide a better means than the absolute amount of profit for measuring a fair tax burden.

The "basic rate" is but the means for calculating the effective rate. The canton, the commune, and the parish all levy their own tax on profits by applying to assessable income some multiple of the "basic rate." In Zurich the multiple for the cantonal tax is 110% of the basic rate, for the communal tax 125% of the basic, and for the parish tax 13.4% of the basic. Summing the three multiples of the basic rate yields an effective rate of local taxation of company profits.

To the local tax burden must be added the smaller national burden, known as the Federal Defense Tax. Its computation is even more complex, varying directly with the ratio of profits to capital and inversely with the level of cantonal and communal taxes. As illustrations we will cite only <u>average</u> effective rates.

Summing the local and national effective rates yields a schedule of total effective rates for the taxation of business income, a graduated scale in which

the tax burden increases with the ratio of profits to total capital. Some sample rates are:

RATES OF TAXATION
(in 1969)

		Ratio of Profits to Capital			
		5%	10%	20%	30%
Zurich:	Local	6.21	12.42	24.84	24.84
	National	2.09	3.12	4.59	5.18
	Total	8.30%	15.54%	29.43%	30.02%
Geneva:	Local	7.37	11.14	18.78	23.81
	National	2.09	3.12	4.59	5.18
	Total	9.46%	14.26%	23.37%	28.99%

These rates seem remarkably low. They cannot be directly compared with corporate tax rates in other countries, however, because the Swiss also levy an additional tax on capital as such, without regard to income. It is levied by the cantons, communes, and parishes, not by the central government. Unlike the basic rate for income taxation, this basic rate for capital taxation does not vary with the ratio of profits to investment. In the cases of Zurich and Geneva, it is a constant, though in some other cantons it varies directly with the amount of invested capital. The canton, the commune, and the parish each increase the basic rate for capital by the same multiples used for increasing the basic rate on income, and apply the resulting effective rate to the value of capital assets, interpreted in the broadest sense, of a company. Summing the three effective rates yields a total effective rate for the tax on capital, which in Zurich is .373%, and in Geneva is .414%.

We can see, therefore, that a comparison of corporate tax rates in Switzerland with those in other countries is not directly possible. An

average rate structure for the whole country could be calculated, or representative and important cantons, such as Zurich and Geneva, can be isolated. But the total tax burden varies sharply with two variables: the ratio of profits to capital, <u>and</u> the value of capital assets as such. A general conclusion, however, is possible: a Swiss corporation probably enjoys a total tax burden significantly lighter than other European corporations, perhaps by a difference of 10 to 20 percentage points, unless the Swiss corporation has a very high profit/capital ratio and fairly large capital assets.

Taxes are withheld on dividends and on some interest payments to resident individuals and corporations at a 30% rate. There is no withholding tax on royalties or fees. Taxes withheld may be recovered, however, by credit or direct refund, provided the dividends or interest from which they are withheld are included in taxable income.

Tax treaties provide for substantial reduction in withholding taxes on dividends and interest remitted to non-residents. The U.S.-Swiss treaty reduces the 30% on dividends to 5% if the American company holds 95% of the stock of the Swiss affiliate, and to 15% otherwise. It also reduces the withholding rate on interest payments to 5%. It should be noted, however, that transactions between parent companies and affiliates are closely scrutinized. Those not deemed to be "at arm's length" are adjusted and treated as hidden profit distributions subject to withholding taxes in the same way as dividends.

The <u>Swiss</u> tax burden on dividends to an American parent corporation is likely to be lighter than the corresponding burden on dividends to residents. The latter can obtain full recovery of taxes withheld, but the dividends received are then subject to individual or corporate income tax. They do not,

therefore, technically escape double taxation, but, in comparison with other countries the initial taxation is relatively modest. The non-recoverable but very light taxes withheld from dividends distributed to an American parent corporation represent the final Swiss levy. The dividends then fall, of course, under the jurisdiction of the American tax authorities. Reduction in the Swiss tax on dividends depends, in fact, on certification by the tax authorities of the recipient's country that they will subject dividends received to their own taxation.

Swiss branches of foreign companies are taxed on the profits fairly attributable to their operations, by application of any of several methods for computing such attribution. The method adopted may be negotiated in advance. There is no additional tax on branch profits repatriated.

SOUTH AFRICA

Normal commercial or industrial corporations resident in South Africa face an income tax on profits derived from operations in South Africa at a rate of 41%, and from operations in South West Africa at a rate of 35.875%. Dividends received from other companies are exempt from this income tax.

There is, in addition, an undistributed profits tax of 25%, but it is levied only on the amount by which dividends distributed fall short of what the tax laws determine to be "distributable income." In general, "distributable income" is defined as net profits minus the normal income tax, minus the cost of new plant and machinery, and minus a ploughback allowance of 45% of total net profits. (In our simplified cross-country comparison of corporate taxation, it will be assumed that the model South African company distributes enough of its income to avoid the undistributed profits tax.)

There is no tax on dividends to a resident individual. They are included in his taxable income, but relief from double taxation is provided, not as a credit against his tax bill, but as a deduction from taxable income of a certain percentage of the amount of the dividend. (33% is a representative deduction.) Dividends to non-residents, however, both individual and corporate, bear a withholding tax of 15%. This is reduced to 5% for the U.K. and the Netherlands, and to 7.5% for Switzerland, but there is no reduction for the United States. There is also a withholding tax of 10% on interest payments to non-residents, and of about 12% on royalties remitted abroad.

The South African income of branches of foreign countries is taxed on the same basis as the income of resident corporations. Although there is a withholding tax deducted from dividends distributed from a local subsidiary to its foreign parent, there is, contrary to the practice of some other countries, no additional taxation, beyond that of the normal income tax, on branch profits remitted to its home office.

COMPARATIVE SUMMARY

A simple overview cannot do justice to the complexity of business taxation, but it might convey a workable estimate of the range of differentiation. Table 6 compares the incidence of the corporate income tax among the countries. Mexico, Venezuela, and Switzerland are omitted, since they have graduated rates which permit no single comparison. A model corporation is assumed to earn a taxable income of 100 units, half of which it retains, half of which it distributes. The actual amounts retained and distributed differ only in those countries with a dual rate system, and in France, which grants a sizeable refund of corporate taxes to the shareholders.

Table 6

Resident Corporation Retains Half of Profits, Distributes Half to Resident Shareholders

		United States	Canada	United Kingdom	Germany	France	Australia
1.	Total Taxable Income	100	100	100	100	100	100
2.	Corporate Income Tax	-48	-50	-40	-15 (local business tax)	-50 4/ (-37.50)	-47.50
	a. on Distributed Profits				-6.38		
	b. on Retained Profits				-20.82		
3.	Gross Dividends Distributed	26	25	30	36.12	25 4/ (37.50)	26.25
4.	After-Tax Retained Profits	26	25	30	21.68	25	26.25

Table 6

(Continued)

	Brazil	Belgium	Italy	Japan	Netherlands	Argentina	South Africa
1. Total Taxable Income	100	100	100	100	100	100	100
2. Corporate Income Tax	-30	---	-37 (incl. local business tax)	---	-46	-33	-41
a. on Distributed Profits		-17.50 1/		-18 3/			
b. on Retained Profits		-20 2/		-23.50 3/			*
3. Gross Dividends Distributed	35	32.50	31.50	32	27	33.50	29.50
4. After-Tax Retained Profits	35	30	31.50	26.50	27	33.50	29.50

1/ Includes surcharge.
2/ Including surcharge, and assuming a representative rate from a variable scale. (See text.)
3/ Including local taxes.
4/ 37.50 is actual amount, after adjustment for shareholder's credit.

* There may be additional taxes on undistributed profits. (See text.)

In Table 6 we have omitted the taxation of dividends after they are distributed to resident individuals or corporations. (See country descriptions for this information.) But the tax treatment of dividends distributed abroad, or of branch profits repatriated, by the foreign and by the American tax regimes, is central to an understanding of the total tax burden on American direct foreign investment.

In principle an American company is liable to American taxation on its total income, from foreign as well as domestic sources. If applied without regard to foreign taxation, this principle would result in severe double taxation, with significant erosion of the profits from foreign investment. It would violate the neutrality of taxes between domestic and foreign investment, imposing a heavy penalty on the latter, and undercut not only the profits of particular American businesses, but also the positive return, through the balance-of-payments, to the American economy as a whole. American tax laws offer several methods for resolving this problem. We shall ignore the complex exceptions and qualifications, and examine, in simplified form, their "pure" operation.

The two major forms of relief from international double taxation are the deferral of taxes, and the granting of foreign tax credits. An American corporation owning 10% or more of the stock of a foreign subsidiary pays no American taxes on its income until that income is repatriated to the U.S., i.e., until the subsidiary distributes it as dividends to its parent. (A major exception to this principle is the taxation of so-called "controlled foreign corporations." This exception was intended to eliminate deferral of taxes on income accruing to a "base company", or holding company, set up in tax haven countries to receive the income generated by the productive operations of subsidiaries in other countries. For present purposes we can ignore this kind of company.)

Reinvested earnings are, in effect, deferred indefinitely, escaping American taxation altogether. They bear only the income tax of the host country, even though the subsidiary may be wholly American owned. This creates, in countries whose corporate income tax is less than the American, a definite tax bias in favor of increasing direct foreign investment, via reinvestment abroad, as opposed to repatriation and subsequent reinvestment in America or distribution to American shareholders.

Deferral of American taxes is enjoyed only by foreign incorporated subsidiaries of an American company, not by its foreign branch office. American corporations are granted full use of foreign tax credits to offset American taxes on their foreign branch earnings, but those taxes cannot be deferred, even if the earnings are not repatriated. On the other hand, the losses of foreign branch operations may be deducted from domestic earnings in calculating total taxable income, while the losses of foreign subsidiaries are not deductible.

Tax credits are granted American corporations, against their own corporate income tax, to the amount by which their foreign earnings have been taxed by the country of their origin. This applies to all foreign withholding taxes on dividends. It also applies, if the American parent has at least a 10% ownership in the foreign subsidiary, to the income tax levied by the country of origin on the profits underlying the dividend. As a result, <u>American</u> taxes payable on income earned abroad are but the difference between the foreign tax rates (income and withholding) and the American tax rate. If that difference is nil, the U.S. Treasury receives nothing. If foreign tax rates exceed the American rate, the American corporation pays the full foreign rate, but no American taxes. It receives no refund for the excess of foreign taxes, but it can carry forward the difference as an offset against future American taxes. If foreign taxes are

lower than American taxes, the corporation's total tax payments, foreign and domestic, are precisely what they would have been had the income been earned entirely at home.

Since the foreign tax credit system equalizes the total taxation of domestic and foreign repatriated profits, the only way an American corporation can benefit from lower tax rates abroad is through reinvestment of foreign earnings. This is a notable incentive to reinvestment only to the extent that foreign tax rates are in fact significantly lower than American. A glance at the bottom line of Table 6 permits a rough but quick comparison of the magnitudes of difference. The after-tax retained profits of foreign subsidiaries do exceed after-tax retained profits within the United States in several countries, though it is difficult to judge at what point the difference might become a prominent factor among the many considerations behind the decision to reinvest or repatriate. The promise of increased future earnings from increased output would generally weigh more heavily than the relatively minor tax advantages. One might also note that the larger tax differences tend to occur in countries which qualify as "less-developed."

To calculate the effective rate of total taxation of repatriated earnings, we must deduct from dividends the amount of foreign withholding taxes and the amount of American taxes payable after the granting of foreign tax credits. In Table 7, the gross dividends from Table 6 are distributed to an American parent corporation, which receives the net after deduction of the withholding rate. For income from all "developed" countries, the U.S. tax due is calculated by applying the U.S. corporate tax rate (48%) to the amount of gross dividends plus the amount of foreign corporate taxes paid by the subsidiary on the profits underlying those dividends. Since the original profit base was 50, U.S. tax due is uniformly 24.

In calculating the tax due on dividends from "less-developed" countries, however, the U.S. tax rate is applied only to gross dividends. Thus U.S. taxes due on income from Brazil and Argentina are lower than in the other cases.

The American corporation is granted credits, against this tax liability, equaling the amount of taxes withheld from dividends plus the amount of foreign corporate taxes paid by the subsidiary on the profits out of which they were distributed. In several cases the level of credits exceeds the U.S. tax liability, so no U.S. taxes are paid. The excess credits are not always, however, simply lost. Within limits they may be carried forward several years, or pooled to offset U.S. taxes due on dividends from other foreign subsidiaries.

In those instances in which the credits are less than taxes due, the corporation pays the U.S. Treasury the difference. Its amount of dividend income, after all foreign and American taxes, permits calculation of the total effective rate of taxation on repatriated earnings. Table 7 reveals that the total tax rate on repatriated foreign earnings dips below the U.S. rate (48%) only for Brazil and Argentina, which benefit from the special tax concession granted income from the LDC's. The effective tax rate on reinvested earnings, however, is sometimes lower than the U.S. rate, and often lower than the rate on repatriated earnings from that country. France and Germany constitute the only exceptions, due to their shareholder's credits and dual rates.

To the extent that these data permit any general conclusions, they would indicate that, among the developed countries, tax differentials could provide special incentives to American foreign investment only in the sense that they might encourage reinvestment instead of repatriation. But the differential behind this incentive is of a significant magnitude only in the case of the U.K., Belgium, Italy, and South Africa, and in the two LDC's. In the other cases of reinvested

Table 7

	Canada	United Kingdom	Germany	France	Australia	Brazil	Belgium	Italy	Japan	Netherlands	Argentina	South Africa
Gross Dividends	25	30	36.12	25	26.25	35	32.50	31.50	32	27	33.50	29.50
Withholding Rate	15%	15%	15%	5%	15%	25%	10%	5%	15%	5%	12%	15%
Net Dividends	21.25	25.50	30.70	36.25*	22.31	26.25	29.25	29.92	27.20	25.65	29.48	25.07
U.S. Tax Due, Before Credits	24	24	24	24	24	16.80	24	24	24	24	16.08	24
Foreign Tax Credits	28.75	24.50	19.30	13.75	27.69	23.75	20.75	20.08	22.80	24.35	20.52	24.93
U.S. Tax Payable	0	0	4.70	10.25	0	0	3.25	3.92	1.20	0	0	0
After-Tax Dividend Income	21.25	25.50	26	26	22.31	26.25	26	26	26	25.65	29.48	25.07
Effective Tax Rate on Repatriated Profits	57.5%	49%	48%	48%	55.4	47.5	48	48	48	48.6	41.4	49.8
Effective Tax Rate on Reinvested Profits	50%	40%	56.6%	50	47.5	30	40	37	47	46	33	41

* Includes special shareholder's credit.

earnings, and in practically all cases of repatriated profits, the investor must suffer a tax burden equal to, and often greater than, the corresponding American burden if he had invested at home instead of abroad.

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