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Recent Tax Developments and Issues Affecting Canada-United States Transnational Business Activities

*by Robert D. Brown**

I WOULD LIKE TO say that it is a pleasure to be here, and I'd like to start right in with a potpourri of current Canadian tax developments that may be of interest to all of you. First of all, I will comment on the current position of foreign investors under the Canadian Foreign Investment Review Agency (FIRA). FIRA is the feared watchdog of Canadian sovereignty, and the flag carrier in the battle for Canadian economic independence. The FIRA, for those of you who don't know, is a Canadian government agency that was established in 1974, and has as its job the preservation of the economic purity of Canadian business. It must provide advance approval for takeovers by foreigners of existing Canadian businesses or corporations, and it must also provide advance approval of any effort by foreigners to start a new Canadian business (one in which such foreigners were not engaged in 1976). Now, it is important to recognize that the Foreign Investment Review Agency was established not as a result of some whim of a small group of politicians or civil servants, but rather as a reflection of a growing feeling of apprehension in Canada about foreign, basically American, ownership of Canadian business. At about the time that the agency was established, United States direct investment in Canada had reached thirty-two billion dollars in book value. About one-half of the Canadian manufacturing sector was and still is foreign controlled.

The FIRA rules dealing with the takeover of existing Canadian businesses came into effect in 1974 and similar rules providing a screening process for starting a new Canadian business by non-residents came into effect in late 1975. Accordingly, we now have about three years of operations under the FIRA package and this provides enough time for some assessment of its implications.

The experience has both been interesting and irritating. Perhaps, the most appropriate comment about life with FIRA is that it has tended to prove the rule that governments are always trying to solve last year's problem. At just about the time that the Candian government moved to control new foreign investment in Canada it became apparent that foreign investors were rapidly cooling on the attractiveness of Canada as a place for new economic investment. After two years of bad business conditions, rising unemployment, inflation and the decline of the value of the Canadian dollar our nationalistic fervor seems to have abated a bit. A recent press release put out by FIRA

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stated flatly that "the government of Canada continues to welcome foreign investment that will contribute to the healthy growth of the Canadian economy."

However, FIRA continues to operate under the same legal structure and set of ground rules as was established at the time of its inception. Although I will not take the time to detail those similarities, I will only refer to the recent experience of investors and others with FIRA. That experience can be summarized in the following manner.

First of all, the interesting thing is that after a considerable amount of hesitation the interest of foreign investors in Canada is beginning to pick up. It may be that the decline in the value of the American dollar has made Canadian assets and businesses appear cheaper to foreign investors. It may be that they know something about the Canadian economy that we don't, but in any event there appears to be a modest increase in interest by foreigners in investing in Canada. This is shown by the applications being processed by FIRA for takeovers of Canadian corporations. The number of investment proposals filed with FIRA in fiscal 1978 was fifty-two percent higher than in 1977. Takeover applications filed with the Agency in fiscal 1978 numbered 288, compared with 186 in 1977, an increase of fifty-five percent. (See Table I)

Second, the attidue of FIRA on foreign takeovers and new business applications does seem to have softened—at least slightly. The percentage of considered applications that are rejected has fallen dramatically in recent years and is now less than five percent. (That is, ninety-five percent of all completed FIRA applications that are processed by the Agency are approved, based on 1978 statistics just released.) (See Table I) Now, this means that ninety-five percent of all conceivable takeovers or new business applications are in fact approved because the approval rate is calculated on the basis of the applications that are in fact completely processed by the Agency and does not take into account two things. First of all, the number of investors that never apply because they are discouraged by the rules themselves. Second, investors that apply and subsequently withdraw their application because they recognize that it is not going to be approved or will be approved with unacceptable conditions. FIRA does, therefore, have an adverse implication far higher than the five percent rejection rate, but that rate is dramatically lower. However, FIRA, which was at one point, rejecting almost twenty percent of all applications, is now turning down only about five percent—and this in itself is an indication of a substantial shift in policy.

FIRA, despite this softening, is still concerned with takeover applications which have a high political visability or which seem to threaten existing Canadian businesses. These are the types of takeover applications by foreigners with which the most trouble will be experienced.

The main criteria used by FIRA to judge the acceptability of proposals from United States and elsewhere to takeover existing Canadian businesses or start new businesses is the test of whether the application will be of significant benefit to Canada. In this area the significant factors are, first of all, the im-

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pact of the proposal on Canadian employment. These days, if a proposal involves the creation of new jobs, it will receive very serious and preferential treatment. (This is particularly true whenever you are considering anything that will inject new jobs in an area of high unemployment, and most particularly, in Quebec.) If a foreign investor is simply going to takeover an existing company and there will be no change in employment, the application will have considerably less appeal.

The effect of the proposed on Canada's balance of payments, that is, anything that would tend to increase exports from Canada, is looked upon with particular favor. Further, the possible availability, not necessarily immediately but ultimately, of an equity interest in the business to Canadians is also a big plus in the FIRA application.

The next point is that getting approval for a FIRA application is still very much of a negotiation game. FIRA is becoming more sophisticated and more precise in securing firm commitments on various issues as a price of approving applications. Dealing with FIRA now involves the delicate form of gamesmanship as the applicant tries to avoid getting pinned down to specific conditions and as FIRA tries to exact those conditions as a price of approval. Again, it is very difficult to judge. Much may depend on the degree of sensitivity of the application, including such factors as possible increased competition with existing Canadian businesses, or where the takeover involves some contact with the Canadian public and therefore might draw a nasty editorial in the *Toronto Star.* All of these are possible negatives: Where they exist, then, in order to get an application accepted one must include some positives such as commitments on employment, exports and so on. If an application has few negative factors, it may be unnecessary to include a great many of the positives for acceptance.

One of the critical factors in FIRA decisions is the attitude of provincial governments in the geographic areas that will be affected by the new business. FIRA applications are automatically referred for information to the provincial governments and their response can be critical. Many FIRA applicants from the United States would do well to check with provincial authorities first when they are trying to clear an application through the FIRA. This applies in all provinces and it particularly applies in those provinces such as Quebec and the Maritimes that have a very high unemployment ratio and are generally very interested in proposals that will provide new employment or anything that will keep existing businesses afloat.

And the last point is that many investors from abroad are still not aware that FIRA approval is required for any sale of control of a Canadian business even if that sale is from one foreigner to another. If one United States corporation acquires control of another United States corporation which has itself existing Canadian subsidiaries, then that change of control is a change of control which is subject to FIRA approval, such approval being far from certain.

On balance, FIRA has become somewhat easier to deal with over the past three years and certainly applications are now being processed somewhat

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more speedily than previously was the case. But FIRA is still alive and well, and takeover and new business applications need to be well documented in order to pass the significant benefit test. Commitments on employment and trade can be exacted as a price of approval and sensitive applications still run into very tough going.

QUEBEC

Now as soon as any Canadian steps outside of Canada he is likely to find that one of the first topics on which he is approached is what is really going on in Quebec? As a Canadian I can only respond that I wish I knew because the situation seems no clearer in Canada than out. The obvious facts about Quebec are these. There is a substantial group of Francophones who feel very strongly that they have not been able to obtain a satisfactory outlet for their culture, language and identity within the terms of the present Canadian federation. Whether this group comprises a minority or majority in Quebec depends entirely on how one defines the issues presented and the remedies sought. I think that there is a majority of Francophones in Quebec who believe that Canadian federation has been less than completely fair to their aspirations. These Francophones are looking for some sort of a new deal relating, in part, to economic opportunities for themselves within Quebec and, in part, to the aspirations of culture and linguistic independence within Canada. If one wishes to address simply the issue of immediate separation and independence for Quebec, then I do not think that at this moment or in the foreseeable future there is likely to be a majority of Quebecois in favor of this particular solution.

On about April 15, 1978, the Quebec Liberal Party elected Claude Ryan, an intellectual with very substantial prestige in Quebec, as its leader. It is very likely that Mr. Ryan will be able to give Mr. Levesque, the current Premier, quite a run for his money. But even if Mr. Ryan is elected in the next Quebec election, which is not likely before 1980, this is not going to solve the Quebec problem. Mr. Ryan in his way is likely to be just as uncomfortable as Mr. Levesque is in his, even though their objectives and their views of the advantages of the Canadian federation are entirely different.

I feel that the separation of Quebec from Canada is not very likely in the foreseeable future. However, there are increasing trends not only from Quebec but right across the country that will likely force some modifications in the present structure of Canada over the next decade, involving increased decentralization of government powers. In my view it would be a tragic state if the result of this adjustment were a weaker and economically divided Canada and I do not think that this is what the majority of Canadians want.

With respect to the economic effects of the situation in Quebec, these will continue almost irrespective of political developments. Montreal is gradually turning more and more from a center of international business into a city that will be the financial and commercial capital of a Francophone Quebec. More large businesses will gradually shift their headquarters from

Montreal to Toronto (although fewer are likely to have the courage or stupidity of Sun Life to announce the change so publicly). The Francophone community in Montreal will gradually assume a greater and greater influence on business operations, including the legal and accounting professions, and within a short period of time business operations in Quebec will be truly reflective of the "French fact."

CORPORATE REORGANIZATION—RECENT CHANGES IN CANADIAN TAX LEGISLATION

Well, so much for pleasant topics. Let's talk about something nasty, such as the tax rules on corporate reorganizations in Canada. These have been thrown up in the air and juggled around recently, and I won't go into all of the technical details. But, I will mention some of the particular implications of recent changes that will be of particular interest to those outside of Canada.

First of all, the March 1977 federal budget did contain a number of tax amendments that will gradually simplify tax rules in Canada. This is indeed welcomed news given that the trend has been quite the other way ever since 1971. One of the key changes made in 1977 was the repeal of designated surplus as a Canadian tax concept. Those of my audience who do not know what designated surplus is can therefore remain forever blissfully ignorant of its convoluted history, its technical problems and its complex definition.

Basically, designated surplus was a concept that was introduced into the Canadian Income Tax Act in 1950 to prevent the conversion of ordinary income into capital gain. The rule stated that when one Canadian corporation acquired control of another Canadian corporation then the surplus of the acquired corporation became designated or frozen. This designated surplus of the acquired company could not be distributed to the new parent company, either directly or indirectly, without the imposition of substantial additional tax. The rule was designed to prevent an individual from selling the shares of a corporation which he owned to another company, recognizing a (before 1972) tax-free capital gain, and receiving debt which would then be repaid to him on a tax-free basis. But as the years rolled on, the provisions became more and more complex due to the ingenuity of taxpayers in circumventing these provisions so at the end we had a whole structure in the Income Tax Act dealing with that designated surplus including many provisions which apply the rules in circumstances where there was no possible element of dividend stripping or conversion of income into capital gain.

Well, from April 1, 1977 onward, the designated surplus rules are totally repealed. As a consequence, it is now possible in Canada to liquidate an acquired corporation into the acquiring Canadian corporation either by direct winding up or through a statutory merger. In any case involving the liquidation of a wholly-owned Canadian subsidiary into its Canadian parent company, the winding up can now be accomplished on a completely tax-free basis in virtually all cases. Also, it is possible to arrange for the merger of two or more corporations through statutory amalgamations, again on a completely

tax-free basis and with no concern about the designated surplus rules that used to prevent this. The repeal of the designated surplus rules therefore makes Canadian corporate reorganizations and acquisitions much more flexible.

First of all, it is now possible to do bootstrap financing in Canada. That is, the assets of an acquired company can be used to help finance the purchase of its own shares. This involves the acquisition of the shares of a company, its liquidation into the acquiring company, the use of the funds or assets so acquired to assist in the initial share purchase, and the use of the income of the acquired business to cover the interest expense of the funds that were borrowed. The amended rules provide the much needed flexibility for existing corporate groups because the Canadian tax system still does not include the right to file a consolidated tax return. This means in Canada it is possible to have a corporate group, in which some companies in the group make money and pay taxes, while other companies in the same group incur losses and have no way to offset such losses. The new reorganization rules mean that it will be far easier, from a tax viewpoint, to combine the businesses, and their income and losses, into a single corporate entity. The new provisions also mean that it is now possible to effectively merge, through statutory amalgamations, companies incorporated in different jurisdictions.

In Canada, companies can be incorporated under the laws of any of the ten provinces or under federal law. There is only a very limited right to merge, through a statutory amalgamation, two companies incorporated in different jurisdictions. And for a number of reasons that I won't go into, a statutory amalgamation is one of the most convenient ways to merge companies for tax and other reasons in Canada. For example, an Alberta company and an Ontario company can be merged (through a statutory amalgamation) to form one new corporation. But it is not possible to merge a Quebec company with a federal company because the corporate law does not permit it. This situation was an impediment to various restructurings of Canadian corporate organization. With the repeal of designated surplus it is now possible to avoid these difficulties. For example, if you wish to merge a Quebec and a federal company, the shares of the Quebec company can be rolled into a new federal corporation and then the Quebec corporation can be liquidated up into the federal corporation, which then can be merged with another federal company. The new provisions facilitate the shifting of corporate jurisdictions which may be desirable for a number of reasons.

Another change that is also very helpful in getting together groups of companies in Canada are the changes in the rules relating to loss carryovers. Now, for the first time, loss carryovers flow through a statutory merger or the winding up of a wholly-owned subsidiary. That is, the surviving entity can take advantage of whatever loss carryover position was in the subsidiary or the merging affiliate. These carryover of loss rules are still subject to various restrictions that are designed to prevent trafficking in loss companies, and basically the carryover is not available if, as a result of the reorganization, there is both a change of control of the company with the loss and a change in the business in which the loss was sustained.

But there was a price to be paid by the business sector for the simplification of the corporate tax rules which are inherent in the 1977 tax changes. The primary change here is that the 1971 surplus accounts are repealed. And again, for those of you who don't know what the 1971 surplus accounts are, then you are very fortunate and can remain forever blissfully ignorant. They are a transitional thing. The only thing worth noting is that there were some rules that allowed calculated numbers which were called, for convenience, 1971 surplus accounts, to be distributed to shareholders under favored tax provisions. Now, as far as non-resident investors are concerned, the only one that is of real interest is the provision that allowed 1971 capital surplus to be distributed to non-residents as a dividend that is not subject to Canadian withholding tax. Such a dividend does reduce the adjusted cost basis of the shares but this is frequently of no real importance to the foreign shareholder. The availability of 1971 capital surplus in most circumstances perished at the end of 1978. For Canadian corporations which are owned by non-residents, there should have been some examination before the end of the year to see whether there was any 1971 capital surplus. A rough estimate of 1971 capital surplus can be arrived at by taking the accumulated capital gains of the company since its inception, plus its earned income retained before 1949, plus about thirty-three other adjustments. If the foreign controlled Canadian company has 1971 capital surplus it might be worth thinking about getting it out, but in the case of a Canadian corporation controlled by non-residents, in order to get it out you have to deal first of all with the 1971 undistributed income of the Canadian corporation, which is another calculated number that I won't go into. Whether it is worthwhile dealing with that 1971 undistributed income which may involve the payment of a fifteen percent tax in order to get at the layer of 1971 capital surplus is simply a question that requires calculation.

Another new anti-avoidance rule that will be of considerable interest to foreign investors is related to the redefinition or abandonment of such exotic Canadian tax concepts as paid up capital, a paid up capital deficiency, debt limit, and all sorts of other weird and wonderful things. The changes in this area involve a new rule that relates to the situation where a foreigner, a non-resident of Canada, sells shares in one Canadian company to another Canadian company. The rule would apply if a United States parent company with two Canadian subsidiaries sold the shares of one of the Canadian companies to the other Canadian company. After April 1, 1977, the entire gross sale proceeds, in this type of situation, will be deemed to be a dividend and will be subject to withholding tax to the extent that the proceeds exceed the paid up capital of the shares transferred. Paid up capital simply means the par value of the shares.

Now, this rule is simply designed to prevent the extraction of income from Canada without withholding tax from intercompany sales of shares. But it is something that must be carefully considered in all corporate reorganizations, and it's something that is relevant in some circumstances involving the

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rollover rules. It's an interesting question incidentally as to whether the application of this provision clashes with the existing terms of the Canada-United States Tax Treaty. There are authorities in Canada who consider that it does, and that what Canada is doing when it imposes a fifteen percent withholding tax from this type of transaction is indirectly taxing the capital gain of a non-resident. In the case of a United States resident with no permanent establishment in Canada, it is argued that capial gain should not be taxed in Canada because of article 7 of the Canada-United States Tax Treaty. The Canadian authorities don't agree with this point of view and it may ultimately make an interesting court case.

TAX INCENTIVES

Very briefly, I might just review a few recent developments in Canadian tax incentives. Canada is a great county for incentives. We are always dreaming them up and we have a new batch some of which you might be interested in. The first one comes out of Finance Minister Chretien's recent budget, and it relates to scientific research. There is now an incentive deduction, an extra deduction of fifty percent of the increase in spending on scientific research over a base period. That is, fifty percent of any increase in scientific research spending over what the corporation spent in a base period is allowed in addition to the 100% of all the scientific research one is allowed in Canada on a current basis in any event. This base period, ultimately, will be the three previous years after certain transitional rules.

The investment tax credit in Canada has been rearranged and strengthened, although not quite to American levels. The investment tax credit has now been extended to 1980. The tax credit will now apply to eligible expenditures on machinery and equipment acquired before July 1, 1980. The general rate of the investment tax credit remains at five percent but is increased to 7.5%, or ten percent in certain designated low-growth regions of Canada.

Another point of interest to non-resident investors is that the existing exemption from non-resident withholding tax for interest on government bonds and certain long-term corporate bonds is extended to apply to all such securities issued before 1983. This is simply an extension of an existing rule. Note that long-term corporate bonds with five year or longer maturity dates issued by Canadian companies to non-residents in arm's length situations remain exempt from Canadian withholding tax on the interest. As a result of this change, it's interesting to note that there has been a considerable shift in the borrowing pattern of Canadian subsidiaries, and that they are not tending in many cases to borrow abroad from foreign banks, possibly with the support of the guarantee of the parent company, with the interest then being exempt from Canadian withholding tax.

Another interesting change in Canada is that on the sale of business assets, any tax that arises on the sale of any business asset can be postponed where the proceeds are reinvested in other business assets before a specified time, one or two years. If a taxpayer sells a plant, takes the proceeds, and

reinvests them in a new factory somewhere else within a specified time period, the capital gains tax and the recaptured depreciation can be deferred.

To provide some recognition to the fact that accounting profits can be overstated because of inflation, taxpayers can now claim a special deduction of three percent of the value of opening business inventories. That is, three percent of the amount of the inventories of goods at the beginning of the tax year, is a deductible expense. It is not recapturable or claimed back. It is simply a recognition. A very rough and ready recognition to inflation.

Finally, Canadian individual taxpayers are not entitled to a dividend tax credit and gross-up at the rate of fifty percent with respect to dividends received from Canadian corporations, up from the previous level of thirty-three percent. I note this because Mr. Ullman, Chairman of the Ways and Means Committee of Congress, is busy pushing his ten to twenty percent dividend tax credit here in the United States.

UNITED STATES TAX REFORM

As a guest in the United States, I take some pleasure in noting that tax reform is not an exclusively Canadian disease. As you heard from our speaker at lunch today, you're about to get infected too and I though I might give you a bit of a Canadian viewpoint on some aspects of your tax reform proposals just to let you hear from the other side of the fence. There are a number of items in President Carter's tax reform package that would have an impact on Canadian business, and Canadian economic activity.

First of all, there is the proposed substantial cut in business tax, a cut in the corporate rate from forty-eight percent, to forty-four percent. If that ever survives through Congress, then this would tend to make the American industry much more competitive with its Canadian counterpart and might even induce us to do a few things too, so keep up the good work.

With respect to individual taxation, the President's program includes a modest across-the-board tax cut as well as significant changes concerning tax shelters, itemized deductions. I'll just offer one comment here. It is universally accepted that Canadian personal taxes, income taxes, are substantially above those in the United States. This is probably still true but the interesting thing is that the difference between the two has been narrowing considerably in recent years. That is, Canadian taxes are nowhere near as much above United States personal taxes as was the case five years ago. This is primarily due to the fact that the Canadian tax system is indexed so that each year, automatically, the personal exemptions and the width of all of the rate brackets are increased by a factor derived from the cost of living. For example, in 1973, at the beginning of the indexing, the maximum rate of income tax (about sixty-two percent in Ontario) was reached at the $60,000 taxable income level. By 1978, this maximum personal tax bracket had risen to $91,260. Because of indexing, the real burden of personal taxes in Canada has remained relatively static over the last four years, while in the United States, Americans have been subject to higher and higher personal taxes as inflation has moved them into higher tax brackets and diminished the value

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of personal exemptions. The proposed reductions in United States personal taxes put forward by the President, accompanied by the rather horrendous increases in social security taxes, will do little to prevent the tax gap with Canada from narrowing further.

The item in the President's tax reform package that is, of course, of greatest concern to Canadians is the proposal to end "deferral." The proposal has already been outlined by Mr. Rosenbloom. It seems that the proposal has been put forward because, as President Carter said in his message to Congress, the present rules in taxing foreign earnings only when remitted run counter to his goal of increased investment in the United States and the creation of jobs for American workers. Under the President's proposal, the foreign tax credit would continue to be available with respect to the foreign subsidiaries that are taxed immediately in the hands of parent companies in the United States. The effect of the termination of deferral therefore would be to impose immediate United States tax on the American shareholders of controlled foreign corporations to the extent that the foreign taxes now paid on such income were below the taxes that would be imposed if the income had been earned in the United States. Further, the President's proposal to end deferral would apply to the income of any controlled foreign corporation in which United States shareholders (counting only shareholders who own either ten percent of the voting stock or ten percent of stock by value) own in the aggregate fifty percent of the voting shares or fifty percent of the stock by value. These United States shareholders would then be required to include in their income annually thier share of the income of the controlled foreign corporation. And, for the purpose of these rules, the taxable income of the controlled foreign corporation will be computed in accordance with United States tax law. The proposal, therefore, really requires United States shareholders to treat their controlled foreign corporations as branches of the American enterprise and include in their income on a United States tax basis their share of the revenues and deductions of such foreign corporations.

The combined rate of federal and provincial corporate income taxes in Canada tends to range around forty-eight percent. It might therefore be supposed that the immediate taxation to a United States parent company or shareholder of its share of the income of a controlled Canadian corporation would not in fact have serious results. The Canadian taxes already paid on the income of the Canadian subsidiary should be large enough to offset through the United States foreign tax credit, the United States taxes imposed on the same income.

However, the situation is in fact much more complex. While the nominal rate of Canadian corporate tax does tend to range up to the fifty percent level, the methods of calculating taxable income under Canadian tax rules is substantially different from that in the United States. Under the President's proposal, the income of a Canadian subsidiary would have to be restated on an American tax base, using American tax concepts. Because of a variety of Canadian incentives, the effective rate of Canadian tax, calculated on income determined on an American tax basis, will frequently be below the standard

American rate. The most obvious reasons are as follow: (1) Canada has a lower rate of corporate tax (about forty percent) on the manufacturing and processing profits of Canadian corporations; (2) Canadian capital cost allowances are in general at rates far more generous that those allowed for tax purposes in the United States (Canadian corporations, for example, are allowed to deduct off new machinery and equipment acquired for manufacturing use over two years using a straight line depreciation method); (3) Canadian corporate income tax is reduced by an investment credit from five to ten percent (allowed on the acquisition of certain new equipment); (4) Canadian corporations can now claim a special inflation deduction of three percent of the value of opening inventories; (5) Additional incentive allowances are available to Canadian taxpayers increasing their spending on scientific research, investing in certain high-risk energy projects, and deriving income from resource sources. Accordingly, the enactment of the proposed United States termination of deferral could have the effect of allowing the United States Treasury to tax away the benefit of these Canadian incentives, to the extent that they reduce the effective Canadian tax rate below the United States tax rate. Considering that almost fifty percent of our manufacturing industry as well as other large portions of Canadian business are controlled by American shareholders, the adverse implications of this proposal for the Canadian economy could be staggering. In addition, the United States proposal will not merely subject the earnings of foreign subsidiaries of United States shareholders to the equivalent burden of tax that would be paid if such income had been earned in the United States. In fact, it would impose a higher level tax because even though the income of a controlled foreign corporation will be computed on a United States tax base, such income will not be eligible for a variety of American incentives that are restricted to United States operations, such as the United States investment tax credit for investment in United States plant, and the accelerated depreciation system. Moreover, because of the timing differences in the recognition of income and expense between Canadian and American tax laws, the possibility exists of double taxation of the same income, only partially through the carry forward and carry back mechanisms of the United States foreign tax credit. Of course, any actual computation of the effect of the new provisions would have to take into account the overall position of affected American taxpayers, who compute their foreign tax credits on an "overall" basis.

Former Treasury Secretary Blumenthal, in his testimony on the tax proposals before the House Ways and Means Committee referred to the possible reaction of foreign governments to the United States new rules. Mr. Blumenthal was not greatly concerned with the possibility that foreign governments might revoke tax incentives now granted to American subsidiaries, when the effect of such incentives was no longer inducing economic activity by the subsidiary but instead was a transfer payment to the United States Treasury. The President's message to Congress indicated that if and when it appears to be in the national interest to permit tax deferral with respect to the income of foreign subsidiaries in specific countries, such treatment can be provided selectively,

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under negotiated tax treaties involving mutual concessions. This cheerful supposition may have rather ominous implications for Canada. One Washington commentator, in reacting to the President's message, said that it reminded him of a story of a man who negotiated with another over a pail of water: "But," said the second man, "I don't want a bucket of water." "Ah," said the first man, "but you will, because I'm just about to set you on fire." That is, perhaps, the type of attitude that is reflected in Mr. Blumenthal's view that if we end deferral in American tax policy all the other countries will immediately offer us large concessions in order to reinstate deferral. The proposed end of deferral is a very serious matter to Canada because of the structure of our tax system and the weight of American investment in Canada. If it was enacted I think it would have serious implications for cross-border investment. First of all, it would neutralize a very large part of the effect of Canadian incentive measures. In addition, the Canandian government, undoubtedly would stop granting the incentives if over half of its net benefit simply flowed through to the United States Treasury. And, the second thing it would do in real terms is make the American investment less valuable to Canada because if we could not influence it through incentive measures then it is less useful to us to have American investment in Canada. The third thing it would do, of course, not only with Canada and other countries, is it would invite the sort of retaliatory action that would simply create a border tax warfare around the world and that would be in no one's interest.

Another issue that is of concern to Canadian business relates to the proposals not by the President, but by Chairman Ullman of the House Ways and Means Committee, to enact a limited tax credit for the United States individual shareholders of United States corporations. Such a credit would mean that Canadian corporations would find that their shares would be less marketable in the United States, resulting in some narrowing of the equity markets for Canadian securities.

The end of deferral as well as the other proposals are, of course, American tax issues that will have to be resolved in the United States by whatever Congress happens to feel about the measures, but they do have implications abroad and I think also they have implications for the structure of the entire American economic activity around the world in the next few years. The President's proposals are far from being enacted at this point, but Canadians will be glancing anxiously across the boarder for the next few months to see just how these tax changes are developing. After years of traumatizing tax reforms in Canada, the Canadian tax system seems to have settled down a bit, and Canadians can only hope that the United States does not become committed to changes that may upset the good relations between the two countries.

TABLE I

FOREIGN INVESTMENT REVIEW AGENCY
OUTCOME OF APPLICATIONS

	Year ended March 31			
Takeovers	1975	1976	1977	1978
Reviewable applications	150	144	186	288
Applications not dealt with in prior year	-	58	49	44
	150	202	235	332
Allowed	63	110	153	241
Rejected	12	22	19	11
Withdrawn	17	21	19	12
Forward to next year	58	49	44	68
	150	202	235	332
% of resolved applications (excluding withdrawals):				
Approved	84%	83%	89%	95%
Rejected	16%	17%	11%	5%
New Business[1]				
Reviewable applications		26	238	316
Applications not resolved in prior year	—	—	20	51
		26	258	367
Allowed		4	166	300
Rejected		—	14	14
Withdrawn		2	27	23
Forward to next year		20	51	30
		26	258	367
% of resolved applications (excluding withdrawals):				
Approved		100%	92%	95%
Rejected		—	8%	5%

[1]Provisions did not come into effect until October 1975.