Canada-United States Law Journal

Volume 14 | Issue

Article 23

January 1988

Tax Aspects of U.S.-Canada Competitiveness

George G. Goodrich

Recommended Citation

George G. Goodrich, *Tax Aspects of U.S.-Canada Competitiveness*, 14 Can.-U.S. L.J. 177 (1988)
Available at: https://scholarlycommons.law.case.edu/cuslj/vol14/iss/23

Tax Aspects of U.S.-Canada Competitiveness

*George G. Goodrich**

I. Introduction

One of the most common points of debate preceding the enactment of the Tax Reform Act of 1986 and continuing through today concerns the ability of the United States to remain competitive with the major industrial nations of the world. Some of the reasons for the concern are obvious when one looks at the U.S. balance of payments, the falling value of the dollar, and the U.S. trade position vis-á-vis its major trading partners. A popular form of the discussion, however, does not necessarily include these major points, but rather it tends to focus on whether or not the U.S. federal income tax system plays a major role in the U.S. competitive position.

The Tax Reform Act of 1986 was initially touted in such terms as "fairness," "equity," "efficiency," maybe even "simplicity." Growth and competitiveness however, did not emerge as the prominent economic issues until after Congress completed action on tax reform. The issue was not so much tax reform, deficit reduction and competitiveness. Rather, the issue was: given the reality of tax reform, what direction should economic policy take to enhance the competitiveness of U.S. industry?

It would be a mistake to conclude that growth and competitiveness difficulties are transitory problems that are susceptible to a quick fix. The problems did not develop overnight. The U.S. economy grew by only 2.3% per year from 1973 to 1985, compared to a rate of 3.7% for the 1948 to 1973 period. The United States is not a large debtor nation, borrowing more from abroad than it lends. Its problems, in short, are deeply rooted and will take time to solve.

The U.S. trade deficit reflects the simple fact that the country is spending or consuming more than it is producing. The consumption orgy is being financed by borrowing from foreigners. There are only two ways to cut the trade deficit: reduce spending or increase domestic production. Since federal spending is now at a post World War II high of nearly one-fourth of gross national product, a preference would be for spending reductions rather than higher taxes. But a political stonewall, with one side refusing to cut spending and the other adamantly opposed to higher taxes, only worsens the problem and delays its solution. Obviously, spending can be reduced in a variety of ways. A tight money pol-

* Partner in accounting firm of Arthur Andersen & Company.

icy, for example, would curtail domestic spending by reducing investment. However, growth and competitiveness require more investment, not less.

In order to curtail the trade deficit, the United States needs to increase domestic production for both increasing exports and providing import substitutes. Tax policy can play a role in encouraging domestic production. During the debate on tax reform, much was made of the need to establish a "level playing field." But an income tax is never level between consumption and savings. By its very nature, an income tax punishes investment, particularly when the reform raises corporate taxes and the cost of capital for new investment. Tax neutrality among investments is a laudable objective, but we also need neutrality between consumption and investment.

Much has been written about the fact that the 1986 Tax Reform Act would increase corporate taxes by about $120 billion over the 1987-91 period, roughly a 20% increase. Some specific issues that must be addressed are: what has the elimination of the investment tax credit and the revision of depreciation allowances done to capital spending plans? Assuming that neither Congress nor the administration will ever agree to expensing or immediate write-off of capital purchases, what stance should tax policy take toward capital cost recovery? How important are tax incentives to capital formation?

What of the alternative minimum tax ("AMT")? In its most innocuous form, the AMT can be viewed as a complex prepayment of regular tax liability. Supporters of tax reform praised its promise that all forms of investment would be more equally treated. It was believed that improved utilization of capital stock, referred to as efficiency gains, would more than offset any downturn in investment associated with the loss of the investment tax credit. Will the Act lead to a more productive pattern of investment? Does the Act help or hurt the ability of U.S. industry to compete internationally?

Some have argued that with its low tax rates, the United States is now a tax haven. Will more money from abroad be invested in the United States, or because of the loss of the investment tax credit, inventory capitalization rules, accounting changes and the AMT, is it now more attractive for U.S. industry to invest abroad?

This Paper will be confined to analyzing the tax impact on the ability of the United States to remain competitive throughout the world, focusing at times on the differences among the taxing systems of the United States, Japan, and Canada. Many authors and speakers choose to focus on the competitive aspects of U.S.-Canadian taxation, dwelling on the minute differences in the tax laws of the respective countries which may provide one or the other with a competitive advantage. The inference is that these differences in the tax law will play a significant role in a particular industry's choice of what country in which to operate.

At first glance, the effects of the tax differences would appear to be highly positive for the United States. Indeed, as noted above, some have suggested that tax reform will make the United States a tax haven. The facts, however, generally lead one to conclude that the taxing systems of the United States and Canada have historically played a very minor role in the determination of where a firm will operate. In recent years, more and more companies have chosen to look at their North American operations (United States and Canada) with little regard to cross-border differences in the taxing statutes. These firms could look to the Environmental Protection Agency guidelines and the import content rules for exemption from the emission control standards, which appear to regard the two countries as a single geographic entity for purposes of complying with certain laws. For the most part, there are numerous political, geographic and labor-intensive reasons as opposed to substantive taxation reasons for locating operations in either or both countries.

II. Historical Tax Background

From an historical perspective, the 1982 and 1984 U.S. legislation provided substantial incentives to heavy capital-intensive companies such as auto, steel, and heavy equipment manufacturers. This was evidenced by the continuation of the investment tax credit, the research and development credit and other such incentives to the manufacturing and construction industries. For the most part, the Canadian taxing structure provided similar incentives; therefore, from an incentive standpoint, these industries remained on a relative par in their respective countries. Few, if any, incentives were provided to the working-capital-intensive companies. In retrospect, many feel that the lead time for the manufacturing companies to recover from the economic decline in the late 1970s was too long to provide a direct stimulus to the economy, and many economists expressed the opinion that the tax incentives were provided to the wrong industries. The anticipated growth industries were more in retail and service industries which, if provided with the proper incentives, possibly could have achieved short-term results in the market place.

The Tax Reform Act of 1986 and the additional 1987 legislation reversed much of the stimulus provided by the reforms of the 1982 and 1984 Tax Acts. Through a tax rate reduction, benefits were provided to all sectors across the board, including the retail, service, and high technology industries, while at the same time taking away many of the incentives such as the investment tax credit and the reduction in the qualified research and development credit, which had tended to benefit the capital-intensive industries. This legislation could be described, and often was described by the politicians, as being a fair tax bill. The focus generally was on the reduction in tax rates for both individuals and corporations from 50% to 28% and 46% to 34%, respectively. However, the Tax Bill also contained what is commonly referred to as base-broadening measures. In simple terms, these are the hidden revenue generators of the tax law which, when properly analyzed, result in a significant increase in taxation, often to the point where taxes will be higher for certain industries than they were with the prior rate structure. These base-broadening measures also tend to result in the taxation of hypothetical income and increased compliance burdens placed on many taxpayers. Many of these base-broadening measures have an impact on the ability of U.S. companies to remain competitive.

III. Competitive Factors

While the combined effect of these provisions on competitiveness is debatable, a few tentative conclusions can be drawn. First, tax reform is *not* likely to have a major impact on the U.S. trade balance, which registered a $170 billion trade deficit in 1986. Second, tax reform will affect the composition of trade, making capital-intensive goods less competitive, but making services, labor, and research and development-intensive products more competitive. Third, for businesses producing and operating outside the United States, but selling into the U.S. market, the possibility of trade restrictions cannot be ignored.

Given the U.S. balance of payments deficit, the declining dollar, and the trade deficit, the machinery was in place to focus on rate reductions which would make the United States very attractive to both domestic industries and foreign investors. In many respects, the rate reductions adopted by the 1986 Tax Act caused many to view the United States as a tax haven, certain to attract foreign investors. In hindsight, given the base-broadening measures, it would be foolish to conclude that the United States achieved a tax haven status. In fact, many of the provisions of the 1986 and 1987 tax law dealing with capital gains, the taxation of various securities transactions, and the dramatic change in the taxation of international operations have caused many foreign investors to withdraw from the United States into a safer investing climate.

In addition, there is uncertainty as to whether the 34% corporate rate will remain in effect. Taxes on corporations have actually been increased by tax reform, with a $120 billion increase projected in corporate taxes over the 1987-91 period. Thus, the question facing a foreign business with regard to its U.S. operations is similar to that facing a U.S. business; will it pay higher or lower taxes because of future tax reform?

Most observers agree that the 1986 Act increases the cost of capital for new investments in plant and equipment. This is because the lower corporate rate does not sufficiently compensate for the loss of the investment tax credit, the lengthening of depreciation allowances, and the base-broadening provisions, such as the AMT. With higher taxes on new investment, capital-intensive U.S. and foreign-owned businesses can expect to pay higher U.S. taxes.

Tax reform may cause a modest improvement in the U.S. trade balance, but if it does, this will not be because U.S. business is more competitive. Rather, it will be because capital is flowing out of the United States.

In explaining this paradox, it is helpful to think of a country's trade balance as equal to the difference between national savings and investment. National savings can come from either the private sector (including business) or government. If the government incurs a deficit this amounts to negative savings; private savings are absorbed. Investment can take either of two forms, domestic or foreign. If foreign investment is negative, then foreigners are investing more in the United States and U.S. firms are investing abroad. If investment exceeds savings, as has been true in the United States since 1980, foreign investment must fill the gap. Thus, the shortage in investment funds is made up by foreign investment flowing into the United States. This increases the demand for dollars and increases the exchange value of the dollar, thereby increasing imports, reducing exports, and generating a trade deficit. Some contend that this is not anything to be concerned about, that fast-growing economies draw capital from the rest of the world. But this misses the point: the United States is consuming too much, saving too little. If foreigners are to have the dollars to make investments in the United States, U.S. citizens and businesses must buy more from abroad than is sold in foreign markets. Capital inflows into the United States must be balanced by a trade deficit.

Tax reform, on the other hand, may cause capital to flow out of the United States since foreign investors will not benefit from the lower individual tax rates. The increased taxes in the corporate sector will reduce after-tax returns received by all shareholders, U.S. and foreign. Foreign capital may leave the United States in pursuit of higher after-tax rates of return. If capital leaves the United States, the value of the dollar will fall and the trade balance will improve. But the consequence of the improved trade balance is reduced capital formation.

As noted previously, there has historically been very little difference between the American and Canadian tax burden in the various industries when all forms of taxation are considered. The differences have not been a major reason for locating a business in either particular country. However, given the Tax Reform Act of 1986 and the resulting tax rate reductions, the United States could have been regarded as a tax haven compared to Canada with its high tax rates. Given the significant rate differential, Canada immediately enacted 1987 legislation which brought its rates more in parity with those of the United States. When one now focuses on the results of both the American and Canadian 1986 and 1987 tax legislation, one may conclude that the combination of federal, state, provincial, and commodity taxes on companies in either of the countries are not significantly different. American companies would have enjoyed a competitive advantage had Canada not immediately instituted legislation to bring the taxing systems into parity. In fact, Finance Minister Wilson, in *Guidelines for Tax Reform*, noted in 1987 that:

> Our corporate tax system must be responsive to the need to insure that investment, whether by Canadians or nonresidents, take place in Canada. We must be sure that the job creating capacity of our economy is maintained and enhanced. In setting the rate of corporate tax, we must also keep in mind the need to insure that our domestic tax base is not undermined as income is shifted to countries with lower tax rates.

While not specifically mentioning the United States, it is obvious that Mr. Wilson's statement was intended to place Canadian companies on par with U.S. companies or at a slight competitive advantage. It was clear that Canada felt that it could not afford to be placed at a competitive disadvantage.

Tax reform may have a significant impact on the competitive position of particular industries. As explained above, taxes on capital-intensive industries will go up and taxes on labor-intensive and technology-intensive industries will fall. This means that the former will become less competitive, and the latter more competitive. Imports of capital-intensive industries and exports of labor- and other technology-intensive industries will increase. Thus, those sectors of U.S. industry that are capital-intensive will be under increased competition from foreign imports.

Apprendix A provides a comparison of the competitive aspects of operating a manufacturing business in the United States and in Canada and concludes that when one considers all levels of taxation, including the commodity taxes, a Canadian manufacturing company would enjoy a modest tax advantage over a U.S. company. Unfortunately, many analyses of this issue stop at that point and do not consider the impact of the eventual repatriation of the earnings of the company to the parent country. Therefore, if a U.S. company has a choice of conducting operations in the United States or in Canada, the extension of the analysis to include the final repatriation of funds into the United States would generally cause one to conclude that the overall tax burden of operating in Canada will exceed that incurred by a U.S. company operating in the United States, principally by reason of the additional commodity taxes. Focusing on tax rate differentials might also cause companies to make decisions which, over the long run, may be erroneous. For instance, to focus only on a tax rate differential at this time and to look at bottom line earnings per share and cash flow which result from the tax advantages could cause a company to suffer a significant economic loss if the tax rate structure were to change.

Many have speculated that the competitive advantages enjoyed by Japanese companies is in some part derived from the fact that there is stability in the taxing structure in Japan. The tax structure in Japan has remained unchanged for several years, and companies have been able to plan with the knowledge that it is likely the taxing system will go unchanged. This has not been the case in the United States where there have been numerous major tax law changes over the last ten years and many minor tax bills in the same period. One need only to look at the 1976 tax legislation, which was then modified in 1978 and 1979, followed by major tax reform in 1980, 1982, 1984, 1986 and 1987. Some have speculated that the United States cannot continue to have such major tax reform every year or two. In many instances, laws are passed and then revised within the same tax year. No company can make long-range investment plans given the likelihood for reform in the short-term which might have a negative impact on the projections.

Given the likelihood for additional tax reform and rate increases in the United States over the next two years, one would normally think that the United States would be in a less competitive position as a result. In fact, as noted above, many foreign investors are making plans for the withdrawal of investment in the United States prior to the effective date of any rate increases. Tax planners are attempting to attract taxable income in this short period in order to take advantage of the lowest tax rates that will probably be seen for many years to come.

International competitiveness will be the number one economic policy issue in the United States in the next year or two. The concern is fueled by the high trade deficit and by a belief that the United States is losing its industrial base. While the former is obviously true, the latter is open to debate. The share of manufacturing output, for example, in gross domestic product has been relatively constant since 1950. The services sector has grown, but at the expense of mining, agriculture, and construction. Nonetheless, policy makers will pay close attention to the competitiveness issue. This has a number of implications for foreign business. Trade restrictions, such as import quotas, surcharges, and tariffs will be considered. It may be desirable for foreign businesses to produce in the United States so that any trade restrictions can be avoided. Japan has already taken this step as is shown by the presence of new auto plants in Ohio. The issue of a value-added tax or some form of consumption tax is likely to be discussed, especially after the 1988 elections. To some observers, a value-added tax is the answer to a range of problems. A broad-based tax would raise about $20 billion for each percentage point of tax. By raising substantial revenue, it could reduce the federal budget deficit and thereby increase national savings. This would improve the trade deficit because the United States could rely less heavily on foreign savings to finance its capital needs. Compared to an income tax, a value-added tax is pro-growth and pro-capital formation because investment spending would not be taxed. Thus, part of the revenues may be used to finance investment incentives, or undo some of the increased capital taxation in the Tax Reform Act. If Canada and Japan adopt a value-added tax as expected, this would increase pressure on the United States to follow suit.

The Tax Reform Act has been advertised as being revenue neutral, neither raising nor losing revenue. Still, behavioral changes with respect to capital gains (not selling assets) the investment tax credit (not making investments) the alternative minimum tax (merging with firms not subject to the AMT) may reduce the expected revenue gains from these provisions. Indeed, the Treasury Department now concedes a five year revenue loss. Chronic deficit problems may increase pressure to reverse the reductions in tax rates. It also may invigorate the search for new sources of federal revenue.

Like their U.S. counterparts, foreign businesses need to pay increased attention to state and local corporate income taxes, which have grown in importance. In 1960, for example, state corporate income taxes were 5% of federal corporate income taxes. In 1985, the proportion had increased to 22%. These issues are now being debated at the state level because of federal tax reform. At the federal level, tax reform reduced individual taxes while increasing taxes on corporations. Given the result of tax reform, there is some likelihood that businesses operating in the United States will be faced with higher state corporate income taxes.

Previously, I alluded to the base-broadening measures which may cause a significantly higher tax burden to companies operating in the United States versus Canada and other developed countries around the world. The more common base-broadening measures that are focused on are the AMT, the uniform cost capitalization method of treating inventories, the reduction in qualified expenditures for the research and development credit, and the taxation of multinational companies.

Since many companies focus on these base-broadening measures, it may be productive to analyze some of these measures in order to expose them for what they really are: revenue-generating measures instituted with little regard to the positive or negative competitive impact of their enactment. Appendix B shows a summary of the more significant measures which are expected to have a material impact.

IV. Uniform Cost Capitalization

Earlier it was noted that a significant part of the 1986 Tax Reform Act was the uniform cost capitalization legislation. This legislation requires basically all industries to include in the valuation of year-end inventories a number of costs previously expensed directly. Historically, taxpayers have been able to look to their accounting methods to determine what costs should be capitalized in valuing ending inventory under generally accepted accounting principles. In fact, for decades, the tax law seemed to have as its foundation the generally accepted accounting principles employed by businesses in preparing financial statements and reports to shareholders.

The uniform cost capitalization measures, in many instances, will not be followed for financial reporting purposes since the costs that are required to be included in ending inventory for tax purposes are not acceptable for financial accounting purposes. As a result, taxpayers will be forced to maintain a dual set of inventory records in order to comply with the financial reporting requirements and the tax reporting requirements. This will place a significant compliance burden on companies, particularly those companies in the United States who employ the last-in-first-out method of accounting for inventories.

While manufacturing companies have historically been required to absorb costs in ending inventory and to an even greater degree since the enactment of the full absorption regulations in the 1970s, the new rules place less of an increased burden on the manufacturing companies while at the same time placing a significant burden on retailers who previously were not required to capitalize any costs in inventory other than perhaps freight. These companies must now develop accounting systems which will permit them to track certain purchasing, warehousing, and distribution costs.

The result of this analysis is that while there is a significant increased compliance burden placed on many companies, there is also fictitious income to be reported and taxed. All of the costs now required to be capitalized in ending inventory will result in higher profits being reported. A company could have identical operations for 1986 and 1987 and yet report higher taxable income as a result of the costs that must now be capitalized as opposed to those that would have been expensed in prior years. This phantom taxable income takes away much of the benefit that was to be derived from the rate reduction.

V. OUTLOOK

The major question facing us is what impact, if any, will future tax changes have on the relative competitiveness of companies operating in Canada. The 1986 reform produced 2,000 changes to the Internal Revenue Code, nearly 75 pages of new forms and nearly 50 new tax regulations since it became law. The Internal Revenue Service fears that there is a bombshell waiting to explode in the current filing season. This sense of paranoia is very real and very justified, and members of Congress are beginning to feel it as well. Studies are already under way seeking ways to simplify the AMT, passive activity rules and the limitations on interest deductions. Nonetheless, taxpayer frustration and anger stemming from the 1988 filing season will be transformed into new pressures on Congress to back away from many of the changes made in 1986.

The major issue before Congress this year, in addition to the elections, is the budget deficit. If attention is diverted to a tax bill, it is unlikely to get much momentum until it is provided with a vehicle for passage — it must have a clear impact on the budget. Therefore, while many speculate that we now have the lowest tax rates we will ever see, no one is predicting a major tax bill this year. Rather, predictions involve focusing on long-term reviews of several key areas, such as taxation of life insurance companies, the low income housing tax credit, tax penalties, and the taxation of corporate mergers and acquisitions. None of these areas would likely have a major effect on the competitive aspects of operating in the United States or Canada.

Appendix A

U.S.-CANADA TAXATION OF MANUFACTURING OPERATIONS OHIO V. ONTARIO

	U.S.	CANADA
Federal taxes	34	27 - 23
State/Provincial	5	13.5 - 13
Local	2	-0-
Investment Tax Credit	-0-	3 - 0
Research and Development tax credit (Narrow base)	20	20 - ?
Minimum Tax (Broad base)	20	

NOTE: All figures are expressed in percentages. No effect has been given to indirect consumption taxes, i.e., sales, exercise, commodity taxes.

APPENDIX B

SUMMARY OF BASE-BROADENING MEASURES OF TAX REFORM

Issue	Consequences
1. Uniform Cost Capitalization	a. All businesses must capitalize rather than expense many additional costs, resulting in higher taxable income with no change in the economics.
	b. Businesses are being forced to modify or completely overhaul their cost accounting systems to accommodate this major compliance burden.
2. Alternative Minimum Tax	a. This parallel tax system forces many companies to pay a tax even though generally accepted accounting rules and economics show that they suffered a loss, or should have paid a lower tax.
	b. In many respects, the AMT may be regarded as a prepayment of a future tax liability.
3. Limitations On Utilization Of Foreign Tax Credits	a. The new "basket" approach to classifying foreign source income may create significant excess credits which will increase the worldwide effective tax rate of multinationals.
	b. The compliance burden to cope with these rules has forced multinationals to spend large sums to develop or acquire software to cope with this burden.
4. "Super Royalty" Provisions	a. Royalty rates must be reevaluated annually to ensure that they are currently at arm's length. This will increase U.S. taxable income.
	b. Since enforcing this rule will be on a hindsight basis, it is unlikely Canada will allow a deduction unless an actual cash payment is made pursuant to the written agreement.