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Trade Effects of the Tax Reform Act of 1986

by Glenn W. White*

If the United States had a strong trade balance and was concerned that its trading partners could not survive unless it redressed the situation, it would have found a device for solving the problem when it adopted the Tax Reform Act of 1986¹ (herein referred to as TRA 1986). Of course, the fact is that the United States has a terrible trade balance and should be doing everything possible to remedy the situation. That being the case, we have from a trade perspective, adopted a very bad national policy. Even if Canada snatches defeat from the jaws of a potentially very significant victory by emulating the U.S. tax legislation, the United States will still be a long way from being home free and dry, because not all of its foreign competitors are likely to forego such a splendid opportunity to enhance their position at our expense. Where did we go wrong?

From an international trade perspective: We enhanced the availability of the U.S. market by lowering the taxes on sales and service activity.² At the same time, the new act decreased personal tax rates,³ and penalized personal savings thus increasing the propensity to spend and consume.⁴ To further complicate this, we put severe penalties on the employment of capital in the United States.⁵

Let's examine all of these provisions and their effect on the opportunities for trade between the United States and Canada. Canada has a relatively favorable three year capital cost recovery system for manufacturing assets.⁶ This is contrasted with the pre-Tax Reform Act of 1986⁷ system of Accelerated Capital Recovery System (ACRS) which provided a five year write off on what is best described as a straight line basis. When the U.S. allowance of a ten percent investment tax credit was taken into account the U.S. capital cost recovery system wasn't too bad.

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¹ P.L. 99-514, 99 Cong., 2d Sess. (1986). Now the Internal Revenue Code of 1986 (I.R.C. of 1986).

² New corporate rates: 1987 - 40%; 1988 and after - 34%. The other changes in the law effectively increase the taxes on employment of capital.

³ New individual rates: 1987 - maximum 38.5%; 1988 - 28% with clawback producing a 34% rate for a strata of income roughly between \$71,900 - 149,250 for a married couple.

⁴ Differential rates of tax on capital gains and tax deductible contributions to IRAs were repealed. Use of 401(k) and many retirement related benefits were curtailed.

⁵ The investment tax credit was repealed. Depreciation on most capital assets slowed and research and development credit diminished.

⁶ CAN. CONS. REGS. ch. 945 (1978).

⁷ I.R.C. § 168 (West Supp. 1986).

Even in the relatively sparse economic years of the 1980-84 period, investment in plant and equipment in the U.S. economy remained at reasonable levels.⁸ With the loss of the investment tax credit, together with the lengthening of lives for depreciable assets for most of U.S. industry, the U.S. capital cost recovery system will be one of the slowest among the major industrial countries.⁹ The cost of capital for equipment under the 1986 law will increase by 62.2% according to the Economic Report of the President.¹⁰

This will, in all likelihood, result in diminished U.S. investment. Where is that diminution of investment most likely to occur? The benefit of lower tax rates will favor the employment of assets that produce the highest rate of return. This is so because the lower tax rate most strongly affects the businesses having high profit margins.

Businesses producing commodity type assets with low marginal rates of return will obtain little benefit from the lower tax rate. At the same time, they will be strongly affected by the loss of those provisions that tend to mitigate the bias of a tax on net income against the employment of capital. Those who favored 1986 Tax Reform Act argued that the most efficient allocation of national resources will occur only if high return projects are accepted. This disregards the fact that those relatively low rate return assets that produce basic commodities like iron, steel, aluminum, chemicals, and refined petroleum products are vital to the economy, and unless those production facilities are renewed and made technologically current, the implications for the foreign trade picture are not at all attractive. It is not likely that a large economy like that of the United States can operate efficiently without indigenous production of basic building block commodities.

The economy needs to participate fully in the advanced technologies that are being developed today. Examination of the structure of the new U.S. tax law, however, gives us little reason to rejoice about the growth of the new high-tech companies either. To the extent those new enterprises need to employ substantial amounts of capital, at least in comparison to their early profitability, they will find the imposition of the new alternative minimum tax to be an impediment to their expansion. The new alternative minimum tax falls most heavily on high growth rate firms.¹¹ New investment should be anticipated in high profit margin

⁸ G. BOSKIN, *IMPACT OF THE 1981-82 INVESTMENT INCENTIVES ON BUSINESS FIXED INVESTMENT*, (1985).

⁹ ARTHUR ANDERSEN & CO., *INTERNATIONAL COMPARISON OF THE PRESENT VALUE OF COST RECOVERY ALLOWANCES FOR DIFFERENT TYPES OF EQUIPMENT*, (1986), (This special study was commissioned by the Coalition on Jobs, Growth and Int'l Competitiveness, for the American Council for Capital Formation.)

¹⁰ COUNCIL OF ECONOMIC ADVISERS, *ANNUAL REPORT TO THE PRESIDENT*, Jan. 29, 1987 (Daily Executive Report (BNA) Special Supplement #20, Jan. 29, 1987).

¹¹ Harter, *How Tax Reform Would Affect Companies With Different Growth And Profitability Characteristics*, 31 TAX NOTES 297 (1986).

businesses by firms that are already established and who themselves have high profit margins.

This bill protects the established firms in two ways. First, it does not impose its burden on capital, on old capital. Thus, new entrants, either by way of expansion or new entry, are discouraged. Second, the established firm that already has a tax liability that is only partially offset by the new expansion will not feel the effects of the alternative minimum tax.

What then are the implications of this for trans-border trade? Manufacturing outside the United States for sales inside the United States should be relatively attractive. This is particularly so if the effective tax rate on the foreign manufacturing activity is low. "Effective tax rate" is the critical term here. The statutory rate of tax for this purpose is immaterial, or at least relatively so. The impact of the new U.S. tax law is to impose a relatively high tax on capital. Countries that elect to impose relatively lower rates of tax on capital will have an edge on firms located in the United States who are their direct competitors.

Looking at TRA 1986 from another aspect, it is worthwhile to note that profits from selling goods in the United States will enjoy a relatively low rate of tax by world standards. The firm located in Canada with manufacturing facilities will find their southern neighbor an attractive outlet for Canadian produced goods. This position is further enhanced by the fact that individual taxes were reduced by TRA 1986 by about \$120 billion over the next five years.¹² This pumps a fair amount of consumption into the economy. If one were to assume that the rates of tax in the United States would stay down long-term, there would be even greater cause for rejoicing in Canada, because slower industrial growth in the United States should make more of the market available to imported goods.

Viewing any international issue on the basis of taxes alone is not very realistic. So it is in this instance. There will be other effects including changes in the relative value of the U.S. dollar as a result of more imports that will tend to offset the availability of the market generated by taxes in the United States. Moreover, it might not be sound to expect the U.S. statutory tax rate to stay low indefinitely. Already there is concern that the rates should be raised for high income individuals and corporations.¹³ If the United States increases its statutory rate of tax while retaining this broad based levy, it will have what is probably the highest effective rate of corporate income tax in the industrialized world.

Another factor making an even more consumption-oriented economy than we have had until now is the enactment of provisions that lessen the propensity for individuals to save and invest. Tax deferred in-

¹² H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., II-865, Table A.1.

¹³ DAILY TAX REPORT, 236 (BNA) Dec. 9, 1986, p. LL-2; DAILY TAX REPORT, 176 (BNA) Sept. 5, 1986, p. G-5; DAILY TAX REPORT, 8 (BNA) Jan. 13, 1987, p. S-9.

vestments in Individual Retirement Accounts (IRAs) have been repealed. These accounts have had a strong effect on middle-income America.¹⁴ In addition, there is some uncertainty of what happens to the funds that otherwise would have flowed into tax sheltered investments. Whatever deficiencies they had, and they were many, those investments did attract dollars that now will flow elsewhere, some probably to consumption. Along with the other changes that were wrought by TRA 1986, was the repeal of any tax rate differential on capital gains. Beginning in 1988, capital gains will be taxed at ordinary income rates. There is a preferential rate for capital gains in 1987. Capital losses will only be recognized against capital gains under the new law.¹⁵ This places an even higher risk factor on capital investment. The disequal treatment of gains and losses only serves to heighten the prejudice against savings and investment. Without being overly paranoid, it is reasonable to point out that the measures taken have encouraged consumption, not only by placing more funds in the hands of those most likely to consume, but has also penalized savings to a degree that will force more consumption.

Under the new law, corporate profits of foreign operations of U.S. based business will be taxed at 34% for the years after 1987. The implications of this for transborder trade are several. Investments in foreign manufacturing operations will be quite attractive if the foreign rate of tax is low. As noted previously, the Canadian capital cost recovery system is relatively attractive and provides a low effective rate of tax on manufacturing operations. On that basis, it seems almost inevitable that some manufacturing operations will stray across the border to Canada. There may be some attractiveness for a non-U.S. based firm to sell through a U.S. incorporated entity. The build up of business related assets within the corporation can be financed with its U.S. earnings. This would save the incremental difference between the United States and Canadian rates on the affected amounts.

Manufacturing operations almost always bring technology with them. To transfer technology from the United States to a foreign subsidiary as a part of the subsidiary's capital has not been tax effective since 1984.¹⁶ Transfers of technology have to be made for an ongoing royalty, unless one is prepared to accept a severe tax burden. The need to receive a royalty is not at all bad news for transfers to a foreign manufacturing location for a United States based firm. With the U.S. statutory tax rate being lower than the rates of tax in most industrialized nations, U.S. based firms face a situation of being in chronic foreign tax credit limitation. Royalties received from related parties constitute general basket income for foreign tax credit limitation purposes.¹⁷ A reasonable royalty

¹⁴ WISE, *INDIVIDUAL RETIREMENT ACCOUNTS & SAVINGS, TEXAS & CAPITAL FORMATION*, (National Bureau of Economic Research 1986).

¹⁵ I.R.C. § 1211 (1986).

¹⁶ I.R.C. § 367(d) (1984).

¹⁷ I.R.C. Code, § 904(d)(3)(C) (1986).

that passes the arm's length test for purposes of the host country's law, and is thereby deductible, is desirable. It provides low-taxed foreign source income that serves to offset the limitation problem.

The TRA 1986 has generated a new problem for U.S. firms who transfer technology to their foreign affiliates. Under the new law, transfers of technology must receive a royalty that is ". . . commensurate with the income attributable to the intangible."¹⁸ This provision represents an abandonment, in the statute, of the principles enunciated in the regulations under I.R.C. § 482.¹⁹ This is certainly an abandonment of the traditional concept of an arm's length measurement. The largest problem is that it seems to give the revenue authorities a look back at whether the business has been sufficiently profitable to warrant an additional royalty. Arguably, this is an arm's length standard, although not in the traditional sense. The capacity this provision has for mischief is not insignificant. How many tax practitioners would like to go back to the Canadian tax authorities five years after the fact and argue that the royalty initially charged must now be revised upward by some substantial amount. Certainly the Revenue Canada authorities will not be amused. Moreover, one wonders whether the Competent Authority procedure (in the U.S.-Canada Income Tax Treaty) will benefit greatly from this strain.

The U.S. taxpayer may, however, find these adjustments very acceptable, provided that the additional amount of royalty is deductible by its subsidiary outside the United States. As a matter of fact, the Internal Revenue Service may find such adjustments do not generate any additional revenue because of the foreign tax credit limitation. Unless the provision is enforced with some consistency, the provision has the capability of being unfair.

To the extent the provision is enforced, it seems likely to first generate a lot of effort at the Competent Authority level and then to generate a substantial amount of litigation. This is because the increase in income will occur several years after the fact, and the taxpayer will have no meaningful standard against which to judge the risk. There is a higher than normal likelihood of a need to litigate if no collateral adjustment is possible in the other country. One fear corporate tax administrators have is of the issue that builds up over the years without any ability to judge its size and earnings impact. This issue is susceptible of generating that sort of problem.

Apart from the general mischief generated by this provision, it is disturbing because of its departure from the generally accepted concepts of arm's length standard as recognized, not just by the United States, but by other countries as well. This permits the auditor, on an after the fact basis, to make general adjustments based on a subjective standard understood only by those who have a doctorate in economics. Such adjust-

¹⁸ I.R.C. Code, § 482 (1986).

¹⁹ Treas. Reg. § 1.482-2.

ments can be made even if one complied with the requirements governing transborder transactions. The subjectivity lies in the analysis of what profit margin might have been acceptable if the taxpayer had known the profitability of the product before it was licensed. The U.S. Treasury Department might in other areas like to employ this uncertain subjective test, whose efficacy will be judged by economists, under theories not necessarily known to the taxpayer at the time of inception of the project.

There is a substantial belief that the solution to this whole set of problems resides in the use of cost sharing agreements. While those agreements may work well for some, it is unlikely that they will have universal appeal. When the regulations under I.R.C. § 861²⁰ were finalized, many thought that the use of cost sharing agreements might be the solution to the problems, at least in the area of research and development allocations. That did not prove to be the case. There is a strong argument to use royalties as the means of obtaining return for the enterprise's research efforts. While it is not particularly apposite in the context of a Canada-United States situation, the desirability of not having the corporation's technology generally resident in every country in which one does business is not so apparent. For example, if the technology is owned by the local subsidiary company that participates in the cost sharing agreement, the nonpractice of the patent, in the case of patented technology, may cause it to fall into the public domain. It is unlikely that every compound will be manufactured in every location. On that basis, technology of substantial value may pass into the public domain.

In quite a different vein, the question of where research should be done poses an interesting issue for companies with profitable operations on both sides of the Canadian-U.S. border. The TRA 1986 temporarily dealt with one of the more important problems which multinational companies who have substantial research and development activities face. The operation of Treasury Regulation § 1.861-8, as it relates to research and experimental expenses, was completely suspended, once more, in 1986 by the 1985 Budget Reconciliation Act.²¹ For 1987, a direct allocation of 50% of United States incurred research and development expenses will be made to the United States.²² Unless further legislation is adopted in 1987, the full force of the existing regulations will become extant for 1988 and subsequent years. With the problem of chronic foreign tax credit limitation facing most U.S. based taxpayers, the unabated application of Treasury Regulation § 1.861-8(e)(3) is a grim prospect.

Canada, on the other hand, has invoked a series of incentives for the encouragement of research activity. These incentives for research include a full 20% research and development credit, and an immediate

²⁰ Treas. Reg. § 1.861-8.

²¹ Omnibus Budget Reconciliation Act of 1985, 26 U.S.C. § 861 (1986).

²² I.R.C. § 1216 (1986).

write off for capital expenditures for new research facilities.²³ In comparison, the United States offers a 20% research and development credit that is incremental.²⁴ Moreover, the TRA 1986 carefully circumscribes the definition of research and development so that the definition applicable for deduction and foreign source allocation rules is more favorable than that which will qualify for research and development credit purposes.²⁵

This suggests that future research and development programs should be developed in Canada. For a U.S. firm that needs additional research and development activity, contracting with a Canadian firm that can qualify for these incentive programs should produce a lower after tax cost. Even more attractive from a United States viewpoint would be the possibility of contracting directly with a subsidiary in Canada. In that situation, the possibility of benefiting from the profit on the contract is present. This would bring down the cost of the effort and maintain the confidentiality of the work done to a significant extent.

Another area that is of some interest is the impact of the TRA 1986 on the independence of the subsidiaries of United States concerns operating in Canada. For many years there has been a tendency in the Internal Revenue Code to fragment items of income for the purposes of determining the foreign tax credit limitation. This tendency started in the 1960s when the United States was concerned about "hot money" running to Canada in order to take advantage of high interest rates and then the interest would be repatriated to the United States under the protection of foreign tax credits from other operations. A separate basket for third party interest was created in the Foreign Investor's Tax Act of 1966.²⁶ Since then, several separate baskets have been created.²⁷ The most recent Act continued this practice and now passive income received from third parties generally will be a separate basket of income. This effectively denies foreign tax credit relief for such items. This is a case of taxpayer activity which optimizes the use of foreign tax credits through tax planning schemes. This brings on curative legislation that is quite harsh. Not only is a separate basket created, but to the extent that the third party interest bears a withholding tax of at least five percent, it is cast into a separate basket for purposes of calculating the foreign tax credit limitation.²⁸ When the rules for allocating deductions against foreign source income are taken into account, it is possible that a five percent or greater withholding tax on gross interest payments could help shield other interest income in the separate basket from tax. To ensure that taxpayers find

²³ Income Tax Act, R.S.C. ch. 63, § 37(1)(a) & (b) (1970-71-72) as amended.

²⁴ I.R.C. § 41 (1986).

²⁵ I.R.C. § 41(d) (1986).

²⁶ Foreign Investor's Tax Act of 1966, 26 U.S.C. § 1 (1966).

²⁷ *E.g.*, I.R.C. § 907(a) (1954); 22 U.S.C. § 2601 (a) (1975) (Oil Related Income); Revenue Act of 1971, 26 U.S.C. § 38 (1971) (DISC Income).

²⁸ I.R.C. §§ 904(d)(1)(A-B), 904(d)(2)(A-B) (1986).

no relief from this provision, the separate basket with a high withholding tax was created. To slam the door even more firmly on potential tax planning schemes, withholding taxes in companies in which the U.S. shareholder has a shareholding of between 10-50% do not qualify as taxes for purposes of the foreign tax credit.²⁹

The implications of this for subsidiary corporations is that their ability to deal with independent third parties in businesses that may generate separate basket income is going to be curtailed. For instance, it will be more attractive for the U.S. parent to require that its foreign affiliates minimize cash and let the parent use the cash than to let the subsidiary lend cash out in the country of its operations. Because of the operation of the investment in U.S. property rules, the method for transferring cash is likely to be through dividends with the consequent effect of keeping retained earnings in foreign subsidiary companies quite low. Does this make them less attractive in the countries in which they reside? Will it mean their operations and opportunities will be constrained?

Licensing third parties from such subsidiary companies will also be relatively unattractive. As a matter of fact, licensing third parties generally will be unattractive for U.S. corporations. This would seem to lessen the value of the technology of U.S. corporations. More importantly, the flexibility of the subsidiaries is reduced by this legislation.

Will those negotiating treaties on behalf of the United States be inclined to let foreign countries with whom they negotiate hold withholding rates at levels of five percent or more just to ensure that the passive income not only falls in the separate basket, but is also kicked out into the high withholding basket for interest income? It is probably too early to speculate on the impact of TRA 1986 as it relates to the treaty negotiating posture of the U.S. Treasury Department. Concern is appropriate if the abandonment of conventional thinking in the area of intercompany pricing becomes more wide spread. This area is already one that is not easily administered either by the affected governments or taxpayers. The impetus to this activity that has flowed in some measure from the regulations under § 482 of the Internal Revenue Code has formed a body of rules that we are only now coming to understand. Radical departures from those concepts will not make international tax administration any easier.

CONCLUSION

The United States has probably enacted a tax measure that will injure its balance of trade in more than an insubstantial way. U.S. based firms can be expected to exercise greater control over their affiliates in Canada, and elsewhere, because the separate baskets for limiting the application of the foreign tax credit discourage the allowance of foreign

²⁹ I.R.C. §§ 904(d)(2)(E)(ii) (1986).

subsidiaries to participate in activities that generate those sorts of income.

The views of U.S. Treasury regarding intercompany transactions and their taxation in the international arena may be in a state of change that should be a matter of concern to all those who are affected.

Canada may be in a position to take advantage of the poor position of the United States. The largest risk from the Canadian point-of-view is that it may be inclined to follow the U.S. model. Not only would that, in some measure, curtail its potential advantage, but it may slow capital formation and growth in the Canadian economy. That would seem to be doubly bad policy for the Canadians. Some growth in the Canadian manufacturing sector should occur as a result of the U.S. legislation. This would be reflected in facilities built by Canadians to service the U.S. market. In addition, some U.S. based concerns may increase their Canadian presence to take advantage of the favorable disparity between the capital cost recovery systems of the two countries.

Establishment of sales organizations in the United States by Canadian firms may be encouraged as a result of the recent legislation. Sales and service activity is encouraged by the low tax rate. Some commentators have even suggested that it may encourage firms to have functions, such as accounting, done in the United States.

Favorable aspects of the Canadian law, as they relate to the encouragement of research and development activity should result in more activity in Canada than would otherwise occur. Because the Canadian system treats this activity more favorable than the United States, some activity that would otherwise occur in the United States should flow to Canada.

The Tax Reform Act of 1986 is a bad piece of national policy insofar as the international trade implications are concerned. The U.S. balance of trade will be injured by this legislation.

