Tax Havens: Investment Distortions and Policy Options

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Differences in business income tax rates among nations create the opportunity for tax minimization by diverting capital through lower tax jurisdictions. Furthermore, the opportunity to use a tax haven alters the relative rates of return between domestic and foreign investment. Financial reporting is often not sufficient to inform existing or potential stakeholders about the use of tax havens, limiting their ability to evaluate the risk of share price fluctuations in response to changes in tax regimes. For Canada, both national and international policy action is warranted in the context of these increasingly important issues.

OVERVIEW

The utilization of tax havens in order to reduce business income taxes in a legally acceptable manner raises increasingly important policy issues. Tax minimization by businesses means that governments of both originating and host countries may not receive the same level of tax revenue from international investments that they would receive from domestic investments. The potential to use a tax haven may be one of the determinants of international investment flows, quite apart from the many non-tax forces impacting investment decisions (Beamish, Morrison and Rosenzweig 1997; Casson 1986; Dunn-
For analytical purposes, we consider a tax haven to be any jurisdiction that imposes a lower tax on corporate income than does the jurisdiction from whence the foreign direct investment originates, or the jurisdiction in which the investment ultimately is made. We also include as tax havens those special low tax entities such as a Barbados International Financial Centre Operation that exist in high tax jurisdictions.

The apparent growth of tax haven usage in recent years warrants greater consideration of this subject. A 1998 OECD publication entitled Harmful Tax Competition refers to such tax issues as “an emerging global issue.” The Organization for Economic Cooperation and Development warns that “globalization has also had the negative effects of opening up new ways by which companies and individuals can minimize and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital (OECD 1998, p. 14).

Tax havens enable corporations to reduce the taxes that they pay on the returns to capital that they invest outside their home country. With respect to financing, the process for reducing taxes in this way often involves the purchase of equity in a tax haven entity, which in turn lends, on an interest-bearing basis, to a third-country investment entity. Returns to capital in the third country may escape tax, at least partially, by being transferred to the tax haven as tax-deductible interest. In determining the total tax impact, the corporation must consider both income taxes and withholding taxes. These net returns are then available for reinvestment as loans by the tax haven entity. Alternatively, returns to capital that accumulate in the tax haven can be distributed to the home-country corporation as dividends. Many countries have special tax provisions for dividends received from corporations located abroad, and many also offer tax credits for dividends received. With respect to dividends from foreign direct investment, certain countries use the exemption method, while others use the deferral method with a credit. If a corporation has access to the exemption method, and if the income earned by the tax haven entity qualifies for this purpose, capital can be distributed tax free to the home country. If the home country uses the deferral method with a credit, and assuming that the credits would be extremely limited, given the low rate of tax being paid in the tax haven, planning would be required for the repatriation of such low-taxed income, such as the use of companies structured to mix high and low tax sources of income. Tax haven usage may be financially advantageous as a result of the time value of money, even if taxes are imposed when returns to capital are eventually repatriated. Of course, the income may never be repatriated to the home country.

The comparison of after-tax rates of return among alternative potential investment sites, given the opportunity to use a tax haven, depends on many factors such as the tax rates in various jurisdictions, the fees charged in the tax haven, and the costs of maintaining a tax haven entity; a threshold income level is necessary to make the use of a tax haven profitable.

In this paper, Canada’s tax situation is used for purposes of illustration. Some commentaries have suggested that Canada has one of the more generous regimes for the taxation of international outbound investment. For example, Canadian tax rules provide for full deductibility of interest on funds borrowed to make foreign investments; and there is a favourable exemption system with respect to dividend flows. Foreign accrual property income (FAPI) of a controlled foreign affiliate of the Canadian taxpayer is included in the Canadian taxpayer’s taxable income in the year it is earned. However, the recharacterization of property income into active business income for various payments, including interest, rent and royalties, between foreign affiliates of a Canadian corporation, permits the movement of active business income from one jurisdiction to another without the negative impact of the
FAPI accrual rules. These types of tax planning arrangements may be different — and in certain cases more restrictive — in other countries.

For Canadian public policy, a central issue is whether Canada’s taxation of income from international outbound investment should be made more restrictive, at the same time, however, assessing the negative impact that such restrictions might have on Canada’s international competitiveness. Related to this issue is the set of policy reforms that Canada should support in current and forthcoming international discussions and negotiations on this subject.

THE PUBLIC POLICY DILEMMA

In deciding upon the taxes to impose on income earned abroad, a country confronts two conflicting objectives. First, a country generally would like to tax income earned abroad at the same effective tax rate as income earned domestically in order to leave corporations indifferent, from a tax perspective, as to whether they invest domestically or abroad. This position is based on the view that economic efficiency rather than tax considerations should influence foreign investment decisions. Here the objective is to achieve “export neutrality” in terms of capital flows. Literature concerning the determinants of international investment has generally been developed on the implicit assumption that countries have been able to achieve this objective, although this assumption is clearly false insofar as tax haven usage is concerned.

However, each country is also influenced by a second objective. Corporations that are domiciled due to residency or incorporation within its borders should be subject to tax on foreign investments at the same effective rate as corporations that are domiciled in other countries. Otherwise, domestic corporations would be placed at a competitive disadvantage in their foreign operations vis-à-vis corporations located elsewhere.

When the parent corporation borrows in its home country for the purposes of international investment, it may be able to reduce its taxable income by the amount of the interest on money borrowed. International comparisons indicate a wide variation in practice concerning interest deductibility, with some countries, such as Canada, allowing for full deductibility, and many others providing for direct or indirect limitations. The report of the Technical Committee on Business Taxation, chaired by Jack Mintz, recommends, with some limited exceptions, that the deductibility of this interest be disallowed (Canada. Department of Finance 1998). Until such time as a change is made, a corporation may not only delay or avoid taxes on its foreign investment by using a tax haven but also deduct the interest on the capital used in the foreign investment against the profits that it earns within the home country. Not only does foreign investment enable a corporation to pay a lower tax rate on that investment than it would domestically, but also the foreign investment enables a corporation to reduce the tax payments on its existing domestic operations. In view of this tax deductibility of interest on money borrowed domestically for the purposes of investment internationally, the level of interest rates in both home and host countries may also become a determinant of foreign investment decisions. In this regard, inflation rates may play a role, raising interest rates, and thereby impacting the tax-related attractiveness of the foreign investment. Inflation in a foreign country could increase profits earned by the foreign affiliate, but the higher profit levels may not incur a proportionally greater tax if a tax haven is used.

The existence of tax havens enables a corporation to delay incremental tax payments indefinitely, regardless of the home-country tax legislation, simply by accumulating returns to capital within the tax haven subsidiary and continually reinvesting in active businesses. Payment of dividends to the parent corporation raises another problem for the home country: Whether, and at what rate, to tax dividends paid by the tax haven corporate entity to the home-country corporation? In general, if a corporation paid
tax at the full corporate rate and if the shareholder receiving the dividends also paid tax at the full personal rate, then double taxation would result. Many countries provide for a reduced level of taxation on dividends in order to avoid this double taxation, and many countries allow dividends to be paid to the home-country parent on a tax-free basis.

Some countries do attempt to impose taxes on dividends received from active foreign-owned business income in order to deal with this dilemma. Dividends can be taxed on entering the country, with a credit given for the amount of foreign taxes actually paid by the foreign affiliate. In certain situations, it may be possible for a corporation to avoid such taxes simply by accumulating returns to capital within the tax haven entity and reinvesting them from that entity. In addition, there are planning techniques that a corporation can use to disguise such distributions to its home-country parent. As the simplest manoeuvre, the foreign affiliate may be able to distribute money to the home-country parent in the form of a loan. Beyond this there are more complex schemes of converting what would otherwise be “taxable surplus” in the foreign affiliate into “tax exempt surplus.” The tax considerations discussed above may also tempt corporations to alter their reporting practices so as to shift profits from their home country to foreign affiliates, and thence to a tax haven. Once again, the attractiveness of tax havens is not simply to achieve a higher after-tax rate of return on foreign investment compared with domestic investment, but also to reduce or eliminate taxable income on existing operations in the home country.

The more onerous the approach which a country takes to the taxation of foreign-source income, the greater the probability that its corporations will seek to relocate to other countries. To counteract this, countries may enact domestic legislation to make it costly to migrate. For example, Canada deems a disposition of a corporation’s assets at fair market value if the corporation migrates. This can result in a significant Canadian tax liability. While this may constrain the corporation, the shareholders of the corporation could simply create a foreign corporation in a more desirable country to conduct future expansion plans. Consequently, it is only through the establishment of international taxation norms that tax havens would lose their power to influence international capital flows. However, the enforcement of appropriate norms would be extremely difficult.

In order to reduce or eliminate the role of tax havens, some have proposed that corporate income taxes should be imposed on the basis of a hypothetical profit allocation in accordance with the percentage of the corporation’s global sales that occurs within each jurisdiction. Assuming the practical problems of consolidation of foreign investments can be overcome, this policy could alter the tax incidence for established investments; however, it would not eliminate the role of tax havens as a determinant of international investment so long as some jurisdictions did not impose this kind of hypothetical profit allocation. In view of the limited scope for individual country action in this regard, international negotiations to establish a “level playing field” should be considered. Without unanimous international action, tax havens can distort tax incidence and corporate location decisions. As a result of current tax policy differences among jurisdictions, corporations are discouraged from paying taxes in their home country as well as their host country. Furthermore, administrative and compliance costs in the use of tax havens impact both tax authorities and taxpayers.

Moreover, the question arises as to whether a corporation should enjoy the benefits provided by host governments without paying an equitable share of income taxes to those governments. For host governments, there are tax policies that can be used to limit the loss of corporate tax revenue. In particular, rules can establish a ceiling on debt-equity ratios for tax purposes, so that a corporation cannot reduce its taxable profit to zero by shifting all of its profit to a tax haven as interest on debt. These rules against “thin capitalization” of resident companies...
by non-residents may act as a safeguard. However, success in increasing tax revenue may come at the cost of losing foreign direct investment to other countries that lack such rules.

A substantial body of literature in economics has analyzed the impact of tax differences between two countries. Much has been written comparing the US and Canadian tax systems from this perspective (Block and Walker 1984; Slemrod 1990; Shoven and Whalley 1992; Mintz and Whalley 1989; Maslove 1995; Boskin and McLure 1990). A central theme of much of this literature is that the increasing internationalization of investment will lead to a harmonization of tax rates and tax provisions in order to prevent international investment from being determined by differences in these rates and provisions. However, this literature fails to incorporate the tax haven concept, and the possibility that capital flows between two countries may be diverted through a third country in order to gain tax advantages. The inevitability of a trend toward harmonization must be questioned so long as existing provisions that permit tax haven usage are continued. For example, much has been written about the need for the federal and provincial governments of Canada to harmonize their tax rates with those of the federal and state governments of the United States in order to make Canada equally attractive to investors. However, this need to harmonize Canadian and US taxes may not be so important as long as tax havens can be used to minimize taxes paid by US corporations on revenue from investment in Canada, and vice versa.

If corporate tax differentials continue, it could be argued that governments should rely to a greater degree on benefit taxation rather than corporate income taxation. A wide variety of taxes can be targeted specifically at the benefits that corporate activities receive from the host-country government, and these taxes cannot be avoided by the use of tax havens. However, as Flip de Kam and Steven Clark have indicated, this prospect may not be desirable:

Increasingly, countries that set relatively high tax rates on capital income run the risk of seeing a growing part of their revenue base evaporate as firms and private investors shift profit and other investment income to low-tax jurisdictions. As the income tax base becomes more mobile, governments may be forced to rely more heavily on taxes imposed on labor, consumption, and nonmobile activities to finance public outlays. These developments tend to make tax systems less equitable and may introduce further tax-induced distortions (de Kam and Clark 1998, p. 936).

A country as economically dominant as the United States may attempt to develop certain elements of its foreign tax regime independently (Brean, Bird and Krauss 1991). The United States has implemented a number of initiatives that have significantly eroded the ability of foreign companies to use foreign tax reduction planning techniques, including the use of tax haven entities, for investment flows into the United States. These initiatives have included debt-equity recharacterization rules, anti-conduit rules, and limitation of benefits provisions which have now been included in the majority of the tax treaties that the United States has concluded.

**The Mechanics of Using a Tax Haven**

At the present time, many countries have established tax treaties, but these do not remove the dilemma discussed above. Some countries have a level of corporate income tax that is much lower than others, while some tax havens have a corporate income tax rate that often is close to zero. Countries that could be considered tax havens or have structures that permit tax havens within them include Antigua, Barbados, Cyprus, Dominica, Ireland, Israel, Malta, Montserrat, Netherlands, Portugal, Singapore, St. Kitts, St. Lucia, St. Vincent, and Switzerland.

For a corporation to take advantage of a tax haven effectively, it must find a means to shift profits
to a company that is resident in the tax haven without incurring significant transaction costs.

It would then be possible to repatriate the after-tax profits to some home countries with little if any additional tax. Canadian income tax law, for example, provides rules that permit this shifting in the case of active business income. The rules provide that active business income earned by a foreign affiliate in a country with which Canada has a tax treaty is only subject to tax in the foreign country. When these profits are repatriated as a dividend, no Canadian income tax is imposed. A foreign affiliate is a corporation, not resident in Canada, in which the Canadian resident, along with related entities, owns not less than 10 percent of any class of issued shares of the non-resident corporation. Indirect ownership is considered in this determination as well. “Active business income,” as defined under Canadian domestic tax law, is a technical term which is beyond the scope of this paper. Suffice it to say that it includes the operating income of most types of businesses other than investment businesses. It also includes interest income received from a related foreign affiliate providing the income was deductible from the active business income of the debtor. This characterization of interest income is the foundation for the following illustrations.

There are a number of alternative means of increasing after-tax returns in the foreign arena. Two structures are described below. The first, a double-dip financing structure, takes advantage of deducting interest for income tax purposes in two different countries. In the second structure, the objective is to reduce withholding taxes imposed on the repatriation of dividends. This is a key planning point when the home country, such as Canada, operates an exemption rather than a credit system for repatriated dividends.

Consider a profitable Canadian corporation that wants to set up an active business in a foreign treaty country that has a normal to high corporate tax rate (Figure 1). By borrowing in Canada to make an equity investment, the Canadian corporation is able to deduct the interest expense. The bulk of the borrowed funds will be invested in the equity of a low-tax company established in a country with which Canada has a treaty. This company can then lend

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**Figure 1**

**Double-Dip Financing**

[Diagram of the double-dip financing structure is shown.]

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these funds to the foreign operating company that
is resident in a jurisdiction with higher income tax
rates, and with which Canada has a tax treaty. The
interest will be deductible in the high-tax country
and taxed in the low-tax country, resulting in a gain
to the extent of the difference in tax rates multiplied
by the interest expense. Because the interest income
was deductible against the active business income
of the foreign operating company, the after-tax in-
come of the foreign financing company can flow
back to Canada tax-free as a dividend.

Because Canada does not tax dividends arising
from exempt surplus, there is no relief or tax credit
provided for any withholding taxes paid to the for-
eign country when dividends are paid. As Lanthier
and Tobin have explained, and as the figure below
illustrates (Figure 2), the use of a Netherlands hold-
ing company can provide withholding tax savings
on earnings in other countries like Belgium, Ger-
many, and Italy (Lanthier and Tobin 1996). In the
initial structure, withholding taxes are applicable at
rates of up to 15 percent on dividends from Bel-
gium and Germany. By restructuring the ownership
of the foreign business entities so that the Nether-
lands entity owns the three other European entities,
the withholding taxes are reduced to 5 percent.

To reduce a company’s ability to transfer profits
to low-tax countries, Canada and most industrial-
ized nations have enacted withholding taxes on vari-
ous payments to foreign entities. Section 212 of the
Canadian Income Tax Act sets the Canadian with-
holding tax rate at 25 percent unless reduced by a
treaty. Because Canada has treaties with most of its
important trading countries, the 25 percent rate is
the exception rather than the rule. For example, in-
terest payments made by a Canadian company to a
US parent corporation, or vice versa, may have a 10
percent withholding tax imposed. If the interest pay-
ment is to or from a UK corporation, the withholding
tax is also 10 percent. Any withholding tax

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**Figure 2**
Minimizing Withholding Taxes

![Diagram showing before and after restructuring of ownership to minimize withholding taxes](image-url)

**Before**
- Canada
  - Belgium: 15% W/H
  - Netherlands: 5% W/H
  - Germany: 15% W/H
  - Italy: 15% W/H

**After**
- Canada
  - Netherlands: 5% W/H
- Netherlands
  - Belgium: 0% W/H
  - Germany: 0% W/H
  - Italy: 0% W/H
withheld, not exceeding 25 percent, is generally creditable against the taxes due by the corporate recipient of the interest.

The imposition of withholding taxes on payments to non-residents is not limited to interest. Section 212 of the Act provides for withholding tax on several types of payments including interest, royalties, and rents. The common element of these payments is that they shift taxable income from one country to another. In a non-arm’s length situation, this shift in income could be quite arbitrary. While dividends are generally paid out of after-tax profits, it is still common for countries to impose a withholding tax on these payments.2

The objective of the tax planner is to find that combination of income tax and withholding tax that, along with transaction costs, results in the highest after-tax return on the funds invested. If international tax treaties are revised, the investment route of choice may simply be changed, as tax planners look for the new best financial route. An indirect method that may limit a foreign company’s ability to extract profits from the home country without paying a “reasonable” amount of tax is the “thin capitalization rule.” These rules restrict the amount of interest that a corporation may deduct on debt owing to certain non-resident investors. In Canada, according to subsection 18(4) of the Income Tax Act, if debt due to specified non-resident shareholders is greater than three times the total of the share capital and retained earnings owned by the specified non-resident, the interest payable to these non-residents on any excess debt is not deductible. A specified shareholder is a non-resident who either alone or with non-arm’s length persons owns at least 25 percent of the votes or 25 percent of the fair market value of all outstanding stock. This rule encourages foreign companies to invest at least one dollar of equity for every three dollars of debt invested in a Canadian company. While restrictions of a similar nature are found throughout the world, they only limit the possible gains from use of tax havens — they do not eliminate them.

**Canadian Taxation of International Investment Income**

This section discusses the Canadian tax treatment when a Canadian corporation sets up an international business operation. The discussion is based on the assumption that the foreign operation will generate active business income and that the operation is controlled by the Canadian corporation. If the foreign business operation is structured as a branch operation, then any income or loss will be reflected in the Canadian company’s tax return in the year it is earned. The Canadian company will be entitled to a foreign tax credit for any income tax paid to the foreign tax authority by the branch.

By selecting the corporate form to undertake the investment, a Canadian corporation has the opportunity to defer any Canadian tax until profits are repatriated in the form of dividends. A dividend received from a foreign affiliate is included in taxable income; however, a tax deduction may be available depending on whether the dividend is considered to be paid out of (i) exempt surplus, (ii) taxable surplus, or (iii) pre-acquisition surplus.

**Exempt Surplus**

When a dividend is paid from a foreign affiliate’s exempt surplus, the Canadian corporation is entitled to deduct the full dividend. No consideration is given to the amount of income tax or withholding tax the income has been subjected to in the foreign tax jurisdiction. As a result, foreign tax planning is particularly significant in the context of exempt surplus, as no further tax will be exacted by the home country when dividends are paid to it. Exempt surplus is primarily composed of active business income earned by a foreign affiliate in a designated treaty country. A designated treaty country is a country with which Canada has negotiated a tax treaty.

**Taxable Surplus**

A dividend distributed out of the taxable surplus of a foreign affiliate results in a tax deduction based on the amount of foreign income tax that has been
paid by the foreign affiliate and any withholding tax. The deduction is limited to the dollar amount of the dividend received. If no foreign tax or withholding tax has been paid, then there is no deduction and the dividend is fully taxable in Canada. A foreign affiliate’s taxable surplus is composed of net after-tax income earned in a country with which Canada does not have a treaty. It also includes dividends received from the taxable surplus of another foreign affiliate and certain types of capital gains.

Pre-Acquisition Surplus
A dividend that is not considered to be paid out of exempt surplus or taxable surplus is deemed to be paid from pre-acquisition surplus. Such a dividend is fully deductible for tax purposes, but results in a reduction of the adjusted cost base of the investment in the foreign affiliate. Because a capital gain is computed as the difference between the proceeds of disposition and the adjusted cost base, the reduction gives rise to an increase in the capital gain when the shares of the foreign affiliate are sold.

Order of Dividends
Ordering rules that determine the surplus category from which a dividend is deemed to be paid indicate that a dividend is deemed to be paid out of exempt surplus to the extent that any is available in the foreign affiliate. If the dividend is greater than the amount of exempt surplus, the balance of the dividend is deemed to be paid out of taxable surplus to the extent that any exists. If the dividend exceeds both the amount of exempt surplus and the amount of taxable surplus, the balance of the dividend is deemed to be paid out of pre-acquisition surplus.

Estimating the Use of Tax Havens
In 1992, the Office of Canada’s Auditor General conducted a study on the use of tax havens by Canadian companies. The Auditor General concluded that “significant amounts of tax revenue are at risk.” The report reads:

We analyzed National Revenue — Taxation’s 1990 information return (T106) database. We found that at that time Canadian corporate taxpayers had “invested” $92 billion ($42 billion in loans and $50 billion in equity) in non-resident companies that they were not dealing with at arm’s length and, in 1990, they had received over $4.2 billion in dividends from them (Canada. Auditor General 1992, p. 50).

According to the study, of this total amount of $92 billion:

$5.2 billion was “invested” in companies in Barbados, a tax haven. In 1990 Canadian companies received over $400 million in dividends from companies in Barbados. Active business income earned in Barbados can enter Canada tax free. This income carries federal and provincial tax credits on dividends paid out to Canadian shareholders ...

$10.9 billion was “invested” in companies in Cyprus, Ireland, Liberia, the Netherlands, and Switzerland, all considered tax havens. In 1990 Canadian companies received over $200 million in dividends from companies in these countries. Active business income earned in these countries can enter Canada tax free. This income carries federal and provincial tax credits on dividends paid out to Canadian shareholders ...

The information returns do not indicate the full extent of the financial activity between parties in Canada and in foreign states. They disclose only transactions that are technically defined as not arm’s length. For example, a Canadian company that has a 50 per cent interest in a company resident in a designated tax haven country and that, in 1990, received over $17.5 million in dividends from the non-resident, was not required to file the T106 information return (ibid.).

These calculations suggest that as of 1990 at least 18 percent of the international investment by
Canadian corporations was invested in tax havens. It is important to note that this $16.1 billion was the amount of the initial investment. With the passage of time, returns to this capital would have accumulated in the tax havens, so that the current values might exceed $16.1 billion. In terms of the volume of dividends received from tax haven affiliates, it is also important to note, as indicated above, that various planning techniques can be used to transfer money to the home-country parent apart from dividends.

In the United States, the stock of foreign-owned financial assets, as of 1995, has been estimated as $1,176.9 billion. Of this amount, $243.4 billion was from the British West Indies. It is reasonable to assume that most or all of the British West Indies investment in the US was tax haven capital. Of course, additional amounts were invested through tax havens other than the British West Indies. This suggests that more than 20 percent of foreign investment in the United States has been invested through tax havens.

**Reporting Requirements**

An additional issue that also deserves consideration is whether corporations should be obligated to report publicly their usage of tax havens, so that shareholders may be aware of their practices. The corporate reporting practices generally required by most governments and accounting standard-setting bodies do not provide information concerning the corporation’s use of a tax haven. Yet, the use of a tax haven may expose shareholders to risks concerning future changes in government tax policies in the tax haven. The reconciliation of statutory and effective income tax rates which are included as part of an annual report generally gives the reader little indication as to the reason why foreign income is being taxed at a lower rate than the statutory rate of the home country. As a result, the reader may have difficulty in determining the adverse impact on earnings per share that might result from changes in tax policy involving the use of tax havens, or of the adverse impact on shareholder value if a tax-planning arrangement is successfully challenged by the revenue authorities, and if the financial statements do not include adequate reserves for the risk of disallowed deductions (as well as interest and possibly penalties). For example, on 1 July 1998, the United States Tax Court announced a decision that reduced the market value of Laidlaw shares (Laidlaw Inc. 1998, pp. 6, 53).

In view of such situations, it could be argued that corporations should be required to provide shareholders with information about tax haven usage. These perspectives support the advocacy of international negotiations to establish common reporting practices and to provide consistent guidelines for management decisions.

**Conclusion**

Tax havens should command increasing attention from policymakers due to the impacts they may have on investment decisions; and also due to the inequities among corporations that result from the use of tax havens by some but not others. By changing certain tax provisions, Canada could reduce the generosity of its regime for the taxation of international outbound investment. This, however, would place certain Canadian corporations at a competitive disadvantage compared with corporations domiciled in some other country. Consequently, there may be advantages in developing a coordinated set of tax regime changes among a number of countries. The distortions, inequities, and shareholder risk created by the use of tax havens cannot be resolved by a single jurisdiction acting on its own.

The OECD Committee of Fiscal Affairs has expressed its view that the problems addressed in its report on tax havens “are already posing challenges for governments and will become increasingly important. Therefore, there is a need both for immediate measures and for an ongoing process to
strengthen further internationally co-ordinated action in this area” (OECD 1998). As a member of the OECD, Canada must decide on what changes it should implement in view of tax haven usage by Canadian corporations investing abroad and by foreign corporations investing in Canada; what immediate measures it should support in the international arena; and what process it should advocate to achieve internationally coordinated action in the future.

In summary, countries should consider the following policy reforms:

• Deny the deductibility of interest on funds borrowed to make foreign investments. The denied interest could later be deducted when taxable foreign profits are repatriated.

• Impose “thin capitalization” rules which limit the amount of capital that a corporation can treat as debt, deducting interest from profit for the calculation of tax.

• Shift tax structures away from corporate income taxation and toward taxation more directly linked to the benefits received by corporations, and toward the taxation of less mobile factors of production.

• Impose restrictions on the degree to which foreign income can be repatriated with taxation at less than domestic rates.

• Agree to impose similar corporate income tax rates and tax provisions.

• Impose reporting requirements on the use of tax havens for corporations listed on their stock exchanges.

• Impose corporate taxes on the basis of the percentage of a corporation’s global sales occurring within each country.

NOTES

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1 Note that much of the economics and business literature in regard to the determinants of international investment focuses on “real” determinants and ignores tax determinants. Even where tax differentials are discussed as a determinant of international investment, the economics and business literature does not include the tax haven issues discussed in this paper.

2 Some countries follow the “imputation” method, whereby dividends paid out of previously-taxed income are not subject to withholding tax, while dividends out of untaxed income bear the full corporate income tax rate. Canada also imposes a withholding tax on dividend payments to non-resident shareholders. The rate is 5 percent on payments to a US parent from a Canadian subsidiary and vice versa. The rate is increased to 15 percent if the Canadian company does not own at least 10 percent of the voting shares. Because dividends are not deductible for tax purposes, the purpose of the tax cannot be the reduction of tax arbitrage. Rather, it is designed to encourage reinvestment of corporate profits in the host country and to ensure that the host country collects some tax at the shareholders level.

3 On July 1, the company received an opinion from the United States Tax Court to the effect that certain advances from a Laidlaw-related foreign entity, based in the Netherlands, during the tax years 1986, 1987, and 1998, were equity rather than debt and interest deductions claimed on these advances were disallowed. As a result, tax of approximately $46.2 million, together with interest of approximately $88.8 million to August 31, 1998, would be payable. Similar claims have been asserted with respect to the consolidated federal income tax returns for the fiscal years ended August 31, 1989, 1990, and 1991. A petition has been filed with the United States Tax Court with respect to these years.... The income taxes at issue for these years is approximately $143.5 million (plus interest of approximately $156.7 million as of August 31, 1998).... In September 1998, the subsidiaries received a Thirty Day Letter proposing that the subsidiaries pay additional taxes of approximately $96.0 million (plus interest of approximately $51.2 million as of August 31, 1998) relating to disallowed deductions in federal income tax returns for the fiscal years ended August 31, 1992, 1993, and 1994 based on the same issues.”
REFERENCES


