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Backgrounder

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Withholding Taxes on Income Paid to Nonresidents: Removing a Canadian-US Border Irritant

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Currently, Canada and the United States each apply withholding taxes on income paid to investors from the other country. Such taxes act as a tariff on crossborder investments. Although withholding taxes provide revenues to each government, the taxes significantly deter investment and reduce the income earned in both countries. I estimate that, for Canada, the increased income earned from new capital expenditures and employment would more than offset the small loss in government revenues, especially in the case of the withholding tax on interest. From Canada's perspective, the bilateral elimination of withholding taxes would substantially improve the efficiency of capital markets, attract foreign direct investment to the country, and help Canadians penetrate the North American market on a more competitive basis.

Recently, Canadian federal and provincial governments have taken steps to make Canada more attractive for foreign investment. For example, they are planning, by 2005, to have lowered general federal-provincial corporate income tax rates from an average of 43 percent to 32 percent, well below the combined US federal and state average rate of 39 percent. However, other significant taxes continue to inhibit businesses from locating in Canada to serve the North American market.

An important irritant is the regime of withholding taxes on income that Canadian companies pay to foreign investors. Although Canada could unilaterally eliminate its withholding taxes (as it has the interest withholding tax

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on long-term indebtedness), such unilateral action forestalls opportunities to reduce or eliminate withholding taxes other countries charge on income received by Canadians, inhibiting their ability to expand globally. Thus, withholding taxes, which are subject to treaty negotiations, are often reduced or eliminated on a bilateral basis.

In order to attract investment or improve the integration of markets in free trade areas, many countries are eliminating withholding taxes on income paid to nonresidents. During the past decade, as part of an effort to improve the free flow of capital, member countries of the European Union have reduced or eliminated certain withholding taxes on crossborder transactions among them. Many Latin American countries, including Brazil and Argentina, have been eliminating withholding taxes in order to attract foreign investment. The United States already has a nil rate of withholding tax on interest from most European countries, and recent discussions between the United States and the United Kingdom have centered on the possibility of eliminating withholding taxes on dividends.

Current bilateral tax-treaty negotiations between Canada and the United States provide an opportunity to assess whether withholding taxes on Canadian-US crossborder investments create more or less economic cost than the revenues that accrue to each economy. For Canada, the matter is a critical policy issue since border irritants with little economic value can limit the ability of Canadians to penetrate US markets.

Eliminating withholding taxes on income would increase capital invested in Canada by about $28 billion.

This *Backgrounder* considers the economic and revenue impacts of the bilateral elimination by Canada and the United States of withholding taxes on income. I estimate that such a change would yield an increase in capital invested in Canada by about $28 billion.[1] One result would be a gain in income to Canadians of almost $7.5 billion, an amount more than four times the estimated revenue loss of $1.8 billion. Even if the change were limited to eliminating only the withholding tax on interest, Canadians would gain almost $5.3 billion in annual earnings (derived from new capital investment) and lose little revenue.

Moreover, the elimination of withholding taxes would create a better climate for businesses to locate in Canada to serve the large US market, rather than to locate in the United States and serve the smaller Canadian market.

Background

Canadian and US crossborder financial transactions are large, providing considerable income to investors on both sides of the border. Canadian investment income from the United States in 1999 was about US$10.1 billion, of which Canadians derived 63 percent from portfolio income (primarily interest income) and the remainder from direct investment.[2] US investors

1 All monetary amounts herein are in Canadian dollars unless otherwise specified.

2 Direct investment is equal to the value of an investor’s interest in a foreign entity when there is at least a minimum (10 percent) threshold of ownership. Portfolio investment is for other claims when ownership is below the threshold.

Table 1: *Withheld Tax Revenues on Canadian-US Crossborder Payments*

	Total	On Interest	On Dividends and Other
	(millions of dollars)		
	Canadian Withholding Taxes on Payments to Americans		
1994	1,167	122	1,145
1995	1,279	140	1,139
1996	1,845	142	1,730
1997	2,003	167	1,836
1998	1,721	n.a.	n.a.
1999	1,975	n.a.	n.a.
	US Withholding Taxes on Payments to Canadians		
1994	163	33	130
1995	233	49	284
1996	406	94	312
1997	344	98	246
1998	250	52	198
1999	n.a.	n.a.	n.a.

n.a.: Not available.

Source: Data from PriceWaterhouseCoopers, with US figures converted to Canadian dollars.

received US$18.9 billion of investment income from Canada in 1999, of which about half was derived from portfolio investments, primarily interest income (see PriceWaterhouseCoopers 1999).

Withholding Taxes

Dividend and interest income accounts for most income subject to withholding tax both countries. In 1999, Canada collected$2 billion from withholding taxes on US residents, while in 1998 (the latest year for which data are available) the United States collected about $250 million.[3] As shown in Table 1, the revenue from the interest withholding tax is a small proportion of total withholding tax receipts, even though interest is by far the more important income flow between the two countries. The low amount of withholding tax collected on interest results from the significant exemptions both countries provide. Canada's domestic law establishes the general rate of withholding tax, which is 25 percent on dividends, interest, royalties, and other payments, except copyright royalties and interest on government debt and arm's-length, long-term debt obligations that are exempt from withholding tax. The United States, under its domestic law, levies withholding tax at a 30 percent rate but provides a broad exemption for portfolio interest paid to nonresidents. (*Portfolio debt* is similar to arm's-length debt in concept.)

Like many bilateral tax treaties, the Canada-US Tax Treaty lowers withholding tax rates. Canada levies a 15 percent withholding rate on dividends paid to US residents and reduces that rate to 5 percent when the US recipient has a minimum 10 percent of the voting shares in the Canadian company.[4] Canada also levies a 10 percent withholding tax on interest payments on arm's-length indebtedness (generally less than five years) and on non-arm's-length indebtedness (such as borrowing by a Canadian subsidiary from a US parent).

The current withholding tax on dividends received by Canadians is 15 percent but it is reduced to 5 percent when the recipient has a sufficient

3 US numbers are based on information supplied by PriceWaterhouseCoopers, using data provided by the US Internal Revenue Service. Canadian numbers are based on Statistics Canada (2000).

4 A 10 percent withholding rate applies on qualifying dividends paid from Canadian nonresident-owned (NRO) companies to US recipients. However, Canada is phasing out NROs as a special entity.

share of ownership in the US corporation. The United States applies a 10 percent withholding tax on interest paid to a Canadian.

Tax Crediting

Tax crediting is an essential concept in the way withholding taxes affect investment.

Tax crediting is an essential concept in the way withholding taxes affect investment. Canadian governments allow resident taxpayers to credit foreign withholding taxes against their Canadian income tax to avoid double taxation. Also, corporations may credit foreign corporate income taxes against their Canadian tax although Canada levies no tax on foreign affiliate dividends. Most dividends remitted to Canadians from the United States are from the active business income of US foreign affiliates and, therefore, are exempt from Canadian tax. Foreign interest income received by a Canadian taxpayer is fully taxed, with a credit given for withholding taxes.

The United States taxes foreign-source income, including dividends and interest, earned by its citizens and US corporations. Thus, Canadian withholding taxes and corporate income taxes (the latter deemed to be paid on dividends) are credited against US tax.

US tax is assessed on a global basis, meaning that income and foreign tax credits are aggregated across all countries.[5] One implication of this rule is that Canadian tax may be less than US tax but still not credited against it if other sources of income earned by the US parent are highly taxed.

To see how tax crediting operates, consider two cases in which Canadian taxes may or may not be credited against US taxes.

First, assume a Canadian company earns $100.00 in profit[6] and pays corporate income taxes equal to 30 percent. This leaves $70.00 that can be distributed as a dividend. Under the US-Canada treaty, the withholding tax levied on dividends is 5 percent, or $3.50. Thus, the dividend distribution after payment of the Canadian withholding tax is $66.50. Total Canadian tax is therefore $33.50 ($30.00 + $3.50). Assume that the US parent pays corporate income tax at the rate of 35 percent. The US tax on dividends remitted to the US parent, grossed up by Canadian corporate and withholding taxes, equals $35.00. The US tax owing on income earned in Canada is $35.00 net of $33.50, or $1.50. In this case, all of the Canadian tax is credited against US taxes.

Now consider a case in which withholding taxes are not fully credited. Suppose a Canadian subsidiary pays $100.00 as interest on a loan from a US parent. The Canadian withholding tax on interest payments is 10 percent, yielding $10.00 payable to the Canadian government. To finance the loan to the Canadian subsidiary, the US parent incurs $95.00 in interest expenses, providing net income of $5.00 (a not unusual spread between lending and borrowing rates on financial transactions). The US parent pays corporate

5 US rules restrict crediting of taxes within “baskets.” The general basket provides the most relief; there are restrictions for other sources of income, such as interest from high-withholding -tax countries (when withholding tax rates are more than 5 percent).

6 For illustrative purposes here, I ignore various differences in the definition of profits under US and Canadian law.

income tax, before the credit for the Canadian withholding tax, at 35 percent on $5.00 of income, or $1.75.[7] Given that the Canadian withholding tax of $10.00 is more than the US corporate income tax, the firm pays no US corporate tax.[8] Overall, the US parent incurs a loss on its loan to the subsidiary equal to $5.00 ($100.00 – [$95.00 + $10.00]). Thus, to avoid incurring a loss, the parent needs to increase the interest rate it charges to the subsidiary. However, that rate, before withholding tax, may be above the rate charged by other, perhaps less favorable, sources of debt finance. This case illustrates an important problem when withholding taxes are applied to income before expenses. Such withholding taxes could ultimately raise the cost of finance for the Canadian borrower.

At present, about 36 percent of foreign earnings received by US parents is subject to foreign taxes that exceed of US tax liabilities.[9] Thus, a significant portion of Canadian taxes is not fully credited against US tax.

Economic Impact of Withholding Taxes

Canada levies withholding taxes to protect its revenue base and to gain tax revenues that would otherwise flow to another country's treasury.

The Canadian federal government levies withholding taxes for two purposes: to protect Canada's revenue base and to gain tax revenues that would otherwise flow to another country's treasury, although they result from activities that occur in Canada.

First, withholding taxes are thought to protect the revenue base since income paid to nonresidents may otherwise not be subject to Canadian tax. This consideration is especially important when the Canadian corporate income tax rate is above foreign tax rates and taxpayers are likely to try to shift interest and other expenses into Canada and income to other jurisdictions. However, now that Canadian federal and provincial corporate income tax rates are being reduced below US rates, taxpayers will have an incentive to shift income into Canada and expenses to the United States. Thus, in the Canadian-US context, it is now less important to impose withholding taxes for the explicit purpose of protecting Canada's tax base.

Second, withholding taxes may be credited against taxes levied by a foreign country on income earned in Canada. As illustrated above, when withholding taxes are fully credited against foreign income taxes, they represent a transfer of revenue from the foreign to the Canadian treasury; the taxpayer writes two cheques instead of one, but pays the same amount of tax. However, even with full crediting, complying with withholding tax regimes forces taxpayers to incur other costs, including the delay costs arising from credits being paid in the United States after the time the tax is withheld by Canada.

7 Other complexities, including thin-capitalization rules, interest allocation rules, and the US alternative minimum tax, could affect the degree to which taxes are credited.

8 The parent might be able to credit the Canadian withholding tax against US taxes on other sources of income.

9 Estimated by PriceWaterhouseCoopers (1999) from data provided by the US Internal Revenue Service.

Harmful Effects

Although withholding taxes are an attractive source of revenue for Canada, especially when fully credited, they have quite substantial harmful effects on the economy. These problems include:

Withholding taxes act as a tariff on cross-border portfolio capital flows.

- *Acting as a tariff on crossborder portfolio capital flows*. Withholding taxes can interfere with the free flow of capital across the Canadian-US border. In the absence of crediting, US withholding taxes discourage Canadians from investing in North American funds to improve the performance of their portfolios.[10] Similarly, without full crediting, US taxpayers would require higher returns on securities issued by Canadian borrowers. The withholding tax penalty on crossborder capital flows can therefore reduce foreign portfolio investments and opportunities for diversification by Canadians.
- *Deterring foreign direct investment*. Foreign direct investment results in the transfer of capital, managerial skills, and technology from foreign countries to Canada. Without full crediting, withholding taxes may reduce the business income foreign investors earn, thereby discouraging foreign direct investment. If, as a result of non-credited withholding taxes, the return on Canadian investments is less than what can be earned abroad, foreign investors are likely to take their capital to countries that offer greater after-tax profits. With less foreign savings, capital investment in Canada declines, thereby reducing the earnings of working Canadians. Further, US withholding taxes on payments to Canadians discourage Canadian businesses from investing south of the border, resulting in greater concentration of activities at home or in other countries with more favorable tax regimes.
- *Impairing the North American efficiency of Canadian-based multinationals*. Withholding taxes interfere with the operations of a company located in both Canada and the United States. Given the integration of North American markets, businesses may operate in several states and provinces with different branches and subsidiaries. Since withholding taxes apply only at the Canadian-US border, their presence can harm the efficiency of North American operations by discouraging certain forms of transactions internal to the company. For example, it is easier to shift financial resources to a California branch from Massachusetts than from Ontario. Thus, Canadian-US withholding taxes ultimately make it disadvantageous for businesses to locate operations in Canada.

From Canada's perspective, the economic cost of withholding taxes is that they inhibit the efficiency of its capital market, US foreign direct investment in Canada, and the efficiency and competitiveness of Canadian-based

10 There is a similar argument about the limitation imposed on retirement savings plans that require investors to hold a maximum proportion of assets in foreign securities. The regulation has imposed substantial costs on investors who are unable to hold optimal portfolios that allow for greater returns with improved diversification (see, for example, Fried and Wirick 1999).

multinationals. The benefit of withholding taxes is that they shore up government revenues. A key element of any economic evaluation of withholding taxes is the degree to which they are credited. When fully credited, they have little impact on investment, except for compliance costs.

When fully credited, withholding taxes have little impact on investment, except for compliance costs.

Overall Assessment

There have been relatively few economic studies of withholding taxes, especially in the Canadian-US context. Brean (1984) estimates that Canada's withholding tax on portfolio interest is effectively borne by the Canadian borrower. In other words, the interest withholding tax is shifted to the borrower, resulting in higher borrowing costs in Canada. Using a panel set of data from various countries and years, Eijffinger, Huizinga, and Lemmen (1996) estimate that, for government debt, about one-half of interest withholding tax is shifted forward to borrowers.

With respect to foreign direct investment, most economic studies incorporate the withholding tax as part of the cost of capital. Devereux and Freeman (1995), for example, estimate that the tax has little effect on the choice between foreign direct and domestic investment. However, with a better set of data from individual US and Canadian companies, Cummins (1996) suggests that a 10 percent increase in the Canadian cost of capital relative to the US cost would result in a 10 percent reduction in Canada's share of investment by US companies. Altshuler and Cummins (1997) also show that the impact of taxes on Canadian investment outbound to the United States is substantial. None of these studies separates the effect of dividend and interest withholding taxes from corporate income taxes in terms of their impact on investment.

The Investment Impact of Withholding Taxes

In this section, I assess the effects withholding taxes have on investment in Canada and Canadian government revenues.[11] To begin, I examined the impact of eliminating Canadian-US withholding taxes on investment in Canada. (Given data limitations, the analysis does not consider how Canadian-US withholding taxes affect the opportunities for Canadians to invest in US markets, which could give rise to other economic benefits to Canada.)[12]

Portfolio Investment

An important impact of withholding taxes on crossborder portfolio transactions is that they raise the cost of debt and equity financing. Canadian withholding

11 My analysis does not take into account all economic benefits that would arise from the elimination of withholding taxes, such as improved opportunities for portfolio diversification by Canadians and increased earnings from new US investments owned by Canadians. Nor does the analysis provide a measure of the economic loss arising from distortions caused by withholding taxes.

12 For this analysis, I drew on a model developed at the International Tax Program at the University of Toronto. See Chen (2000) for a description of the methodology.

Table 2: *Effective Tax Rate Reduction on Capital in Canada with Elimination of Canadian-US Withholding Taxes*

	Manufacturing, Ownership by		Nonmanufacturing, Ownership by		Total, Ownership by	
	US[a]	Other[b]	US[a]	Other[b]	US[a]	Other[b]
			(percent)			
Under current law	35.3	26.0	38.3	29.7	37.2	28.5
After elimination of interest withholding tax	35.0	24.7	38.4	28.4	36.8	27.2
After elimination of dividend withholding tax	29.5	26.0	32.8	29.7	31.3	28.5
After elimination of both	29.1	24.7	32.8	28.4	31.1	27.2

Note: Calculations assume planned federal and provincial corporate rate reductions have fully taken place by 2005. Estimates include capital taxes and sales taxes on capital imports. Manufacturing comprises 46 percent of US-owned and 32 percent of non-US-owned assets held in Canada.

[a] Only US-owned companies that are paying more foreign tax than US tax on foreign earnings worldwide.

[b] Non-US-owned companies, including those that are Canadian-owned.

Source: University of Toronto, International Tax Program.

taxes on portfolio income (interest and dividends) raise the cost of funds borrowed from US lenders, who require a higher return on their savings if they are to invest in Canadian, rather than US, securities. Most significantly, withholding taxes on arm's-length interest increase the cost of short-term borrowing for Canadian businesses since such taxes on gross interest, rather than on the lending margin, are not credited against foreign taxes.

The impact of a tax change depends on its *incidence* (who ultimately pays it?) Using the most conservative earlier studies, I assume that the cost of interest withholding taxes on US investors is evenly split between Canadian borrowers in short-term debt markets. Recall that a reduction in statutory tax rates affects the overall return to capital, changing the effective tax rates. To demonstrate the potential impact of withholding taxes on portfolio interest for Canadian borrowers, I estimated the effective tax rate on capital for manufacturing and nonmanufacturing industries using the corporate income tax rates that are scheduled to prevail in 2004).[13] The results (see Table 2) show that eliminating the withholding tax on interest from short-term, arm's-length investment in non-US-owned manufacturing and nonmanufacturing in Canada would push the combined effective tax rate down from 28.5 percent to 27.2 percent, or by 1.3 percentage points.

US Foreign Direct Investment

As already mentioned, withholding taxes on dividends and interest, when not fully credited, can deter US foreign direct investment. Assuming that

13 See Chen (2000) for an explanation of the effective tax rate on capital used in the analysis below. See also PriceWaterhouseCoopers (1999) for a detailed discussion of the model that I derived at an earlier time.

Table 3: *Impact on Canada's Capital Stock of Eliminating Canadian-US Withholding Taxes*

	Increase in Capital if Owned by Residents of		
	United States	Other[a]	Total
	(billions of dollars)		
Elimination of interest withholding tax	0.5	18.1	18.6
Elimination of dividend withholding tax	9.5	—	9.5
Elimination of both	10.0	18.1	28.1

[a] Including Canada.

Sources: PriceWaterhouseCoopers 1999; author's calculations.

uncredited dividend and interest withholding taxes are fully reflected in higher costs in Canada for US multinationals, the elimination of such taxes could lower the cost of capital and the effective tax rate on capital for US companies that cannot fully credit their Canadian taxes against US tax liabilities. If Ottawa eliminated both dividend and interest withholding taxes for US investors, the effective tax rate on US manufacturing and nonmanufacturing companies, without full crediting, would fall from 37.2 percent to 31.1 percent, or by 6.1 percentage points. This fairly steep reduction would be primarily related to the elimination of the withholding tax on dividends.[14]

An Empirical Estimate

The impact on investment in Canada arising from the elimination of the withholding taxes would be significant (see Table 3). My estimates are based on three assumptions:

- The stock of fixed assets and inventory held in Canada is about $1.2 trillion, of which US companies own approximately 20 percent.[15]
- Taxes affect the demand for capital by increasing the cost of capital, and Canadian businesses' long-run demand for capital stock increases at the same rate as the proportionate decline in the cost of capital.[16]
- Many US taxpayers who incur Canadian withholding taxes can credit them against their US tax liabilities. But withholding taxes on dividends and interest affects 36 percent of US investment in Canada due to the inability of US firms to credit them against US tax liabilities.
- There is no change in the financing of companies.

Eliminating the withholding taxes US investors pay on income received from Canada would increase Canada's capital stock by a total of $28.1 billion ($9.5 billion from the dividend withholding tax and $18.6 billion from the

14 US companies borrow little short-term debt so the elimination of the interest withholding tax on short-term, arm's-length debt would have little impact on US effective tax rates.

15 From Statistics Canada, *Fixed Capital Flows and Stocks*, CANSIM. US ownership based on information derived by the Technical Committee on Business Taxation (Canada 1998).

16 Thus, I assume that the demand elasticity for capital with respect to changes in the cost of capital is equal to one. This figure is the midrange of estimates of demand elasticities, which range from one-half to two. See Mintz (1995) for a review of studies.

Table 4: *Annual Revenue and Income Impacts of Eliminating Canadian-US Withholding Taxes*

	Interest	Dividends and Other	Total
		(billions of dollars)	
Static revenue effect	–0.1	–1.9	–2.0
Dynamic revenue effect	small	–1.8	–1.8
Annual income gain to Canadians	5.3	2.2	7.5

Source: Author's calculations.

interest withholding tax). The stock of US-owned capital in Canada would rise by $10 billion and non-US-owned capital stock by about $18.1 billion. Even though dividend withholding taxes are much larger amounts than interest withholding taxes, the relatively smaller impact of eliminating the former reflects the assumption that a significant portion of withholding taxes is credited against US tax liabilities.

Revenue and Income Impacts

The elimination of Canadian-US withholding taxes would thus give rise to substantial increases in investment in Canada. Would Canadian governments lose significant amounts of revenue? Even if they did, would Canadians earn offsetting capital and employment income derived from the greater capital investment?

Methodology

To estimate the annual revenue effects of eliminating withholding taxes, I undertook two calculations (see Table 4). The first was the "static" revenue impact of eliminating Canadian-US border withholding taxes, assuming no changes in investment or financial behavior. Updating values for 2001 by allowing for a 5 percent growth in potential withholding taxes (see Table 1), I estimated that the loss of revenue would equal $2.2 billion. However, the elimination of US withholding taxes would provide some offset. Since they can now be credited against Canadian taxes, their removal would increase Canadian revenues by an estimated $0.2 billion.[17]

My second estimate focuses on the "dynamic" effects on federal and provincial revenues. The elimination of federal withholding taxes would raise both federal and provincial corporate income and capital taxes from new capital investment. That increased investment could also lead to the hiring of more workers and more tax revenue from them, as well as increased personal income taxes on income derived from businesses owned by Canadians. Table 4 reports the dynamic revenue effect only with respect to federal corporate income and capital taxes, which were 0.78 percent of assets, and their provincial counterparts, which were 0.48 percent of assets, estimated for 2005.

I estimated the income Canadians would gain as follows. The increase in investment owned by Canadians from eliminating withholding taxes was

17 The primary effect on Canadian revenues from removing US withholding taxes paid by Canadian residents would largely result from exempting interest withholding taxes. I took the estimate of this effect from information provided by PriceWaterhouseCoopers, Washington, using data supplied by the Canada Customs and Revenue Agency.

multiplied by 7 percent,[18] the before-tax cost of capital.[19] (This increase in capital income would apply only to Canadian-owned investments, since foreign investors would derive the additional capital income from their Canadian investments.) Then, to estimate the gain in labor earnings resulting from new investment, I multiplied the increased capital income by 3.0, which is the ratio of labor to capital income (net of depreciation) for estimates of Canadian business value-added (Canada 1998). As a final step, I estimated the increased income Canadians would earn from the elimination of US withholding taxes and added this amount to the total gain.

Estimates

The static revenue effect of eliminating the interest withholding tax would be about $0.1 billion. However, given the growth of investment on corporate and capital taxes, the loss in revenue to Canadian governments would be almost negligible. Thus, eliminating the withholding tax on interest for US taxpayers would have no appreciable dynamic impact on revenue, but it would lead to $18.1 billion in new capital investment owned by Canadians (see Table 3). From this new investment and the elimination of $0.1 billion in US withholding taxes on interest, Canadian owners would earn $1.4 billion in annual capital income. With additional employment, workers would gain a further $3.9 billion from increased investment in Canada. In other words, Canada is shooting itself in the foot by maintaining the withholding tax on interest, lowering the income of Canadians at little revenue gain to governments.

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For dividend and other withholding taxes, the static loss in revenue for Ottawa would be about $1.9 billion. Given my estimate of the impact of new capital investment, the dynamic revenue loss would be about $1.8 billion. With an increase in capital stock of $9.5 billion (see Table 3) resulting in higher workers' income, Canadians would earn about $2.2 billion more annually after including the income gain of $0.2 billion from the elimination of US withholding taxes on dividends. Eliminating the withholding tax on dividends would thus result in a net annual gain of $0.4 billion.

Although that gain would be significant, it would not be as large as the result of eliminating the withholding tax on interest. Thus, if Ottawa were to take only an initial step in Canadian-US tax treaty negotiations, it should seek to eliminate the interest withholding tax.

Indeed, the Technical Committee on Business Taxation (Canada 1998) recommended the unilateral full elimination of the withholding tax on arm's-length interest. Following this recommendation would lead to a revenue loss for Ottawa somewhat larger than would result from bilateral change, but it would be small with profound effects on investment. One can also argue for

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18 Using the University of Toronto model, I estimated the risk-adjusted cost of capital at about 7 percent (net of depreciation).

19 Taxes are included since the revenue is spent on public services and transfers provided to Canadians.

the elimination of the withholding tax on interest on non-arm's-length transactions, although this should be done on a bilateral basis with the United States to maximize gains to Canada.

The elimination of the withholding tax on interest in general raises concerns about possible erosion of Canada's tax base if US businesses increase the indebtedness of their Canadian operations. However, given the proposed reduction in Canadian corporate income tax rates to below US rates, and the recent tightening of thin-capitalization rules that limit foreign businesses from increasing debt invested in Canadian subsidiaries, the interest withholding tax on both arm's-length and non-arm's-length transactions should play a smaller role than it does now. If a need to limit the indebtedness of Canadian subsidiaries remains, the thin-capitalization rules can effectively achieve this aim without resorting to withholding taxes that apply to all non-arm's-length transactions.

Efficiency Cost of Withholding Taxes

Reducing distortive taxes increases the economy's output and thus provides a gain in economic efficiency.

Reducing distortive taxes increases the economy's output and thus provides a gain in economic efficiency. To estimate Canada's efficiency gain from eliminating Canadian-US withholding taxes, we can use a simple model by assuming fixed competitive world prices for Canadian exports and imports of goods and services, a fixed supply of domestic savings, and that income in the hands of public and private sectors is of equal value. The efficiency gain then equals:

the additional capital and labor tax revenues from increased investment due to tax reductions
+ the value of US withholding taxes paid by Canadians
– the loss in Canadian withholding tax revenues paid by US residents.

This estimate requires a careful assessment of policy changes on all taxes governments collect. A very rough estimate, using a personal tax rate on labor income of 40 percent (inclusive of personal income, payroll, and sales taxes)[20] and a fixed proportion of capital to labor income (equal to 3.0), yields an economic efficiency gain of $1.1 billion arising from the elimination of Canadian-US withholding taxes. This analysis provides a conclusion consistent with the one described above, although I do not want to overstate its importance given the assumptions.

Conclusions

Commentators are discussing many Canadian-US border issues. This *Backgrounder* deals with one: Canadian-US withholding taxes on payments to nonresidents. The effect of eliminating Canadian and US withholding taxes (about $1.8 billion annually for Canada) would to lead to a substantial increase in capital invested in Canada of over $28 billion and an income gain of over $7.5 billion annually to Canadians.

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20 This is based on the University of Toronto model I am using in other forthcoming studies.

Given the significant returns to the Canadian economy from eliminating withholding taxes in the Canadian-US market, businesses would no longer face a critical competitive disadvantage in locating here. When it comes to moving capital from Canada to the United States, Canadian businesses would be as free to do so as would a Californian or New York entity operating within the United States. Given the potential of a relatively small revenue loss and significant gains in investment, there seems little justification to continue withholding taxes in the Canadian-US context.

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