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Current Tax Reading

Co-Editors: David Duff, Tim Edgar, Alan Macnaughton, and Amin Mawani*

Peter Harris, *Income Tax in Common Law Jurisdictions: From the Origins to 1820* (New York: Cambridge University Press, 2006), 514 pages, ISBN 0-521-87083-6

This book is the first of two instalments in a monumental project: tracing the historical origins and development of the income tax in about 60 countries whose income tax systems can be said to be based on the British system. The author is a tax academic in the Faculty of Law at Cambridge University, England. The first instalment of Harris's study examines the origins and early development of the income tax in Britain and some of its colonies to 1820; the second instalment will focus on the development of the income tax in Britain and British-influenced countries from 1820 to the present.

Scholars whose focus is the development of contemporary tax law and policy may be a bit taken aback by the historical scope of the book. Harris begins his study at the beginning of recorded British history, with the first chapter tracing what he sees as the origins of the British income tax from the feudal period through to 1642. The second chapter focuses on the period covering the English civil war and the restoration of the monarchy (1642-1688). Chapter three covers the period from the restoration through to the Seven Years War with France (1688-1763). Chapter four covers the period from the end of the Seven Years War to the eve of the introduction of the modern income tax (1763-1792). Chapter five covers the remaining period through to 1820, which includes the repeal of the first modern income tax in Britain in 1817 and the immediate impact of that event in the colonies over the next three years.

In going back to feudal England, Harris chooses to adopt a loose concept of an income tax. In fact, he traces the origins of the modern income tax to the use of various forms of wealth taxes and poll taxes. Harris's focus throughout is the development of taxation legislation, which he sees as trending toward increasingly prescriptive detail. He examines this process of development in relation to four contemporary

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conceptual issues: (1) the distinction between capital and revenue items; (2) the use of schedular reporting; (3) the treatment of corporations as separate taxable entities; and (4) the use of source and residence jurisdiction to tax.

Scholars of contemporary tax law and policy may find the promised second instalment of this ambitious project more immediately relevant to their work. Nonetheless, this first part of Harris's study is important as a contribution to the academic literature.

As an aside on a perhaps minor point, the title of the book is somewhat odd. Harris frames his study as the development of the income tax in common-law countries, even though taxation is not a common-law subject in the strict sense of law that is judicially made. All taxation law is ultimately statutory, so that any reference to the common law as a legal construct is entirely inaccurate. Harris presumably chose his title to distinguish Britain and British-influenced countries, with a common-law tradition in many areas of law, from those of continental Europe and their civil-law tradition, which codifies all law in one piece of legislation (the civil code). The historical relevance of this distinction in legal methodology is not especially clear in Harris's study. It may serve as a proxy for supposed differences in social and economic contexts that may have had an effect on the development of income tax legislation.[1]

T.E.

Stephen Barkoczy and Daniel Sandler, *Government Venture Capital Incentives: A Multi-Jurisdiction Comparative Analysis*, Australian Tax Research Foundation Research Study no. 46 (Sydney: ATRF, 2006), 230 pages, ISBN 978-0-9752067-8-2

Venture capital is a subject that has not received much attention in the tax policy literature, despite its significance in capital markets and the provision of a broad range of subsidies, including tax expenditures, for its development. An exception is Daniel Sandler's extensive comparative study of venture capital incentives in the United States and Canada,[2] on which portions of this book are based. Here, Barkoczy and Sandler present an important overview of venture capital incentives provided by governments in Australia, the United States, Canada, the United Kingdom, Singapore, Malaysia, and New Zealand. Surveys of the incentives in each of these

1 For a discussion of the possible relevance of the distinction between the common-law and civil-law traditions to the development of certain concepts in taxation law, see Victor Thuronyi, *Comparative Tax Law* (The Hague: Kluwer Law International, 2003), reviewed in this feature (2003) vol. 51, no. 6 *Canadian Tax Journal* 2357-70, at 2357-60.

2 Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Canadian Tax Paper no. 108 (Toronto: Canadian Tax Foundation, 2004).

countries are preceded by overviews of the concepts of venture capital and tax expenditures. The authors accept, without critical comment, the rationale for the delivery of some type or types of government incentive programs for venture capital. In particular, they assume, as most policy makers do, that there are market failures that cause an undersupply of venture capital to small and medium-sized enterprises. The book concludes with some general observations on the design features of particular incentive programs, including a critique of the structural features of various Australian programs.

T.E.

Richard Krever and David White, eds., ***GST in Retrospect and Prospect***
(Wellington: Brookers, 2007), 658 pages, ISBN 978-0-86472-589-9

This book consists of 24 papers and 6 commentaries presented at a conference in November 2006 in Wellington, New Zealand. The occasion for the conference was the 20th anniversary of the adoption of the goods and services tax (GST) by the New Zealand government as part of its revolutionary shift from a highly regulated market economy to one in which government now plays a minimal role. The New Zealand GST is seen by many tax experts as one of the most (if not the most) theoretically pure value-added taxes (VATs) in the world.

The book is organized in seven parts. The first part includes four papers presented by key government actors in the adoption of the New Zealand GST; the headliner is the Honourable Roger Douglas, who served as the finance minister responsible for the market reforms of the 1980s (often referred to as "Rogernomics"). The next six parts of the book are devoted to some of the more contentious issues in GST/VAT design: (1) interpreting GST law; (2) the treatment of financial services; (3) the treatment of real property; (4) the treatment of cross-border services; (5) revenue risks and responses; and (6) economic integration and GST/VAT design. In many of these areas, New Zealand policy makers continue to exercise influence as innovators, driven by a theoretical purity that is not seen in most other countries.

The concluding part of the book consists of a paper by Neil Brooks, "An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defence of the Income Tax." This paper is a tour de force by a tax academic who is well known in Canada and internationally; it alone makes the book worth the purchase price. Readers who are familiar with Brooks's body of work may be surprised by his qualified support of a mix of taxes that includes a GST/VAT and an income tax designed along the lines of the dual income tax systems in the Nordic countries. The hallmark of these systems is a flat rate of tax on capital income alongside a progressive rate structure on labour income, which imposes tax at marginal rates that exceed the flat rate. Although Brooks is known as a valiant defender of progressive rates on all forms of comprehensive income, he has come to grudgingly accept the case for a dual income tax, but not for the conventional reasons cited by policy makers and other tax academics.

T.E.

(2005) vol. 59, no. 2 *SMU Law Review* 435-915

Apparently as a result of the energy and initiative of Christopher Hanna, a tax academic at the Law School of Southern Methodist University, the SMU *Law Review* has occasionally devoted entire issues to articles on taxation law and policy.[3] Although generalist law reviews will often devote entire issues to other areas of law, particularly other public-law subjects, it is rare indeed that taxation is a chosen subject. There appear to be two reasons for this particular issue. One reason is the recent report of the President's Advisory Panel on Tax Reform, released in late 2005.[4] The other, arguably more compelling, reason (given the underwhelming nature of the advisory panel's report) is a celebration of the career of Charles Galvin, a distinguished tax academic who spent a large part of his career at SMU, including a long tenure as dean.[5]

All of the articles in this issue are written by US legal academics. The first 3 articles pay tribute to Charles Galvin. The other 13 articles have no common theme, other than the broad topic of tax reform. The authors and articles are as follows:

- Alice G. Abreu, "Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities"
- Reuven S. Avi-Yonah, "The Report of the President's Advisory Panel on Federal Tax Reform: A Critical Assessment and a Proposal"

3 "Incremental and Fundamental Tax Reform" (2003) vol. 56, no. 1 *SMU Law Review* 3-746, reviewed in this feature (2003) vol. 51, no. 4 *Canadian Tax Journal* 1744-56, at 1744-45; "Business Purpose, Economic Substance and Corporate Tax Shelters" (2001) vol. 54, no. 1 *SMU Law Review* 3-237, reviewed in this feature (2001) vol. 49, no. 4 *Canadian Tax Journal* 1087-98, at 1093; and "Symposium on Time, Tax and Money" (1999) vol. 52, no. 2 *SMU Law Review* 333-655, reviewed in this feature (1999) vol. 47, no. 6 *Canadian Tax Journal* 1573-85, at 1578-79.

4 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: President's Advisory Panel on Federal Tax Reform, November 2005), reviewed in this feature (2006) vol. 54, no. 1 *Canadian Tax Journal* 345-58, at 354-55.

5 Galvin may be best known to some readers for his contribution to one of the more famous debates in the tax literature. The subject of the debate, which took place in the pages of the *Harvard Law Review*, was the desirability of a comprehensive income tax base. The exchange among leading US tax academics was, in fact, prompted by the release in 1966 of Canada's *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) and Boris Bittker's subsequent critique of a comprehensive tax base: Boris I. Bittker, "A 'Comprehensive Tax Base' as a Goal of Tax Reform" (1967) vol. 80, no. 5 *Harvard Law Review* 925-85. Bittker's article, in turn, led to a series of arguments and counterarguments: see R.A. Musgrave, "In Defense of an Income Concept" (1967) vol. 81, no. 1 *Harvard Law Review* 44-62; Joseph A. Pechman, "Comprehensive Income Taxation: A Comment" (1967) vol. 81, no. 1 *Harvard Law Review* 63-67; Charles O. Galvin, "More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR" (1968) vol. 81, no. 5 *Harvard Law Review* 1016-31; and Boris I. Bittker, "Comprehensive Income Taxation: A Response" (1968) vol. 81, no. 5 *Harvard Law Review* 1032-43.

- Charlotte Crane, “Government Transfer Payments and Assistance: A Challenge for the Design of Broad-Based Taxes”
- J. Clifton Fleming Jr., “Replacing the Federal Income Tax with a Postpaid Consumption Tax: Preliminary Thoughts Regarding a Government Matching Program for Wealthy Investors and a New Policy Lens”
- Christopher H. Hanna, “The Magic in the Tax Legislative Process”
- Calvin H. Johnson, “Was It Lost? Personal Deductions Under Tax Reform”
- Michael S. Knoll, “The Section 83(B) Election for Restricted Stock: A Joint Tax Perspective”
- Lawrence Lokken, “Territorial Taxation: Why Some US Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)”
- Paul R. McDaniel, “The Charitable Contributions Deduction (Revisited)”
- Herwig J. Schlunk, “A Minimalist Approach to Corporate Income Taxation”
- Daniel N. Shaviro, “Welfare, Cash Grants, and Marginal Rates”
- William P. Streng, “US Tax Treaties: Trends, Issues, and Policies in 2006 and Beyond”
- Lawrence Zelenak, “The Sometimes-Taxation of the Return to Risk Bearing Under a Progressive Income Tax”

T.E.

Kenneth L. Sokoloff and Eric M. Zolt, “Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions”
(2006) vol. 59, no. 2 *Tax Law Review* 167-241

The authors of this article undertake a strikingly original and important inquiry: they examine “how inequality may influence the design and implementation of tax systems.”[6] The focus of their study is the development of tax institutions in the Americas (North America and Latin America).

Sokoloff and Zolt suggest that there is some evidence for a relationship between the extent of inequality and the types of tax and spending policies adopted by governments in the Americas. After providing a brief history of differences in inequality across the Americas around the time of European colonization, they trace certain trends over the 19th and 20th centuries in the development of fiscal institutions. These trends apparently suggest that greater socioeconomic inequality in Latin American countries is one factor in their weaker reliance on local government spending and progressive tax bases, compared to Canada and the United States. This suggestion challenges the conventional wisdom that technical administrative and compliance difficulties faced by developing countries are the cause of a greater reliance on regressive excise and sales taxes levied by strong central governments.

T.E.

6 At 167.

New Zealand, Inland Revenue, *New Zealand's International Tax Review: A Direction for Change: A Government Discussion Document*
(Wellington: Inland Revenue, Policy Advice Division, December 2006),
74 pages, ISBN 0-478-27149-2, available on the Web at
http://www.taxpolicy.ird.govt.nz

Edward D. Kleinbard, "Throw Territorial Taxation from the Train"
(2007) vol. 114, no. 5 *Tax Notes* 547-64

"Report of the Task Force on International Tax Reform"
(2006) vol. 59, no. 3 *The Tax Lawyer* 649-812

Mitchell A. Kane, "Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks" (2006) vol. 26, no. 1
Virginia Tax Review 53-79

The treatment of income from outbound foreign direct investment is one of the more contentious policy issues in many countries. From a broad perspective, there are two principal issues. One issue concerns the basic question of how to treat this income, given the prior taxing right of the source country. Here the choice is framed as one between a territorial system, under which the foreign-source income is exempt, and a worldwide system, under which the income is taxed by the country of residence of the investor either as earned or on repatriation, with a credit for source-country tax. The second issue is the allocation of interest expense of a resident investor against foreign-source income for deduction purposes. Canada has long used an exemption system, with interest allocation being a hot-button issue. In an entirely unexpected move, the recent 2007 federal budget included a proposal to deny the deduction of interest expense allocated to exempt foreign-source income.[7] In contrast, the United States has long used a worldwide system, with income from foreign direct investment taxed only on repatriation. A long-running policy debate has focused on the desirability of moving to an exemption system, with most advocates of such a system apparently assuming that an interest allocation rule for deduction purposes would be a necessary design feature. These issues are canvassed at both a theoretical and a practical level in the above four publications.

Among the member countries of the Organisation for Economic Co-operation and Development (OECD), New Zealand has stood alone since the early 1990s in its accrual taxation of income from outbound foreign direct investment. However, with the release of this discussion document from the Policy Advice Division of Inland Revenue, the New Zealand government has signalled a significant change in policy direction, which is apparently driven by perceived concerns about the competitiveness

7 Canada, Department of Finance, 2007 Budget, Budget Plan, Notice of Ways and Means Motion To Amend the Income Tax Act, March 19, 2007, resolutions 24-29.

of New Zealand-based multinational enterprises. The discussion document indicates that the current branch equivalent approach to the taxation of active business income from controlled foreign corporations will be replaced with an exemption system. Consistent with standard country practice, accrual recognition would be limited to investment income. A core chapter of the discussion document discusses implementation of the distinction between active and passive income, which this standard approach requires. There is also an important discussion in another chapter of the need for interest expense allocation rules and, in particular, an apparent preference for a formulary allocation approach along the lines of that used in Australia, rather than the tracing approach suggested in the Canadian government's March 2007 budget.

Going against the current of mainstream opinion in the private sector in the United States, the Kleinbard article is critical of proposals to move to an exemption system. Kleinbard highlights, in particular, the pressure that such an approach places on transfer pricing and interest allocation rules. As an alternative to an exemption system for income from foreign direct investment, he prefers accrual recognition of consolidated corporate group income, with interest deductions provided on both debt and equity capital. His cost-of-capital approach would result in recognition of the time-value return on capital to resident savers, with only the return to economic rents taxed at the corporate level. Kleinbard quite correctly notes that, from the perspective of the country of residence of investors, interest allocation is unnecessary. It remains, however, a necessary part of the source-country tax rules for countries that do not adopt a similar cost-of-capital approach.

The Task Force on International Tax Reform is an ad hoc group of tax lawyers, accountants, and academics. Their report canvasses a number of reform alternatives for the US taxation of outbound foreign direct investment, ranging from incremental measures to quite fundamental reforms. Reforms in various areas of the US system are discussed in some detail, following a review of basic policy principles and the technical details of the existing US system. The alternatives are framed in terms of their advancement of specific policy goals.

The Kane article critically reviews the concepts of capital ownership neutrality (CON) and national ownership neutrality (NON) developed in a series of recent articles by Mihir Desai and James Hines Jr., two academic tax economists.[8] The concepts are posited as alternatives to the standard welfare benchmarks of capital-export neutrality (CEN) and capital-import neutrality (CIN) used in much of the international tax policy literature on foreign direct investment. CON and NON focus on efficiencies

8 Mihir A. Desai, "New Foundations for Taxing Multinational Corporations" (2004) vol. 82, no. 3 *Taxes: The Tax Magazine* 39-46; Mihir A. Desai and James Hines Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting" (2004) vol. 57, no. 4 *National Tax Journal* 937-60; and Mihir A. Desai and James Hines Jr., "Evaluating International Tax Reform" (2003) vol. 56, no. 3 *National Tax Journal* 487-502.

associated with patterns of ownership of foreign direct investment, rather than the location of such investment or the savings that finance it. CON is said to support accrual taxation of income of foreign direct investors by residence countries, consistent with CEN. NON is said to support territorial taxation of the same income, consistent with CIN.

Kane argues that the existing empirical literature does not provide evidence of the magnitude of any distortion of the patterns of ownership of foreign direct investment caused by taxation. He reviews a range of non-tax factors that can distort patterns of ownership. He also emphasizes tax rules, other than the method chosen for relief of double taxation by source and residence countries, which can have the same effect. These other tax rules are not, however, accounted for in the theoretical literature, which tends to focus on the method of double taxation relief as the only source of tax distortion. For the purposes of this article, Kane accepts as a premise that some form of ownership neutrality is an appropriate welfare benchmark, and indicates that his future work will critically examine this premise.

T.E.

David Dunbar, "Judicial Techniques for Controlling the New Zealand General Anti-Avoidance Rule: The Scheme and Purpose Approach from Challenge Corporation to Peterson" (2006) vol. 12, no. 4 *New Zealand Journal of Taxation Law and Policy* 324-96

Graeme S. Cooper, "The Emerging High Court Jurisprudence on Part IVA" (2006) vol. 9, no. 5 *Tax Specialist* 273-89

These two articles survey the tax-avoidance jurisprudence under the general anti-avoidance rules (GAARs) in New Zealand and Australia, respectively. Canadian tax practitioners may find the New Zealand survey especially relevant, given that courts have read into the New Zealand GAAR a statutory interpretation overlay to a purpose test, which is similar to the misuse or abuse exception in subsection 245(4) of the Income Tax Act.[9] Cooper's survey of the recent Australian jurisprudence provides an interesting contrast. Unlike New Zealand courts, Australian courts have not read into the Australian GAAR an explicit statutory interpretation overlay, but instead have focused more consciously on the factual characterization of a series of transactions as a "scheme" that is subject to the provision because of the presence of a dominant tax purpose.

T.E.

9 RSC 1985, c. 1 (5th Supp.), as amended.

John E.S. Poyser and David J. Koski, "Use of Trusts in Blended Family Estate Planning" (2006) vol. 26, no. 1 *Estates, Trusts & Pensions Journal* 23-63

Lawyers with estate-planning practices should find this article instructive. The authors use the term "blended family" to refer to the familial group that is formed once the partners to a marriage enter into a subsequent relationship. This group consists of the members of the original and all subsequent relationships. The article thoroughly explores the non-tax and tax considerations that must be accounted for in establishing a division of wealth in these complicated personal circumstances. The authors review the constraints imposed by matrimonial property and dependants' relief legislation. They also thoroughly canvas the use of various forms of trusts as tax-efficient vehicles for the realization of non-tax estate-planning goals.

T.E.

Rodney Fisher, "Taxing Financial Arrangements: Harmonising Tax and Accounting?" (2006) vol. 4, no. 2 *eJournal of Tax Research* 132-52

This article provides an overview of draft legislation introduced by the Australian Treasury department in December 2005 governing the timing of the recognition of gains and losses on debt instruments, as well as hedge tax-accounting treatment. Although this draft legislation has since been replaced by draft legislation released in January 2007, the article remains useful as a description of many of the basic elements of the proposed legislative regime, which have largely been carried forward. The author emphasizes the principles-based approach to legislative drafting and the relationship between tax and financial accounting as two general, and important, features of the draft legislation.

T.E.

Lily L. Batchelder, Fred T. Goldberg, and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits" (2006) vol. 59, no. 1 *Stanford Law Review* 23-76

One of the significant features of the 1988 tax reform in Canada was the conversion of taxable income deductions for a range of personal expenses to non-refundable tax credits. Refundable credits have since been introduced as a means to deliver some transfer payments, as well as a limited number of tax incentives that are intended to alter investment decisions. The authors of this article argue that refundable tax credits should be used to deliver tax incentives that attempt to alter market behaviour to capture positive externalities generated by targeted activities or assets. The case for this delivery mechanism is thus distinguished from the case for the use of refundable tax credits as a form of transfer payment justified on distributional grounds. The authors argue that refundable credits should be the default rule for the delivery of incentives intended to alter market behaviour. In short, absent any evidence of differences in responsiveness correlated with income, a refundable credit delivers the same level of incentive to market participants. The authors accept as a premise that the particular incentive can be justified as correcting a market failure, and that the tax system provides the most cost-effective delivery. However, the article does not limit the efficiency-based case for the use of refundable credits to improvement of the target-effectiveness of spending programs intended to alter market behaviour. The authors also argue that refundable credits can have important income-smoothing effects, which can serve an important macroeconomic stabilization function. In this respect, they avoid the contentiousness in much of the US literature over the use of refundable tax credits as a means to deliver transfer payments justified on distributional grounds.

T.E.

David Hasen, "Liberalism and Ability Taxation" (2007) vol. 85 *Texas Law Review* (forthcoming)

The notion of endowment taxation is an intellectual curiousity that commands the attention of some tax academics in US law schools. Stated simply, the idea is that individuals should be taxed according to their potential to command resources in the market and not on their actual command of resources measured by some form of an index such as income, wealth, or consumption. Endowment taxation gets its intellectual traction from certain notions of distributive justice. But because it would force individuals to work to pay the tax, endowment taxation is not a realistic tax policy option. A more interesting issue is perhaps, to what extent, endowment taxation can be used to supplement recognized indexes of ability to pay.

The author of this article argues that endowment taxation is incompatible with various strains of liberal political theory. Not surprisingly, he emphasizes the well-worn point that endowment taxation would compel individuals to work. The more interesting portion of the article is probably the development of the argument that endowment taxation is inefficient under certain assumptions.

T.E.

Susan Cleary Morse, "The How and Why of the New Public Corporation Tax Compliance Norm" (2006) vol. 75, no. 2 *Fordham Law Review* 961-1018

The author of this article argues that the Sarbanes-Oxley Act of 2002 ("SOX"), securities enforcement efforts, and tax-shelter regulation in the United States have interacted to create a new tax-compliance norm in public corporations, which has resulted in the demise of mass-marketed corporate tax shelters. Morse identifies three elements, in particular, that have contributed to an enhanced compliance norm. The first is increased transparency of the tax decision-making group. This has occurred because of a number of interrelated provisions of SOX. The second element is the imposition of civil and criminal liability in connection with tax-shelter and financial-accounting scandals. This has sharpened the focus of firm leaders on compliance. The third element is a clear and consistent characterization of corporate tax shelters as unacceptable by the Internal Revenue Service (IRS), the US Treasury department, and Congress. This characterization has been maintained despite inconsistent results in the courts, and has combined with the first two elements to strengthen the compliance norm in public corporations.

T.E.

Thomas C. Omer, Jean C. Bedard, and Diana Falsetta, "Auditor-Provided Tax Services: The Effects of a Changing Regulatory Environment" (2006) vol. 81, no. 5 *The Accounting Review* 1095-1117

Paul D. Paton, "Rethinking the Role of the Auditor: Resolving the Audit/Tax Services Debate" (2006) vol. 32, no. 1 *Queen's Law Journal* 135-89

Prior to SOX, audit firms in the United States earned a significant proportion of their revenues from non-assurance services such as consulting and tax. For example, Zeff has reported that in 2000, PricewaterhouseCoopers (US) generated 49 percent of its gross fees from consulting, 33 percent from assurance, and 18 percent from tax.[10] In 1990, Arthur Andersen (US) generated 44 percent of its gross fees from consulting, 35 percent from assurance, and 21 percent from tax. The saturation in assurance markets drove public accounting firms to develop creative tax strategies and cross-sell them to audit clients.

The numerous US accounting frauds in the late 1990s and early 2000s prompted the Securities and Exchange Commission (SEC) and Congress to focus on issues of audit quality and auditor independence. One of the concerns being debated was whether audit firms could provide non-audit services (NAS)—including tax services—to their financial statement audit clients without impairing auditor independence. Arguments in favour of joint provision of audit and tax services included efficiencies arising from the shared knowledge in performing both services that could improve audit quality as well as the firm's tax position. Unlike other NAS, tax services often have a direct and immediate impact on reported net income and cash flows through effective tax rate reduction. Arguments against the joint provision of audit and tax services included potential compromise of auditors' judgment owing to the substantial revenues and high margins from tax services,[11] the auditors' objective ability to judge the appropriateness of sophisticated tax products and strategies sold to audit clients,[12] and the potential risk to shareholder value.[13] While the final version of

10 Stephen A. Zeff, "How the U.S. Accounting Profession Got Where It Is Today: Part II" (2003) vol. 17, no. 4 *Accounting Horizons* 267-86, at 269.

11 Public Company Accounting Oversight Board, *Briefing Paper: Auditor Independence and Tax Services Roundtable* (Washington, DC: PCAOB, 2004).

12 Ken Rankin, "PCAOB Reopens Tax Services Debate" (2004) vol. 18, no. 14 *Accounting Today* 1-38.

13 For example, Kinney et al. show an empirical association between higher tax fees paid to auditors and fewer earnings restatements: William R. Kinney, Zoe-Vonna Palmrose, and Susan Sholz, "Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right?" (2004) vol. 42, no. 3 *Journal of Accounting Research* 561-88.

SOX in 2002 allowed audit firms to provide both tax and audit services to their clients (but not other specific NAS), the possibility existed during the 2000-2002 legislative hearing period that tax would be included in the list of prohibited NAS. Thus, the impending legislation during that period may have pressured public companies and their audit firms to abandon or reduce the joint provision of audit and tax services.

The study by Omer, Bedard, and Falsetta examines firms' reactions to expected changes in the provision of joint audit-tax services during the 2000-2002 period when SOX was being debated. The study relies on proxy statement data on tax fees paid to external auditors and disclosed voluntarily from 2000 to 2002, with appropriate econometric correction for strong selection bias.

The authors find a strong positive association between higher abnormal (or unexpected) audit fees and higher tax fees early in the study period (2000-2001), and a significant reduction in the strength of this positive association later in the study period (2002). This finding suggests a pre-emptive response by firms to separate audit and tax services based on expectations that SOX would eventually restrict or prohibit joint provision of these services. The authors then examine the association between tax fees and the length of the auditor-client relationship and find that while higher tax fees were not associated with longer audit tenure early in the study period, they were positively associated later in the study period. The authors explain this result by arguing that auditor-client relationships are more likely to be longer if the client is receiving higher value from tax services. The results are also consistent with the explanation that new and relatively short-tenure clients may be terminating their tax services or not initiating new tax services. Supplemental comparison of 2003 tax fees paid by 2002 reporters showed a continued decline in the acquisition of joint services even though SOX did not prohibit the provision of joint tax and audit services.

The authors then examine the association between tax-service fees and their benefits measured by a subsequent decline in marginal tax rates. Results from the early period (2000-2001) show that higher tax fees were associated with greater reductions in future tax rates, with the association weakening during 2002, when tax-service fees paid were not found to be associated with future declines in tax rates (after controlling for firm size, income, and tax complexity). The authors explain this reduced return on tax-planning investment as arising from increased scrutiny of potentially aggressive tax strategies.

Finally, the authors examine the decision of firms to voluntarily disclose their tax-service fees. Their evidence suggest that firm size (assets) and auditor size (Big 5/4) influenced the decision of reporting firms to purchase joint tax and audit services, but do not influence the decision to voluntarily disclose tax-service fees separately. Voluntary disclosure was found to be positively associated with tax complexity (for example, foreign tax payments), auditor tenure, and auditor change, and negatively associated with the proportion of NAS fees to total fees.

The article by Paton surveys the debate in the United States over the provision of tax services by auditors. He argues that US regulators have struck the appropriate balance between regulatory oversight and market choice in allowing auditors to continue to provide a broad range of tax services.[14] He then describes some rules-based recommendations that Canadian regulators should adopt to address the uncertainty that a more principles-based approach has generated in Canada.

Amin M., T.E.

Warren B. Hrung, "Determinants of the Choice Between Roth and Deductible IRAs" (2007) vol. 29, no. 1 *The Journal of the American Taxation Association* 27-42

Individual retirement accounts (IRAs) in the United States and registered retirement savings plans (RRSPs) in Canada are both designed to encourage individuals to save for their retirement. The incentives in both plans are offered in the form of a tax deduction at the time of contribution, and a tax exemption for investment income accruing in the plan. The funds are fully taxable upon withdrawal. If the marginal tax rate at contribution is the same as the marginal tax rate upon withdrawal, then RRSPs and IRAs essentially offer tax-exempt investment returns on any eligible investments held inside the respective umbrellas. One of the differences between RRSPs and IRAs is that Canadian rules do not impose any explicit penalties for withdrawals before retirement from RRSPs, while US rules impose a 10 percent penalty on early withdrawals from IRAs.

Since 1998, US taxpayers have also had the choice of making larger non-deductible annual contributions to a "Roth" IRA, which are not taxable upon withdrawal. Roth IRAs, like deductible IRAs, provide a tax-exemption for annual returns while funds are invested in the plan. Financial planners would generally advise taxpayers to use a deductible IRA if they expect their marginal tax rate at the time of withdrawal (normally at retirement) to be lower than their marginal tax rate at the time of contribution; otherwise, a Roth IRA would be preferred. However, future marginal tax rates are not easy to predict so far into the future, since they require estimation of both future incomes and future statutory tax rates.

The author of this article posits that taxpayers' decisions to contribute to a deductible or a Roth IRA will be based on simpler heuristics that are influenced by short-term differences in marginal tax rates. He hypothesizes that the difference between the current-year marginal tax rate (1999 in this study) and the average marginal rate over a three-year period (1998-2000) will be positively associated with contributions to a

14 For an earlier exchange of views on this subject, see Robert James Hogan and Frédéric Brassard, "Standards of Practice and Duties of Tax Advisers in the Post-Enron Environment," in *Report of Proceedings of the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 34:1-47; and Robert D. Brown and Paul D. Paton, "Public Interest, Public Accountability, and Canadian Tax Professionals After Sarbanes-Oxley," ibid., 35:1-55.

deductible IRA. The study offers modest evidence that the high marginal tax rates in 1999, relative to marginal tax rates in adjacent years, are positively associated with the probability of contributing to a deductible IRA. However, this effect—consistent with economic theory—is not economically large. The author concludes that taxpayers are aware of their marginal tax rates and also appreciate the relevance of changes in their marginal tax rates over time. This evidence is interesting in light of Boylan and Frischmann's research findings that the complexity of estimating marginal tax rates leads investors to make suboptimal investment decisions.[15]

Consistent with economic theory, the study also finds that Roth IRAs with their larger annual contribution limits are preferred by taxpayers with greater savings capacity and greater liquidity, even though they do not result in immediate tax savings in the year of contribution. The study concludes that the choice between a deductible IRA and a Roth IRA is influenced by both tax and non-tax factors (income, liquidity, and demographics).

The Roth versus deductible IRA choice is relevant to Canada, given the recent debate on whether Canada should implement a tax-prepaid savings plan (TPSP). Kesselman and Poschmann's proposed TPSP would allow Canadians to contribute up to $5,000 a year without any deductions, earn tax-free investment income, and make tax-free withdrawals at any time without restrictions or penalties.[16] TPSPs would allow higher-income Canadians to shelter more retirement savings and allow lower-income Canadians to withdraw from this source without triggering excessive marginal tax rates in the form of clawbacks.

Amin M.

Jae G. Song and Joyce Manchester, "New Evidence on Earnings and Benefit Claims Following Changes in Retirement Earnings Test in 2000"
(2007) vol. 91, nos. 3-4 *Journal of Public Economics* 669-700

Social security benefits in the United States are clawed back if earnings exceed threshold amounts. This retirement earnings test has been gradually diluted by exempting certain age groups, increasing allowable earnings, and decreasing withholding rates. These dilutive changes have been enacted to encourage older people to continue working while claiming social security benefits as people live longer. The earnings test was removed in 2000 for individuals attaining full retirement at age 65 and over (67 and over for those who reach age 62 in 2022 or later) when Congress enacted

15 S. Boylan and P. Frischmann, "Experimental Evidence on the Role of Tax Complexity in Investment Decisions" (2006) vol. 28, no. 2 *The Journal of the American Taxation Association* 69-88.

16 Jonathan Kesselman and Finn Poschmann, *A New Option for Retirement Savings: Tax-Prepaid Savings Plans*, C.D. Howe Institute Commentary no. 149 (Toronto: C.D. Howe Institute, February 2001).

the Senior Citizens Freedom To Work Act. The removal of this earnings test is significant. It is expected to influence labour force participation and benefit claims of not only those attaining age 65, but also individuals in other age groups.

The earnings test had both a "tax" and a "transfer" feature. The tax aspect was the clawback of social security benefits, while the transfer aspect included a delayed recomputation of retirement credits and benefits. Future benefits for individuals who had not received benefits because of the earnings test were increased for each month in which no benefits were paid. Prior theoretical studies suggest that a delayed retirement credit that is actuarially fair would offset the tax (or clawback) effects of the earnings test. In other words, those subject to the earnings test could "lend" their current benefits in exchange for higher future benefits, either by not claiming current benefits or by working such that their earnings would be above the threshold amount. However, retirees may not be completely aware of the transfer aspect of the earnings test, and may not know whether the transfer is actuarially fair or not.

This study has three main findings. The first and obvious finding is that removing the earnings test affects the behaviour of only those individuals who are earning above the income threshold (that is, subject to the threshold constraint). Second, the study finds no clear evidence that removing the earnings test affects labour force participation. Some detected increase in labour force participation was attributable to the retention of older workers rather than inducement of older workers to re-enter the workforce. Third, following the removal of the earnings test, benefit claims increased by 2 to 5 percentage points among the 65-69 age group and by 3 to 7 percentage points among those reaching age 65.

Amin M.

Lorenzo Garlappi and Jennifer Huang, "Are Stocks Desirable in Tax-Deferred Accounts?" (2006) vol. 90, no. 12 *Journal of Public Economics* 2257-83

Financial and tax-planning literature suggests that tax-disfavoured assets such as bonds should be held inside registered or tax-deferred accounts, while tax-favoured assets such as equities should be held in taxable accounts. However, empirical evidence shows that a large number of investors violate this rule. This study explains why observed practice is rational by explaining that following the "pecking order" (holding bonds inside tax-deferred accounts and equities outside) maximizes the *level* of the expected tax benefit but may not minimize the *volatility* of the tax benefit; thus, investors wanting to avoid volatile benefits under different realizations of stock returns may want to deviate from the pecking order. For example, by holding a similar portfolio in both accounts, investors can achieve more balanced growth and smooth the volatility of the tax benefit. The authors show that for some risk-averse investors, the volatility-smoothing motive can explain the observed asset holding patterns; that is, the pecking order is more likely to be violated when tax benefits are more volatile. The study's intuitive conclusions are that tax benefits are more likely to be volatile when (1) tax rate differentials across assets are more volatile because of changes in the tax law (such as the recent changes in the taxation of income trusts in Canada) or changes in tax brackets for investors; (2) asset returns are more volatile; and (3) investors have large and uncertain liquidity needs.

Amin M.

Dan Dhaliwal, Linda Krull, and Oliver Zhen Li, "Did the 2003 Tax Act Reduce the Cost of Equity Capital?" (2007) vol. 43, no. 1 *Journal of Accounting & Economics* 121-50

The Jobs and Growth Tax Relief Reconciliation Act of 2003 in the United States reduced shareholder-level taxes on equity income. The results of this study suggest that the effect of this legislation was to reduce the overall cost of equity capital by an average of 1.02 percent, with the decline being smaller for firms held largely by institutional investors that did not enjoy a tax rate reduction. These results have interesting implications for the cost of capital of income trusts, given their recent tax rate increases.

Amin M.

Peggy A. Hite, D. John Hasseldine, Simon James, and Marika Toumi, "Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors" (2007) vol. 24, no. 1 *Contemporary Accounting Research* 171-94

This study examines the effects of written communications from the UK tax authority on taxpayer reporting in actual self-prepared and paid-preparer tax returns, comparing normative letters (emphasizing the positive reasons why compliance is advantageous) and sanction-based letters (emphasizing the negative consequences of non-compliance). The research questions investigated are (1) whether targeted written communications by the tax authority are effective in reducing non-compliance; (2) which of five different strategies are more effective (simple offer of assistance, citizenship appeal, threat of audit, threat of audit with possible penalties, and virtual guarantee of a forthcoming audit once the return is filed); and (3) whether the effectiveness of these strategies varies by the type of preparer (self or paid preparer). The taxpayer group studied was 7,300 UK sole proprietors who reported sales below the £15,000 threshold, allowing them to qualify for a simplified format and therefore lower compliance costs. The study focuses on two reported decisions by taxpayers: whether sales exceeded the reporting threshold, and the magnitude of the increase in reported taxable income on tax returns filed after the treatment letters were received.

The results show that both normative and sanction letters were effective in improving actual taxpayer compliance. The communications were particularly effective for self-preparers when reporting turnover. Sanction letters were generally more effective than normative citizenship letters for reported sales. Furthermore, sanction letters were more effective than normative letters for change in reported taxable income, but only for self-prepared returns and not for paid-preparer returns.

Amin M.

Donna D. Bobek, Richard C. Hatfield, and Kristin Wentzel, "An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach"
(2007) vol. 29, no. 1 *The Journal of the American Taxation Association* 93-111

Of the 25.5 million Canadian taxpayers who filed federal income tax returns for the 2005 tax year, approximately 16.4 million, or 64.3 percent, received tax refunds, with the average refund being $1,328 (up from $1,207 for the 2004 tax year).[17] By comparison, in the United States, approximately 80 percent of tax returns filed with the Internal Revenue Service (IRS) in 2003 resulted in a refund, with the average refund being $2,400.[18] Small refunds are common because salaried employees who have their income taxes deducted at source have limited opportunities to be in a taxes owing position at the end of the year. However, some tax filers may arrange for higher tax withholdings or intentionally make higher instalment payments despite the opportunity cost of forgone investment income.

This study examines the underlying reasons why taxpayers make payments that ultimately result in a tax refund. In the first phase, taxpayer participants responded to hypothetical scenarios by deciding to reduce amounts withheld during the year. Most respondents recognized the opportunity cost associated with overpayment. The underlying beliefs (antecedents to behaviour) that emerged were the utility of a refund cheque and the disutility associated with uncertainty about how much they might owe at year-end, as well as their ability to save the required money. A few respondents seemed to overstate the (transaction) cost of paperwork required to reduce withholding amounts (filing form T1213, "Request To Reduce Tax Deductions at Source," in Canada or completing form W-4, "Employee's Withholding Allowance Certificate," in the United States).

In the second phase of the study, the authors employed the theory of planned behaviour to offer evidence on the causes of this overpayment phenomenon. Using structural equation modelling to analyze 140 responses to a hypothetical scenario, they found that those who preferred receiving a refund considered their opportunity cost of higher withholding payments to be relatively low. In addition, such refund seekers enjoyed utility from their plans on how to spend their refund cheque, and disutility from anxiety about unexpectedly owing (any amount of) money when they filed their tax return.

Amin M.

Gregory May, "Getting Realistic About International Tax Arbitrage"
(2007) vol. 85, no. 3 *Taxes: The Tax Magazine* 37-48

The author of this article provides an excellent overview of international tax arbitrage with its many slippery paths. The first section of the article outlines the features of

17 Canada Revenue Agency spokeswoman Jacqueline Couture quoted in Jonathan Chevreau, "The Good and Bad of Intaxification," *National Post*, April 17, 2007.

18 Michael Parisi and Scott Hollenbeck, "Individual Income Tax Returns, 2003" [Fall 2005] *Statistics of Income Bulletin* 9-49.

international tax arbitrage. It identifies the building blocks of a definition of international tax arbitrage, as well as what falls outside the definition. International tax arbitrage requires differences in national tax treatments that are asymmetrical enough to yield a spread on which the taxpayer can trade. Taking different tax positions at home and abroad does not constitute international tax arbitrage. The author offers several examples of situations where (US) national tax laws may invite or require taxpayers to take positions for domestic purposes that are different from positions taken for foreign tax purposes, with none of them appropriately considered international tax arbitrage. Differences between national tax rules are inevitable.

Tax arbitrage requires inconsistent characterizations of the transaction, inconsistent characterizations of the taxpayer's position in the transaction, or inconsistent tax treatments of a transaction that each country characterizes in the same way. These inconsistencies may produce multiple rights to the same benefit or rights to incongruent benefits.

Inconsistencies give rise to arbitrage opportunities when the following three conditions hold. First, the inconsistencies must be sufficiently asymmetrical to yield a spread. Second, the spread must be large enough to support the transaction. This often depends on interest rates, tax advisory fees, and tax rates. Third, at least one taxpayer must be able to trade on the spread. Each of these three conditions is described in further detail, with examples.

The second section of the article catalogues the different basic international tax arbitrage patterns as follows:

- multiple deductions
- domestic deduction without foreign inclusion
- domestic deduction with foreign tax credit abroad
- foreign deduction without domestic inclusion
- foreign deduction with domestic foreign tax credit
- multiple tax credits
- treaty benefits absent foreign taxation

The third section of the article discusses tax policy considerations of fairness and efficiency within the context of continued globalization.

Amin M.

Richard M. Bird, Jack M. Mintz, and Thomas A. Wilson, "Coordinating Federal and Provincial Sales Taxes: Lessons from the Canadian Experience"
(2006) vol. 59, no. 4 *National Tax Journal* 889-903

A VAT (or GST) is a significant source of revenue in more than 140 countries around the world. The United States is the last major holdout in the OECD. This article describes Canada's relatively successful experience with the federal GST and provincial retail sales taxes (RST) over the past 15 years, even though harmonization and coordination between the GST and provincial RST has been limited. After comparing and summarizing the VAT/GST experiences of several countries (notably Canada, Brazil, Argentina, and India), this study suggests that the Canadian experience may be the most relevant for the United States in considering implementation of a technically feasible federal VAT.

Amin M.

Clément Carbonnier, "Who Pays Sales Taxes? Evidence from French VAT Reforms, 1987-1999" (2007) vol. 91, nos. 5-6 *Journal of Public Economics* 1219-29

This study empirically estimates the consumer's and producer's share, respectively, of the sales tax burden for two consumer goods and services that underwent significant rate changes in France. The VAT rate on car sales dropped from 33.33 percent to 18.6 percent in 1987, and the consumer's share of the sales tax burden was 57 percent. The VAT rate on housing repair services dropped from 20.6 percent to 5.5 percent in 1999, and the consumer's share of the sales tax burden was 77 percent. The differential tax shifting on price is driven largely by imperfect competition.

Amin M.