canadian tax journal / revue fiscale canadienne (2013) 61:1, 303-19

Current Tax Reading

Co-Editors: Bev Dahlby, Tim Edgar, Jinyan Li, and Alan Macnaughton*

John Lester, "Managing Tax Expenditures and Government Program Spending: Proposals for Reform" (2012) 5:35 *SPP Research Papers* 1-40

Everyone whose professional life involves the Canadian tax system is well aware that many tax provisions do not concern the raising of revenue; rather, they are spending programs delivered through the tax system (consider the SR & ED tax credit, the charitable tax credit, and so on). Nevertheless, the processes by which these tax expenditure programs are created, evaluated, and reported on in Parliament and public forums are very different from the processes involved in government spending programs. Some commentators would say that tax expenditure programs "fly under the radar" and are not studied sufficiently to ensure that government funds are spent wisely. John Lester, who for many years was head of the Evaluation and Research Group of the Tax Policy Branch of the Department of Finance, falls into this camp. In his report, he has delivered an ambitious set of proposals to reform the federal system, providing a level of detail commensurate with his extensive government experience.

The report begins with a discussion of some fairly arcane details about how the government reviews its expenditures for effectiveness and efficiency and has these expenditures approved by Parliament. Thus, it might appear that only federal public servants would be interested in this study. However, in the latter half of the report it becomes clear that Lester is proposing major changes in the relative powers of different Cabinet ministers over changes in the tax system. He is also reducing the government's ability to control the release of politically embarrassing information about the effectiveness of the system in achieving policy goals.

Currently, the federal budget process gives the minister of finance the exclusive power to develop any tax-change proposal to be put before Parliament. The finance minister could, for example, develop a proposal to abolish cash-basis accounting for farmers without discussing it with the minister of agriculture. Of course, these discussions may take place in some cases, but the general rule gives more or less exclusive control to the finance minister and the prime minister; program ministers may not even be informed of changes until a few days before budget day.

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Lester proposes to reduce the power of the minister of finance over tax expenditure programs and transfer some of the power to the ministers of program departments (chiefly Industry Canada and Human Resources and Skills Development Canada). Program ministers, supported by their officials, would have an active role in the pre-budget period in deciding on tax changes in their program areas. This dramatic change is designed to allow for a comparison of tax expenditures and direct spending measures, so that only those tax expenditures that are truly the best possible way of achieving the government's objectives continue to exist. Lester acknowledges that sharing information in this way creates some risk that budget secrecy could be breached through the release of information on tax changes before budget day, but he describes this as an "unavoidable risk" incurred to achieve the greater benefit of "better management of billions of dollars in program spending."[1]

In governmental terms, the paper proposes that tax expenditure programs be fully integrated into the government's expenditure management system. Departments would be responsible for both tax and spending initiatives relevant to their mandates. Specifically, tax expenditures would be included in "strategic reviews" conducted by government departments on a four-year cycle, in which departments are expected to identify the 5 percent of their spending that is least necessary. These strategic reviews appear to be internal government documents. Presumably, tax expenditures would be included in the two documents presented to Parliament—the reports on spending plans (reports on plans and priorities) and the reports on spending outcomes (departmental performance reports)—but this step is less important because these documents are mostly exercises in public relations.

In addition, Lester's report suggests including tax expenditures in the publicly released "formal evaluations" of program effectiveness conducted by departments on a five-year cycle. Furthermore, and this is the key point, the report proposes that these evaluations should be conducted by the parliamentary budget officer (formerly Kevin Page), who would become an independent officer of Parliament; the parliamentary budget officer would perform a role in exposing problems in tax expenditure program effectiveness similar to the role currently performed by the auditor general in relation to program efficiency. As Lester notes, program managers cannot be expected to provide information "that could be used by political groups to embarrass the minister and/or to set the political agenda."[2] Only the parliamentary budget officer has the independence to be able to deliver the news that a program is not working well at a time when the relevant minister has no plans to change it.

Lester notes that some tax expenditures are not suitable for inclusion in the budgets of program departments on the basis that their goals relate to tax policy rather than spending. These expenditures include provisions aimed at measuring

1 At 26.

2 At 22.

ability to pay (for example, the medical tax credit), achieving progressivity (for example, the basic personal amount), and altering the relative tax burden of capital income as opposed to labour income (for example, the less than 100 percent inclusion rate for capital gains). These exclusions reduce the report's recommended set of tax expenditures that could be assigned to program departments from the 196 in the government's tax expenditure accounts to 114. There is much room for disagreement about this list, and the report has not adequately addressed the point that many of the tax expenditures affect policy areas that are in provincial rather than federal jurisdiction. Still, the report has identified a starting point for reform.

Because of the obvious political difficulties, it is hard to be optimistic about the chances for success of the proposals for reform: no government wants to provide ammunition to the press and opposition politicians, and no finance minister is seeking to reduce his or her own powers. A previous system of having one budgetary envelope for both direct spending and tax expenditures was abandoned in the mid-1980s,[3] and, to put it mildly, the current government seems disinclined to expand the role of the parliamentary budget officer. Still, these are important questions, because many tax expenditures either are questionable from the start or outlive their usefulness. To cite but one example, a measure allowing teachers to make contributions to a registered pension plan beyond the amount allowed to other employees (because teachers interrupted their employment to participate in the Second World War) remained in the Income Tax Act until 1990.[4]

A.M.

Jeffrey Owens, "Global Trends in Tax Systems"
(2012) 68:1 *Tax Notes International* 115-25

This report summarizes the global trends in tax systems, especially those of the member states of the Organisation for Economic Co-operation and Development (OECD) and Brazil, the Russian Federation, India, Indonesia, China, and South Africa (BRIICS). The data are based on publications by the OECD. Part I of the report focuses on trends in tax rates and revenues. Part II discusses global tax uncertainties in 2012.

Regarding trends in tax rates, the report notes that marginal tax rates for personal income tax (PIT) have been lowered on average from over 70 percent in the

3 See a related proposal of the House of Commons Standing Committee on Government Operations and Estimates, *Report: Strengthening Parliamentary Scrutiny of Estimates and Supply* (Ottawa: Standing Committee on Government Operations and Estimates, June 2012) (reviewed in this feature (2012) 60:3 *Canadian Tax Journal* 765-91, at 790-91). The committee proposed that parliamentary committees for each policy area review both direct spending and tax expenditures, and that tax expenditures be included in departments' reports on plans and priorities.

4 Subsection 8(7), as it read before the 1991 taxation year.

1970s to well below 50 percent in most OECD countries. In 2010, the lowest statutory marginal tax rate was below 20 percent (in the Czech Republic and Slovak Republic), and the highest rate was over 50 percent (in the Netherlands, Belgium, and Sweden). The statutory corporate income tax (CIT) rates have been dropping more rapidly during the same period: in the 1980s, the CIT rates were rarely below 45 percent; in 2011, the OECD average rate was below 26 percent. In contrast, however, the value-added and goods and services tax rates have been increasing from 16.7 percent in 1990 to 18 percent in 2010.

There are also some general trends in the taxation of dividends. The top marginal tax rate on dividends in OECD countries was reduced from 49.1 percent in 2000 to 41 percent in 2011. Many European countries have recently moved back to modified classical systems and away from imputation systems. In many countries, dividends are taxed at the personal shareholder level at rates lower than the PIT rates for wage income.

The substantial reductions in PIT and CIT rates have not led to a decrease in the overall tax burden measured by the tax-to-gross domestic product (GDP) ratio. In fact, the ratio has moved upward while the CIT and PIT rates have moved in the opposite direction. The overall tax burden varies across the OECD from less than 25 percent of GDP in Chile, Mexico, and the United States to almost 50 percent of GDP in Denmark and Sweden. These differences largely reflect societal choices about funding pensions, education, healthcare, and other social programs. Revenues have been maintained despite the decreases in income tax rates in part because of base-broadening measures and the elimination of loopholes that had been exploited for tax planning.

Regarding global tax uncertainties in 2012, the report notes the impact of globalization on tax policy, especially in respect of downward pressure on CIT rates in OECD and BRIICS economies, and the shift away from worldwide systems of corporate taxation toward territorial systems. It also notes how countries respond to global pressures through strengthening access to information, anti-abuse rules, and international coordination. It calls attention to the emerging breed of tax activism—scrutiny by the media and forcing of tax matters onto the political agenda by non-governmental organizations. According to the report, the key word that is driving this form of tax activism is "transparency," and the key area under attack is the arm's-length principle. The report predicts that multinational enterprises "that resist this pressure will come under greater pressures."[5] These recent trends will also reinforce the need for chief executive officers and boards to spend more time examining "the financial and reputation risks associated with their tax strategies and to reinforce the linkage between good tax compliance and good corporate governance."[6]

J.L.

5 At 125.

6 Ibid.

"The UN Model (2011) Special Issue" (2012) 66:11
Bulletin for International Taxation 587-627

This special issue of the bulletin contains seven articles authored or co-authored by current or former members of the UN Committee of Experts on International Co-operation in Tax Matters:

- Armando Lara Yaffar and Michael Lennard, "An Introduction to the Updated UN Model (2011)"
- Philip Baker and Tizhong Liao, "Improper Use of Tax Treaties: The New Commentary on Article 1 and the Amended Article 13(5)"
- Liselott Kana and Ron van der Merwe, "The Commentary on Article 5—The Changes and Their Significance"
- Stig Sollund and Marcos Aurélio Pereira Valadão, "The Commentary on Article 9—The Changes and Their Significance and the Ongoing Work on the UN Transfer Pricing Manual"
- Claudine Devillet, "The Text and the Commentary on Article 25—Round-Up of the Changes and Their Significance"
- Rowena G. Bethel, "The Text of and the Commentaries on Articles 26 and 27—Round-Up of the Changes and Their Significance"
- Armando Lara Yaffar and Michael Lennard, "The Future of the UN Model"

It also features an overview article by Jan de Goede and Fraser Dickinson, which sets the context for the special issue on the UN model (2011).[7] Some of the highlights of the issue are outlined below.

The UN model (2011) replaces the UN model (2001),[8] which replaced the UN model (1980).[9] The 2011 model, like the earlier models, incorporates many provisions of the OECD model (2010) and the OECD commentaries.[10] In the words of the committee's chair, "[t]he similarities between the two leading international Models reflect the importance of achieving consistency where possible in international taxation matters."[11] There are also important differences to reflect the divergent membership of the OECD and the United Nations. Below are some distinguishing features of the UN model.

7 The UN model and commentaries were finalized in October 2011 and published in 2012 as United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, May 2012) (herein referred to as "the UN model (2011)").

8 United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/PAD/SER.E/21, 2001.

9 United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/102, 1980.

10 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2010).

11 Lara Yaffar and Lennard, at 590 (Lara Yaffar was the chair; Lennard was the secretary).

First, the role of the UN model is to help countries, especially developing countries, "make informed sovereign decisions regarding tax policy and administration based on: (1) their development plans, an understanding of the likely consequences of different decisions on the revenue financing public aspects of development; and (2) the impact on that private investment that may also fund development."[12] The model is not intended to be prescriptive. Consistent with the UN mission of Financing for Development, the purpose of the UN model is to find a balance between encouraging investment as a route to development and ensuring that the revenue benefits from investment are available to fund development. To ensure the "voice and participation" of developing countries in the creation of international tax norms for the increasingly globalized world, the UN model and commentaries recognize the policy and administrative realities of developing countries.

Second, unlike the OECD model and commentaries that represent the work of the OECD, the UN model is a project undertaken by the committee of experts in their personal capacity and therefore does not represent the views of any particular country or tax administration. There is no mechanism for UN member countries to register their views on the commentaries.

Third, omissions of OECD text in the UN model may mean different things. In general, provisions of the OECD model that were found to be particularly relevant for developing countries are included in the UN model. When the text is incorporated from the OECD model, the commentaries on the UN model explicitly highlight any differing views held by the committee; alternatively, in some cases they exclude certain text. If no comments are made, it should be understood that the text is in accordance with the committee's views. However, any omission of OECD text should not necessarily be interpreted as disagreement with the text. The context reveals whether the omission is because the UN model is in disagreement with the OECD text, the text is irrelevant to the UN model, or the issue is still under consideration.[13]

Fourth, the UN model reflects the philosophy that the developmental role of tax treaties is often best achieved when, on balance, source country taxation rights are preserved under a tax treaty.

Finally, some of the notable divergences from the OECD model and commentaries include the following:

1) *Article 5 (permanent establishments [PEs])*. The UN model retains a "services permanent establishment" provision in article 5(3)(b), which has no counterpart in the OECD model. The UN model also retains four other features that differ from the OECD model (2010): (a) the duration test is six months (rather than 12 months) for building and construction PEs; (b) delivery operations can constitute PEs because they are not listed in the exclusions in article 5(4) of the UN model; (c) under article 5(5)(b), a dependent agent situation can

12 Ibid.

13 See, for example, at 592; and Kana and van der Merwe, at 603.

arise if the agent maintains stock and regularly makes deliveries, even when contracts are not concluded for the principal; and (d) under article 5(6), there is a special deemed PE provision in relation to insurance when premiums are collected in a country or the risks insured are situated there.

2) *Article 7 (business profits)*. In addition to retaining the limited force of attraction rule, the UN model differs from the OECD model by not adopting the "authorized OECD approach" in attributing profits to a PE. The committee considers this approach to be in direct conflict with article 7(3) of the UN model, which generally rejects deductions for amounts paid by a PE to its head office, other than reimbursements for actual expenses.
3) *Article 9 (associated enterprises)*. The UN model contains article 9(3), which is not found in the OECD model. Article 9(3) provides that the obligation in article 9(2) to make a correlative adjustment does not apply in certain extraordinary situations that involve "fraud, gross negligence or wilful default."
4) *Article 13 (capital gains)*. The UN model departs from the OECD model by including article 13(5), which preserves source-country taxation on gains derived from the alienation of substantial shareholdings in resident companies. This provision leaves agreement on what constitutes a "substantial shareholding" to bilateral negotiations.
5) *Article 14 (independent personal services)*. Article 14 is retained in the UN model, even though it is deleted from the OECD model (2000).[14] The main reason for the retention is that many members of the committee consider the provision to be useful for developing countries, and some members believe that deleting it could reduce source taxation rights.[15]
6) *Article 25 (mutual agreement procedure)*. Article 25(5) provides for mandatory arbitration in the event of an inability to resolve a case under the mutual agreement procedure. This provision differs from the arbitration clause in article 25(5) of the OECD model in three respects: (a) under the UN model, only the competent authorities may request arbitration (the taxpayer initiates arbitration under the OECD model); (b) arbitration can be initiated if the competent authorities have not reached an agreement within three years after the case was initiated (two years under the OECD model); and (c) the competent tax authorities can decide to depart from the arbitral decision if they agree on a different solution within six months after the decision was communicated to them.

Philip Baker and Tizhong Liao have authored an interesting article on the improper use of tax treaties. Because Liao is a member of the committee, Baker claims to be the sole source of all critical comments about the UN model and commentaries.[16]

14 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, April 2000).

15 Lara Yaffar and Lennard, at 595.

16 See Baker and Liao, at 598.

Baker takes issue with some examples of the improper use of tax treaties provided in the commentary on article 1. For example, he writes that "the discussion of treaty shopping fails to recognize that some states are more than willing to allow entities formed there to take the benefit of its tax treaties, and some developing and middle income countries are more than happy to accept the FID [foreign income dividend] that flows from such treaty shopping."[17] Baker also notes that "[l]ooking at the examples discussed in the new UN Commentary, it is hard not to come to the conclusion that the Committee was well behind the learning curve when they drafted this material."[18] An example is the single short paragraph discussing derivative transactions. Baker is similarly critical of the UN commentary on the interpretation of tax treaties. The commentary states that the interpretation of tax treaties is governed by rules codified in articles 31 to 33 of the Vienna Convention on the Law of Treaties[19] but notes that "nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties."[20] Baker writes, "[w]ith respect, it can be wondered whether or not this is right," and "any such applications must be consistent with the principles set out in the Vienna Convention (1969)."[21]

The articles in this special issue provide valuable insights into the origins of, and the reasons for, the changes made to the UN model (2011). These insights are helpful to the international tax community because they are not easily found elsewhere.

J.L.

Michael R. Veall, "Top Income Shares in Canada: Recent Trends and Policy Implications" (2012) 45:4 *Canadian Journal of Economics* 1247-72

This article updates Michael Veall's landmark work (with Emmanuel Saez) on the trends in income inequality in Canada to the 2009 taxation year; his previous work ended in the 2000 taxation year. In this article, he analyzes the causes of the rise in inequality and makes some policy suggestions.

Veall urges caution in raising tax rates: "[T]here is some risk that increasing top marginal rates in Canada may yield only small or conceivably negative tax revenue gains."[22] Instead, he prefers increasing the progressivity of the tax system by broadening the tax base and reducing special tax preferences, particularly ones that are concentrated in the upper-income groups. He suggests avoiding different tax treatment for different types of capital income by abolishing measures such as labour-sponsored

17 Ibid., at 601.

18 Ibid.

19 Vienna Convention on the Law of Treaties, signed at Vienna on May 23, 1969, UN doc. A/Conf. 39/27, fourth annex, UNTS 1155/331.

20 Paragraph 30 of the commentary on article 1 of the UN model (2011).

21 Baker and Liao, at 600.

22 At 1262.

venture capital corporation preferences, registered education savings plans, and the employee stock option deduction.

He also suggests making more tax credits refundable so they are beneficial for people who are not in a taxpaying position. Revenue cost should be limited, if necessary, by lowering the rate of the credit rather than by making the credit non-refundable.

A.M.

United Nations, *UN Practical Transfer Pricing Manual for Developing Countries* (New York: United Nations, October 2012) (www.un.org/esa/ffd/tax/documents/bgrd_tp.htm)

The Committee of Experts on International Cooperation in Tax Matters approved the *UN Practical Transfer Pricing Manual for Developing Countries* (2012). This manual contains a foreword and the following chapters and appendixes:

- Chapter 1—Introduction
- Chapter 2—The Business Environment
- Chapter 3—The Legal Environment
- Chapter 4—Building Capability
- Chapter 5—Comparability
- Chapter 6—Methods
- Chapter 7—Documentation
- Chapter 8—Audits
- Chapter 9—Dispute Resolution
- Chapter 10—Country Practices: Preamble, Brazil, China, India, South Africa
- Appendix I—Comparability Examples
- Appendix II—Documentation

The manual is largely consistent with the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.[23] Unlike the OECD guidelines (which, through the recommendation adopted by the OECD Council, the administrations of OECD member countries are committed to following), the UN manual is not a binding document.

The manual explains how the arm's-length approach to transfer pricing can be used effectively by developing countries. It is intended to assist policy makers and administrators in developing countries that generally lack the kind of experiences and resources commonly found in OECD countries. It is a practical, useful explanatory tool, including references to the experience and situations of developing countries and providing examples. Insight into the practices in Brazil, China, India, and South

23 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2010) (herein referred to as "the OECD guidelines").

Africa are particularly useful for taxpayers in understanding the application of the transfer-pricing rules in these large emerging economies, where transfer pricing is becoming an increasingly challenging issue. The information about practices in these countries is particularly valuable because it was provided by country representatives rather than the principal authors of the manual.

The manual is helpful not only to developing countries but also to multinational enterprises doing business in developing countries. Some developing countries, such as India and China, generally emphasize source-based taxation and take a more flexible and pragmatic approach to transfer pricing in order to secure source-based taxation. Taxpayers are well advised to pay attention not only to the OECD guidelines but also to the UN manual in managing their transfer-pricing concerns.

J.L.

Michelle Markham, *Advance Pricing Agreements: Past, Present and Future* (Alphen aan den Rijn, the Netherlands: Wolters Kluwer, 2012), 388 pages, ISBN 9789041140425

Advance-pricing agreements (APAs) have become an important mechanism for managing transfer-pricing issues in many countries during the past two decades. Like most matters associated with transfer pricing, APAs can be complex and highly technical; they can also consume a great deal of time, effort, and expertise on the part of taxpayers and tax authorities—often in two jurisdictions. The inherently global nature of transfer pricing and the internationally accepted arm's-length principle that underlies national transfer-pricing laws mean that best practices in one country can be transported to other countries.

This book discusses APA practices in the United States and Australia, the two countries that concluded the world's first bilateral APA with Apple Computer in March 1991. It documents the problems encountered in the past and the controversies and concerns in the present. On the basis of surveys and interviews conducted by the author, the book also reports the pros and cons of APAs from both the taxpayer's and the tax administration's perspective. It offers insights about the future of APAs, especially in an environment where tax authorities of many countries (including China and India, two of the world's largest recipients of foreign direct investment) are strengthening transfer-pricing investigations, and multinational enterprises are under increasing pressures about reporting and managing tax information. The appendix to the book contains some helpful documents, such as a model APA based on the Internal Revenue Service's revenue procedure 2006-9.[24]

This is the first book to study APAs comprehensively from a comparative and practical perspective. The United States and Australia are at the forefront of APAs, and their experiences as documented in this book should prove helpful to taxpayers and tax authorities in other countries. One of the most interesting aspects of the

24 Rev. proc. 2006-9, 2006-2 IRB 278.

book is its collection of views and insights about the future of APAs by transfer-pricing experts in government, industry, and academia.

J.L.

Wayne Simpson and Jared J. Wesley, "Effective Tool or Effectively Hollow? Balanced Budget Legislation in Western Canada"
(2012) 38:3 *Canadian Public Policy* 291-313

Most Canadian provinces and US states have enacted balanced budget legislation (BBL) to discourage or ban deficit spending. Simpson and Wesley examine the effectiveness of this legislation empirically over the period 1989-2008 in the seven provinces that have implemented BBL (Newfoundland, Nova Scotia, and Prince Edward Island have not enacted BBL). They conclude that BBL has no statistically discernible effect on restraining the growth rate of expenditures relative to revenues in most provinces.

Simpson and Wesley also performed a historical analysis of the "great recession" of 2008-9 for the four western provinces. Governments in British Columbia, Alberta, and Manitoba opted to amend the legislation to allow deficits, while Saskatchewan maintained a balanced budget by withdrawing funds from its stabilization fund. Thus, each province decided that maintaining government services was more important than exercising fiscal restraint.

Overall, BBL was neither as effective in avoiding deficit spending as its advocates wished nor as effective in avoiding deficit spending as its opponents feared.

A.M.

A. Abigail Payne, "Changing Landscapes for Charities in Canada: Where Should We Go?" (2012) 5:34 *SPP Research Papers* [University of Calgary] 1-22

This research paper reports on data concerning Canadian charitable donations for the period 1992 to 2008. Individuals are classified as high-income, middle-income, or lower-income on the basis of the type of neighbourhood they live in, rather than their actual incomes (because of data limitations). These data show that there has been a growth in giving, the bulk of which has come from high-income individuals. Giving by lower- and middle-income individuals has remained stable or, more likely, has declined. Foundations and large charitable organizations have been the recipients of the greatest growth in giving and in direct government funding (since governments often pay charities to provide services, as in the case of children's aid).

A.M.

Eduardo Baistrocchi and Ian Roxan, eds. *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge, UK: Cambridge University Press, December 2012), 988 pages, ISBN 9781107026599

First, a disclaimer: Jinyan Li wrote the chapter of this book on China. Other contributors to the collection include Reuven S. Avi-Yonah (United States), David Duff (Canada), Philip Gillett (European Union), Andreas Oestreicher (Germany), Richard

Vann (Australia), Toshio Miyatake (Japan), Stephen Phua Lye Huat (Singapore), Isabel Calich and Joao Dacio Rolim (Brazil), Andrey Shpak (Russia), Mukesh Butani (India), Juan Pablo Guerrero Daw (Chile), Ofer Granot and Yoram Margalioth (Israel), and Lee Corrick (Africa). The editors also authored chapters: Baistrocchi on Argentina and Roxan on the United Kingdom.

The book discusses more than 180 transfer-pricing cases from 20 representative jurisdictions. It focuses on transfer-pricing law in action and the means by which disputes between taxpayers and tax administrations are resolved. It is intended as a complement to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. All of the transfer-pricing cases discussed in the book are linked to the relevant paragraphs of the OECD guidelines by means of a table.

J.L.

Neil H. Buchanan, *The Role of Economics in Tax Scholarship*, GWU Public Law and Legal Theory Paper no. 2012-52, GWU Legal Studies Research Paper no. 2012-52 (Washington, DC: George Washington University Law School, 2012) (http://ssrn.com/abstract=2094477) (chapter in David A. Brennen, Karen B. Brown, and Darryl Jones, eds., *Beyond Economic Efficiency* [forthcoming])

Economic efficiency has been considered a dominant policy goal in recent tax debates in Canada and elsewhere. Tax proposals are scrutinized to determine whether they enhance or reduce the economy's efficiency. The term "economic efficiency" is used as if it describes a coherent concept. Buchanan claims, however, that "there is no substance underneath the often-impressive superstructure of efficiency analysis."[25] It is simply something that everyone thinks he or she understands. Buchanan further maintains that "[t]his makes it not just unwise, but affirmatively misleading, to base academic analysis of taxation—in whole or in part—on attempts to measure and maximize efficiency."

Buchanan, who holds a PhD in economics from Harvard, unpacks the concept of efficiency by using "Pareto efficiency" to mean what economists mean by "efficiency" and distinguishing it from what non-economists might imagine the word implies. What does Pareto efficiency mean? Buchanan offers the following:

> "A situation is Pareto Efficient if it is not possible to make anyone better off without making someone else worse off." The basic idea, therefore, is that Pareto Efficiency analysis involves comparing gains and losses caused by putting people in different situations, with a Pareto Efficient situation representing the maximum amount of "well-offness" in the society in question.[26]

The "well-offness" of people is measured by their willingness to pay by asking how much someone would be willing to pay for something and comparing it to how

25 At 1.

26 At 3.

much people would be willing to pay for something else. An open market or a "well-behaved" market is Pareto efficient. It allows self-interested individuals to act on their own behalf, seeking advantage in transactions in a way that guarantees that every good and service is ultimately consumed by the person who values it most highly.

The research paper then explains why the standard definition of efficiency ultimately fails to advance our understanding of tax analysis. Pareto efficiency is generally held out as a positive concept with no normative content. Tax policies are often driven by value judgments. Pareto efficiency is ultimately based on assumptions. One assumption is that the market is well behaved, while in fact there are many imperfections in the market. Another assumption is that there is a neutral starting point that forms the baseline for measuring the consequences of people's economic interactions. The choice of the baseline itself is not founded on any overarching principle. There is also a legal baseline problem because there is no "natural" baseline or "free" market; legal rules define all of the boundaries that define the limits of what can be bought and sold in open markets, and these laws are uncertain and change all the time.

While arguing that the Pareto efficiency criterion is neither a coherent nor a meaningful way to assess policies, Buchanan does not rule out all economic analysis. On the contrary, he suggests that economic tools are very useful in assessing policies. For example, how people respond to incentives is a potent factor in tax policy analysis.

> The core of good scholarly analysis of tax law, therefore, involves thinking through how changes in the law will change behavior, and assessing the consequences of those changes. While Pareto Efficiency analysis purports to do just that, it is ultimately nothing more than an elaborate superstructure that actually requires (but hides) value judgments, without offering any independent or positive insights that are not otherwise available.[27]

J.L.

Michael J. Graetz and Rachael Doud, *Technological Innovation, International Competition, and Challenges of International Income Taxation*, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper no. 460 (New Haven, CT: Yale Law School, October 2012) (*Columbia Law Review* [forthcoming])

There is a rich body of literature on international taxation, some of which was created by one of the authors of this article.[28] There is also a vast body of literature on tax incentives for research and development (R & D). And yet, there has not been

27 At 20.

28 See, for example, Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation" (1997) 46:5 *Duke Law Journal* 1021-1109; Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 54:3 *Tax Law Review* 261-336; and Michael J. Graetz, *Foundations of International Income Taxation* (New York: Foundation Press, 2003).

much written about the international tax implications of tax incentives for R & D. This article fills that void. The central questions addressed by the article are the implications of cross-border mobility of factors of production and intellectual property (IP) income for designing cost-effective national tax incentive measures and the effective taxation of international IP income derived from tax incentives.

The article examines three major types of tax incentives supporting innovation in the United States and Europe: incentives for R & D, "patent boxes" that provide preferential taxation of income from intangibles, and incentives for advanced domestic manufacturing. On the basis of existing research evidence, the article evaluates how well these tax incentives work. It concludes that R & D tax incentives may increase the amount of R & D and the number of R & D employees, but their cost-effectiveness is less certain than their advocates claim. There is also considerable evidence that tax incentives result in shifting the locations where firms perform R & D rather than increasing the amount of R & D that firms perform. Because patent boxes are relatively new, the extant data are too limited to adequately assess the effectiveness of these measures, but their effectiveness is doubtful: "Given the mobility of IP income, one cannot help but conclude that firms are more likely to shift income eligible for tax reductions from patent boxes to low-tax jurisdictions than to increase local R&D in response to patent-box tax breaks."[29] It is also doubtful whether the domestic manufacturing incentive encourages R & D because basic R & D is rarely located in the same place as manufacturing.

After concluding that, at most, only R & D incentives are justified, the article discusses the common "tax minimization games" played by multinational enterprises (MNEs) to lower the income taxes on IP income. One game is political: the R & D coalition in the United States has been legendary in its ability to maintain R & D tax incentives. The other game for MNEs is voting with their feet. Whenever local law fails to conform to the interests of powerful MNEs, the option of shifting operations and/or income to a jurisdiction that is more favourable to these interests is always available. The article provides examples of the techniques used by Microsoft, Google, and others to shift income to low-tax jurisdictions.

How is it possible to link location-specific tax incentives and the mobility of IP income in designing international tax policy? Graetz and Doud consider the various existing proposals, including moving to territorial taxation, expanding the controlled foreign corporations rules, using formulary apportionment for dividing the revenue of MNEs, lowering corporate tax rates in the United States, and imposing a US minimum tax founded on a destination-based subtraction-method value-added tax with a business deduction for the costs of labour. They argue that "forging a much closer link between a company's level of U.S. sales and its minimum U.S. taxable income" is the most effective method. "Anything less seems unlikely to succeed."[30]

J.L.

29 At 35.

30 At 108.

Yariv Brauner and Martin J. McMahon Jr., eds., *The Proper Tax Base: Structural Fairness from an International and Comparative Perspective— Essays in Honor of Paul McDaniel* (Alphen aan den Rijn, the Netherlands: Wolters Kluwer, 2012), 257 pages, ISBN 9789041132864

This book contains essays written in honour of Paul McDaniel, who died in 2011. These essays focus on tax expenditure analysis, an area that was pioneered by McDaniel, along with the late Stanley Surrey. The theme is structural fairness in the income tax base of a country as well as the division and/or harmonization of the income tax base among jurisdictions. The essays are organized into three parts: tax expenditures, the fair tax base and international tax reform, and a comparative perspective.

The book begins with McDaniel's last scholarly work, "The Staff of the Joint Committee on Taxation Revision of Tax Expenditure Classification Methodology: What Is To Be Made of a Change That Makes No Changes?" published posthumously by the Canadian Tax Foundation in 2011.[31] This article criticizes the attempt by the staff of the Joint Committee on Taxation to revise the tax expenditure budget analytical model in a manner that was unprincipled, lacking true progress, and potentially detrimental to the original goals of the tax expenditure project. Four essays continue with the tax expenditure focus. In "Taxing Tax Expenditures," Martin J. McMahon Jr. examines whether the value of tax expenditures should be included in computing the income of the recipient. In "The Tax Expenditure Concept Globally," Miranda Stewart provides a comparative analysis of the tax expenditure concept and a survey of the global use of tax expenditure analysis and reporting. In "Tax Reform and Tax Expenditures in Australia," Richard J. Vann considers the strengths and weaknesses of the tax expenditure concept as a tool for tax reform, especially in the context of recent Australia tax reform proposals. And in "Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules," Laura E. Cunningham and Noël B. Cunningham praise McDaniel's insistence on the need to maintain a sharp distinction between tax expenditure analysis and tax policy analysis, and to analyze the former as spending programs and apply the traditional tools of tax policy analysis, such as equity, to structural provisions.

Part II contains three essays that focus on the quest for a fair tax base in the context of a substantive tax reform. The essay by James Repetti and Diane Ring, "Horizontal Equity Revisited," discusses the utility of the notion of horizontal equity in the tax reform analysis and concludes that it is relevant only in the context of distributive justice. The essay by Lawrence Lokken, "What Is This Thing Called Source?" explores the concept of source for international tax purposes. The essay by Yariv Brauner, "Formula Based Transfer Pricing," seeks to demonstrate that the arguments against replacing the arm's-length principle with formulary apportionment do not apply, or are significantly weaker, in light of the collapse of the current transfer-pricing regime.

31 In Lisa Philipps, Neil Brooks, and Jinyan Li, eds., *Tax Expenditures: State of the Art* (Toronto: Canadian Tax Foundation, 2011), 3:1-13.

Part III contains four essays focusing on European tax issues. In "The EU Proposed CCCTB: Some Tax Treaty Issues," Kees van Raad discusses the tax treaty implications of the proposed Europe-wide common consolidated corporate tax base (CCCTB). The CCCTB is based on formulary apportionment, which is apparently inconsistent with the arm's-length principle in bilateral tax treaties. Van Raad suggests that cross-border issues be solved before the CCCTB is adopted. The other essays are "Shared Legal Orders: Some Thoughts about the Influence of EU Case Law on International Tax Law Rules of the EU Member States," by Irene J.J. Burgers; "Intra-Group Loans: A Swedish Perspective," by Bertil Wiman; and "European VAT and Jurisdiction To Tax," by Antonio Vázqeuz del Rey.

The quest for fairness is universal, but the means for achieving it have been controversial. The essays attack this issue from various perspectives, including tax expenditure analysis, the utility of horizontal equity, structural reforms to protect the tax base or divide the tax base among jurisdictions, and global and comparative analysis. The intellectual debates, which are inspired by the late Paul McDaniel, contribute significantly to the literature.

J.L.

Michelle H. Yetman and Robert J. Yetman, "The Effects of Governance on the Accuracy of Charitable Expenses Reported by Nonprofit Organizations"
(2012) 29:3 *Contemporary Accounting Research* 738-67

The Canada Revenue Agency serves an important monitoring role with respect to charities, requiring them to supply financial information and making that information public. A piece of information that is particularly relevant to donors is the ratio of charitable-to-total expenses, since donors are quite averse to having their donations spent on overhead expenses. One always wonders how accurate the charities' published data are, but until now it has been difficult to know how to tell. This article advances that line of research by developing plausible indicators of inaccuracy, such as reporting zero fundraising costs or zero administrative costs or reporting fewer of these costs than would be statistically predicted on the basis of the objective characteristics of the charity (such as amounts of private donations and amounts of total expenses). The article then shows, with US data, that charities with stronger governance mechanisms are less likely to provide inaccurate data.

A.M.

Dean Neu, "Accounting and Undocumented Work"
(2012) 29:1 *Contemporary Accounting Research* 13-37

This article studies how the labour market works for undocumented workers—workers who do not possess an unrestricted social insurance number (SIN) and thus are not working legally in Canada. Specifically, the article examines how the market is affected by the fact that employers have to keep accounting records: not just tax records but also financial records related to minimum wage legislation and health and safety legislation. The research is based on a review of these legal requirements, 50 interviews with people who had been undocumented workers or who have had connections with them, and 10 interviews with accountants who are involved in the preparation or use of these financial statements. The research could be of particular interest to the Canada Revenue Agency.

In each case, the worker's motivation in participating in the transaction is to earn income while avoiding detection and deportation. The employers' motivation is almost always to pay the lowest price possible to obtain the services of a given quality of worker, but other considerations could also be involved, depending on which of the following five types of transactions is occurring: (1) informal economy transactions, in which the purchaser, who is not a business, forgoes a receipt (motivation: price only); (2) off-financial statement transactions, in which a business uses some of its cash revenues to pay undocumented workers and then reports for tax purposes neither the revenue nor the expense (motivations: price, employer's income tax, minimum wage laws); (3) employment transactions, in which the undocumented worker supplies a false or "rented" SIN to the employer and the employer pays the worker by cheque and withholds tax (motivation: price only); (4) independent contractor transactions, in which the employer treats the undocumented worker as an independent contractor, regardless of the real relationship (motivations: price, employer-paid payroll taxes, minimum wage laws); and (5) intermediary organization transactions, in which the employer delegates the problem of finding workers to an employment agency or contactor and pays this party for the workers' services (motivations for the employer: same as for the independent contractor).

The strength of this study is its focus on the integration of the factors motivating the employer or purchaser; too often tax people think of the tax factors only and miss part of the picture. In addition, the article provides valuable context, explaining other factors that facilitate the transaction, such as individuals who cash cheques for a fee so that undocumented workers can avoid financial institutions.

A.M.

Sadok El Ghoul, Omrane Guedhami, and Jeffrey Pittman,
"The Role of IRS Monitoring in Equity Pricing in Public Firms"
(2011) 28:2 *Contemporary Accounting Research* 643-74

Can increased tax auditing be good for a firm by reducing the cost of equity capital? This provocative research question is suggested by the idea that active monitoring by tax authorities protects minority investors; tax authorities can be seen essentially as another shareholder eager to prevent insiders from siphoning off corporate resources. The article does not go any further in explaining exactly what types of behaviour both the minority investors and the tax authority seek to prevent (one does not expect insiders actually to be stealing from the firm). Nevertheless, the data on US firms examined by the authors show that the cost of equity capital falls by 58 basis points when the probability of audit by the US Internal Revenue Service rises from 31 percent to 46 percent (which, according to this data, represents a movement from the 25th to the 75th percentile in audit probability).

A.M.