Current Tax Reading

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

Julian S. Alworth and Giampaolo Arachi, eds., *Taxation and the Financial Crisis* (Oxford: Oxford University Press, 2012), 300 pages, ISBN 978-0-19-969816-5

This book consists of 10 papers preceded by an editors' introduction. The genesis of the book was a conference held in Milan in April 2009. The papers collectively provide an excellent overview and some analysis of the intersection of tax policy and the financial crisis of 2007-8. At a broad level, some of the papers explore the role of tax policy as a cause of the US housing asset bubble and the ensuing banking crisis that precipitated the financial crisis. Consistent with the existing literature on this subject, the general conclusion is that tax policy played, at most, a secondary causal role. That is, certain features of the income tax, in particular, may have amplified the underlying non-tax causes. The principal culprits in this respect are

- the deductibility of home mortgage interest in the United States,
- the deductibility of corporate interest expense,
- the use by financial institutions of tax-deductible hybrid financial instruments treated as equity for regulatory purposes, and
- the use of tax havens in structured securitization vehicles.

Other papers examine the role that tax policy can play in protecting against future financial crisis. The principal focus in this area is the use of special taxes to recover the costs incurred to bail out the financial sector, and the use of corrective taxes to address excessive risk taking and the associated negative externalities. The former includes special levies on the financial sector such as the Obama administration's proposal for a levy, referred to as the fiscal crisis responsibility fee, targeted on the wholesale liabilities of large financial institutions. There is also some discussion of proposals for the taxation of employee bonuses, as well as an excess profits tax. User capital charges and financial transaction taxes are similarly canvassed as instruments intended to buttress prudential regulation and address market failures. Finally, some

* Bev Dahlby is a distinguished fellow, the School of Public Policy, University of Calgary. Tim Edgar is of Osgoode Hall Law School, York University, and the Faculty of Law, the University of Sydney. Jinyan Li is of Osgoode Hall Law School, York University. Alan Macnaughton is of the School of Accounting and Finance, University of Waterloo. The initials below each review identify the author of the review.

of the papers discuss the extent to which addressing continuing problem areas—such as the treatment of financial services under a value-added tax, the relationship between tax and financial accounting, marking to market, and loan loss provisions—can further buttress the goal of supporting regulation in managing systemic risk. The last two papers re-examine the related issue of macroeconomic policy in the face of the severe strain placed on government budgets by the bailout costs.

Many of the authors have already contributed to a growing body of literature on these same aspects of tax policy and the financial crisis, with the papers in this volume reprising much of the analysis already presented elsewhere. Nonetheless, there are some fresh insights and the collection of papers is worthwhile, if only for its synthesis of much of the existing literature in one volume. The titles and authors are as follows:

- Michael Keen, Alexander Klemm, and Victoria Perry, "Culprit, Accomplice, or Bystander? Tax Policy and the Shaping of the Crisis"
- Thomas Hemmelgarn, Gaetan Nicodeme, and Ernesto Zangari, "The Role of Housing Tax Provisions"
- Vieri Ceriani, Stefano Manestra, Giacomo Ricotti, and Alessandra Sanelli, "The Role of Taxes in Compensation Schemes and Structured Finance"
- Thomas Hemmelgarn and Gaetan Nicodeme, "Can Tax Policy Help To Prevent Financial Crisis?"
- Douglas A. Shackelford, Daniel N. Shaviro, and Joel Slemrod, "Taxation and the Financial Sector"
- Daniel N. Shaviro, "Income Tax Reform Implications of the Financial Crisis"
- Geoff Lloyd, "Moving Beyond the Crisis: Tax Policies for the Soundness of Financial Markets"
- Robert N. McCauley and Kazuo Ueda, "Government Debt Management at Low Interest Rates"
- Katarzyna Anna Bilicka, Michael P. Devereux, and Clemens Fuest, "The Effects of Fiscal Consolidation on Short-Term Growth: A Review and Implications for the UK"
- Donato Masciandaro and Francesco Passarelli, "Regulation and Taxation: Economics and Politics"

T.E.

David Albouy, "Evaluating the Efficiency and Equity of Federal Fiscal Equalization" (2012) 96:9-10 *Journal of Public Economics* 824-39

The renewal of Canada's Fiscal Arrangements Act in 2014 will determine the federal government's equalization payments to the provinces for the remainder of the decade. Given the current differences in the economic conditions of the provinces and their fiscal positions, the next renewal of the equalization formula will be especially important, and the negotiations will almost certainly be highly acrimonious. For this reason, and because there have been substantial changes in the equalization program since the O'Brien committee report in 2006,[1] a detailed review of the basics of the equalization program is timely.

This article by David Albouy, a Canadian professor of economics at the University of Michigan, is the latest in a long line of contributions that Canadian economists have made to the theory and practice of fiscal equalization. Albouy presents a comprehensive extension of the model of equalization developed in the classic article by Boadway and Flatters,[2] where the rationale for equalization payments is to correct the misallocation of labour that results when regional governments offer different net fiscal benefits to their residents. As in the Boadway and Flatters model, individuals are assumed to be perfectly mobile between regions, and their location decisions are based on the package of public services, taxes, consumption of private goods (or real after-tax wage rates), and local amenities that is available in different regions. In equilibrium, land rents, which determine the price of housing and other local non-traded goods, adjust so that an individual is equally well off residing and working in all regions. Otherwise, any utility differentials based on location would lead to migration to the region where utility is higher and induce an increase in housing prices to re-establish the utility equilibrium.

Albouy extends the Boadway and Flatters framework in a number of ways, most importantly by incorporating in the model heterogeneous groups with different labour productivity, a federal proportional income tax on labour incomes, and federal group-specific lump-sum transfers. He derives an expression for the federal transfers that will lead to an efficient allocation of the population across regions by equalizing the net fiscal benefits available to individuals of a given type in each region. The formula for the net per capita transfer to individuals of a given type or group reflects four components:

1. a federal tax differential component, which is positive (negative) for individuals in regions with higher than average (lower than average) wage rates for their group;
2. a component that reduces the federal transfer based on the regional government's source-based tax revenues from land rents, resource royalties, and taxes on capital;
3. a public good externality component that reflects the gain from spreading the cost of regional government's public service to a new resident (which would be zero if it were a publicly provided private good); and
4. a non-location-specific component based on the federal government's concerns for distributional equity.

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1 Canada, Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track* (Ottawa: Department of Finance, 2006).

2 Robin Boadway and Frank Flatters, "Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results" (1982) 15:4 *Canadian Journal of Economics* 613-33.

Albouy's article makes two main contributions to the theory of equalization transfers. First, federal transfers should be higher in regions where federal tax payments are higher because productivity and wage rates are higher in that region. In the absence of this adjustment to transfers, a proportional federal income tax reduces the incentive to move to regions with higher productivity and wage rates. An example may help to clarify this point. Suppose that in the absence of a federal income tax, a group of individuals would be indifferent between earning $40,000 in Alberta and earning $30,000 in Prince Edward Island because of the environmental amenities in the latter province. If the federal government imposes a 20 percent tax rate on these incomes, the after-tax income differential is reduced to $8,000 and the individuals now prefer to live in Prince Edward Island, distorting the allocation of labour between the provinces. Albouy's second major contribution is that his model shows that differentials in the fiscal capacity of regional governments with respect to residence-based taxes, such as sales and personal income taxes, should not enter the formula for the optimal federal transfers; only the differentials in the source-based taxes levied by regional governments are relevant, with higher federal transfers to individuals in regions where the regional government's source-based taxes are lower.

Albouy's empirical application of the model is discussed below. First, however, it is important to note that, unlike the equalization grants that are actually made by the Canadian federal government (and other central governments around the world), the transfers in the Albouy model are made to individuals, on the basis of their region of residence and personal characteristics, and not to the regional governments that levy taxes and provide public services. The distinction between transfers to people and grants to governments is important if only because econometric studies indicate that an additional dollar of grant income has a much greater stimulative effect on spending by a subnational government than an additional dollar of personal disposable income in the hands of its residents. This is the so-called flypaper effect. Recent theoretical and empirical studies (to which I have contributed) show that a flypaper effect can arise when subnational governments impose distortionary taxes, and that the higher the recipient government's marginal cost of public funds, the larger will be the stimulative effect on spending from a grant.

Albouy uses this framework to calculate the per capita net fiscal benefits for individuals in each of Canada's provinces and territories in 2001, based on differentials in federal equalization grants and Canada health and social transfers, calculations of federal tax differentials resulting from higher regional wages, and differentials in provincial source-based tax revenues. Not surprisingly, residents of the territories are shown to have received huge per capita net fiscal benefits—more than $16,000 in 2001. Net fiscal benefits for residents of the Atlantic provinces were about $2,000 per capita, and only slightly lower, on average, for residents of the three prairie provinces. In Alberta, the net fiscal benefit in 2001 was entirely attributable to the provincial government's revenues from oil and gas royalties and corporate income tax revenues. For residents of British Columbia, Quebec, and Ontario, net fiscal benefits were negative, with the largest disparity being in Ontario, at −$1,083 per capita.

The fact that Quebec residents had a negative net fiscal benefit may come as a surprise, given that Quebec is a major recipient of equalization grants; however, Albouy's calculations indicate that Quebec residents in 2001 only received $32 per capita more than the average in federal grants to the provinces, whereas the Quebec government's source-based tax revenues were $422 per capita below the national average. These calculations for Quebec require clarification because it is not clear whether the federal grant differential of $32 reflects the Quebec abatement, whereby the provincial government receives lower federal grants in return for a 16.5 percent reduction in federal income taxes, with correspondingly higher Quebec tax rates. Second, most observers argue that Quebec's source-based tax revenues are understated because Hydro-Québec rents are distributed through low electricity prices. Furthermore, the theoretical framework suggests that all federal transfers, to people as well as to governments, should be used to measure net fiscal benefits. Accordingly, employment insurance (EI), guaranteed income supplement (GIS), and old age security (OAS) transfers, as well as regional development grants, should be included in these calculations. Since EI and, to a lesser extent, GIS and OAS transfers will be higher in low-wage regions with high unemployment rates, they should be included in the calculation of the net fiscal benefits.

Using estimates of the responsiveness of population to net fiscal benefit differentials, Albouy calculates the impact of such differentials on the distribution of the Canadian population among the provinces and the economic losses generated by the distortions in the distribution of the population. These calculations indicate that the population of the Atlantic and the prairie provinces was 30 percent larger than it would have been if net fiscal benefits had been equalized across provinces in 2001. The resulting efficiency loss was estimated to be $4.3 billion in 2001 dollars, or 0.41 percent of income.

One can argue whether these losses are large or small, given the political importance that some might attach to federal transfers in "holding the country together." However, a more important criticism is whether the model is relevant or not. As has already been noted, Albouy's model is a model of transfers to individuals, not transfers to government, a feature that limits the relevance of the model for the design of equalization transfers to provincial governments. A further limitation is that in the model, the federal government can raise revenues by levying non-distortionary lump-sum taxes, and therefore the only resource allocation problem caused by fiscal policies is the allocation of the population across regions. However, when the federal government has to resort to distortionary taxes to raise revenues, and as in the Canadian case, has limited access to resource rents as a revenue source, the objective of equalizing net fiscal benefits has to be compromised to reflect the tradeoff between population allocation distortions, caused by provincial source-based revenues, and the efficiency losses caused by the federal taxes that are used to finance the transfers.

But perhaps the most important limitation of Albouy's model is that it does not reflect the goal or purpose of the Canadian equalization program, which is "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."[3] The wording in the Canadian constitution is deliberately vague, but clearly the objective of equalization is not the efficient allocation of the population across the provinces (a point that Albouy acknowledges in a footnote).[4] Rather, it is to provide funds to provincial governments to compensate for differences in their "fiscal capacity"—an admittedly slippery concept—which has been approximated by per capita tax bases (both source-based and residence-based) in the equalization formulas. While the "efficient allocation of the population" approach to equalization, as exemplified by the Albouy model, may provide measures of the efficiency loss from locational distortions caused by net fiscal benefit differentials across provinces, it does not provide a basis for designing a program that fulfills the constitutionally enshrined mandate of the program.

That said, no single economic model fully reflects the objectives of the equalization program and the other federal transfers (such as the Canada health and social transfers), the constraints imposed by the Canadian constitution, and the available set of tax instruments for the financing and design of intergovernmental transfers. The Albouy model provides some insights into the implications of transfers, but it needs to be supplemented by other models and frameworks to provide policy makers with some guidance in determining the level and form of the equalization program.

B.D.

Kenneth J. McKenzie, "The Big and the Small of Tax Support for R&D in Canada" (2012) 5:22 *SPP Research Papers* 1-19 (http://policyschool.ucalgary.ca)

The March 29, 2012 federal budget included a set of proposals intended to simplify and improve the cost-effectiveness of the scientific research and experimental development (SR & ED) tax credit program.[5] The headline proposal was a reduction in the tax credit rate from 20 percent to 15 percent for corporations other than Canadian-controlled private corporations (CCPCs) effective after 2013. The budget also proposed to reduce the eligible portion of salaries and wages for tax credit purposes from 65 percent to 60 percent in 2013 and 55 percent thereafter. Capital expenditures will no longer qualify for the tax credit and will no longer be fully deductible on a current basis. Finally, the amount of eligible expenses incurred for third-party arm's-length contract SR & ED will be reduced to 80 percent of the amount of such expenses, in an attempt to eliminate the profit element from tax credit eligibility.

3 Section 36(2) of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11.

4 Footnote 17 at 829.

5 Canada, 2012 Budget, Budget Plan, March 29, 2012, at 410-13.

McKenzie argues that these changes to the SR & ED credit, although arguably justifiable, will exacerbate the patchwork of effective subsidy rates for business research and development, with a consequent misallocation of resources. In particular, the budget proposals will result in a government spending program that heavily favours small firms over large firms and labour-intensive over capital-intensive research and development. McKenzie emphasizes these obvious observations with computations of marginal effective tax rates (METRs) or subsidy rates as a summary measure of the incentive effects on investment in business research and development. For comparison purposes, the METR computations are provided for research and development both pre-budget and post-budget, taking into account both federal and provincial tax expenditures for CCPCs and non-CCPCs. McKenzie concludes that a more uniform and less distortionary system of tax incentives is clearly desirable, especially in the face of empirical evidence suggesting that the positive spillover benefits generated by small firms are smaller than those generated by larger firms.[6]

T.E.

Canada, Department of Finance, "Distributional Impact of the Federal Personal Income Tax System and Refundable Credits: Analysis by Income, Sex, Age and Family Status," in *Tax Expenditures and Evaluations 2011*
(Ottawa: Department of Finance, 2012), 31-48

With the widespread public concerns about increases in income inequality in Canada and other countries, this report on the distributional impact of the federal personal income tax is very timely, because the personal tax/transfer system plays a very important role in redistributing income. The analysis is based on taxation data for 2008 for a large sample of tax filers.

Not surprisingly, the report shows that the federal personal income tax is progressive in the sense that the average effective tax rate increases with the individual's taxable income. Indeed, the income-tested refundable tax credits, such as the goods and services tax (GST) credit and the Canada child tax benefit, mean that individuals in the bottom 20 percent of the income distribution, with incomes below $10,354, had on average a negative effective tax rate of 22.3 percent, because they receive federal tax credits while paying little or no income tax. Over 30 percent of tax filers had income increases as a result of the federal personal tax/transfer system. The net transfer to this low-income group was about $12.1 billion, or 11.6 percent of their pre-tax income. On the other hand, individuals in the top 1 percent of the income distribution, earning more than $216,412 in 2008, had an average effective tax rate of 19.7 percent.

6 Nicholas Bloom, Mark Shankerman, and John Van Reenan, "Identifying Knowledge Spillovers and Product Market Rivalry" (unpublished, Stanford University, 2010), cited by McKenzie, at 3.

The federal personal tax/transfer system reduced the degree of inequality of the income distribution in 2008, with the Gini coefficient declining from 0.5197 for the pre-tax/transfer income to 0.4764 for the post-tax/transfer income. Most of the reduction in income inequality was due to the progressive rate structure, with the income-tested refundable tax credits playing a smaller but important role. The income shares of the top 20 percent declined, while the income shares of the bottom 80 percent increased. The income shares of women, and especially women under age 45 in first four deciles, increased. By age, the income shares of those under 45 and over 65 increased, while the income share of the 45 to 64 age group declined.

The report provides a useful update on one of the most important components of the Canadian tax/transfer system. Of course, it has its limitations. First, it is a snapshot of the redistributive effects in a single year, whereas the long-term or lifetime redistributive effects may be more important for judging the overall success of the system in reducing inequality. Second, it does not take into account the important role that the provincial tax/transfer system plays in redistributing income. Finally, it does not take into account the redistributive effects of other taxes, such as the GST or EI contributions, or other federal transfers such as OAS and GIS. The last comprehensive studies of the impact of the tax and expenditure systems were by Dyck[7] and Kesselman and Cheung.[8] Given the current focus on income equality, an update on the redistributive effects of the Canadian fiscal system would be very useful.

B.D.

James Pierlot and Alexandre Laurin, *Pooled Registered Pension Plans: Pension Saviour—or a New Tax on the Poor?* C.D. Howe Institute Commentary no. 359 (Toronto: C.D. Howe Institute, August 2012), 16 pages, ISBN 978-0-88806-879-8

The concept of a pooled registered pension plan (PRPP) is much like that of group registered retirement savings plans (RRSPs). As with a group RRSP or a defined contribution pension plan, a PRPP pools the retirement savings of participating employees in an attempt to realize economies of scale in asset administration. The federal government only recently introduced, in June 2012, the regulatory framework for PRPPs, with the intention that these new vehicles for retirement saving would improve employee coverage primarily at the provincial level, where it is hoped that provincial

7 Dagmar Dyck, "Fiscal Redistribution in Canada, 1994-2000" (2005) 53:4 *Canadian Tax Journal* 974-1006.

8 Jonathan R. Kesselman and Ron Cheung, "Taxation Impacts on Inequality in Canada: Methodologies and Findings," in David A. Green and Jonathan R. Kesselman, eds., *Dimensions of Inequality in Canada* (Vancouver: UBC Press, 2006), 347-416.

governments will adopt comparable frameworks. Because the federal government has only limited pension jurisdiction, the vast majority of employees are subject to provincial legislation. Lack of pension coverage is associated with this group of employees.

The authors of this study critique PRPPs as a retirement savings vehicle primarily because the tax assistance provided for PRPP savings tracks that available to RRSPs and defined contribution registered pension plans (RPPs). That is, the amount of annual tax assistance is capped and is not recoverable in the event that plan participants suffer investment losses. Moreover, taxation on withdrawal of retirement savings means that low- and middle-income plan participants are subject to tax rates and benefit clawbacks that exceed the amount of tax savings on contributions and plan earnings. The authors argue that PRPPs should be made more attractive by permitting tax-prepaid treatment comparable to that for tax-free savings accounts and requiring plan administrators to discourage or prevent low- and middle-income plan participants from electing tax-deferred treatment. They also suggest that PRPPs be permitted to pay out pensions rather than commuting accumulated savings to a registered retirement income fund, and that plan participants be permitted to contribute to their own target benefit pensions free of the annual limit on the amount of eligible contributions. These additional recommendations are intended to track some of the features of defined benefit RPPs.

T.E.

United States, Staff of the Joint Committee on Taxation, *Selected Issues Relating to Choice of Business Entity*, JCX-66-12 (Washington, DC: Joint Committee on Taxation, July 27, 2012), 86 pages

This paper was prepared by the Staff of the Joint Committee on Taxation for a public hearing before the Senate Finance Committee on August 1, 2012. A particularly problematic issue under the current US check-the-box approach to entity classification is the ability of large firms to elect conduit partnership treatment of income and loss. The largest portion of the paper is devoted to an overview of the current check-the-box regulations and the history of the development of entity classification rules in the United States preceding the adoption of the elective approach in 1996. This overview is preceded by the presentation of some interesting data on the number and size of business entities in the United States. The data are broken down into returns filed by entity type; the growth of limited liability companies; size distribution measured in terms of assets and total receipts; business distribution by type; and income/loss distribution. The final section of the paper provides a very brief discussion of possible reform options for distinguishing entities subject to the two-tier corporate income tax from entities subject to passthrough treatment. A notable factor canvassed in this discussion is the size of an entity. There is also some preliminary musing about the possible adoption of a uniform system of passthrough treatment applicable to all such entities in the latter category.

T.E.

United Kingdom, HM Revenue & Customs, *Lifting the Lid on Tax Avoidance Schemes: Consultation Document* (London: HM Revenue & Customs, July 23, 2012), 34 pages

United Kingdom, HM Revenue & Customs, *A General Anti-Abuse Rule: Consultation Document* (London: HM Revenue & Customs, June 12, 2012), 48 pages

Orly Sulami, "Tax Abuse—Lessons from Abroad," *SMU Law Review* (forthcoming)

The United Kingdom has arguably been at the forefront of country practice when it comes to the use of mandatory information disclosure of aggressive tax-avoidance transactions. One of the principal results of the use of this anti-avoidance technique has been a proliferation of specific anti-avoidance legislation intended to address particular tax-avoidance transactions that have come to light through information disclosure. It is perhaps somewhat curious that, although debated over the years, adoption of a general anti-avoidance rule (GAAR) as an anti-avoidance measure has been firmly rejected until now, when it appears that the UK government is committed to finally enacting a GAAR. The first of these two consultative documents discusses a number of measures intended to improve the effectiveness of mandatory information disclosure of tax-avoidance transactions. The second consultative document introduces the legislative features of a proposed GAAR consequent on the earlier release of a commissioned independent report (the Aaronson report) recommending the adoption of a GAAR.[9] The article by Sulami compares the recent codification of the economic substance doctrine in the United States with the GAARs in Australia, Canada, and New Zealand.

Lifting the Lid on Tax Avoidance Schemes discusses mandatory information disclosure in three different respects. The first focuses on the dissemination of information about tax-avoidance transactions to ensure that, where such transactions are identified, the public is suitably informed about the risks of using them. The relevant discussion in the consultation document is quite preliminary in nature and suggests a number of communication strategies, including the use of social media and the HM Revenue & Customs (HMRC) website. At a more substantive level concerning the content of information provided to the public, the consultation document indicates only that HMRC will explore what further information it could, in fact, disclose given its legal duties of confidentiality. The second aspect of information disclosure focuses on the quality of the content of the information. The consultative document suggests, for example, that HMRC will be considering the depth of information about the structure of tax-avoidance transactions, as well as the users and other parties involved in a transaction subject to disclosure. It will also be considering raising the

9 Graham Aaronson, *GAAR Study: A Study To Consider Whether a General Anti-Avoidance Rule Should Be Introduced into the UK Tax System* (London: HM Treasury, November 11, 2011), reviewed in this feature (2012) 60:1 *Canadian Tax Journal* 257-74, at 257-60.

threshold of a reasonable excuse for a promoter who fails to notify a transaction and imposing additional reporting obligations on a promoter who incurs a penalty for failure to disclose. The penalty regime may additionally be reinforced with personal liability for an individual concurrent with that of a firm promoting tax-avoidance transactions. The third aspect of information disclosure addressed in the consultative document concerns the application of the disclosure obligation defined in terms of specified hallmarks of transactions. The consultative document indicates that the requirement of confidentiality will be amended to address questionable interpretations of this hallmark apparently taken by some promoters. In addition, the hallmarks will be extended to specified financial transactions, and the "main benefit test" for loss transactions will be replaced with a stricter "one of the main benefits" test.

In *A General Anti-Abuse Rule*, the UK government reiterates its commitment to the introduction of a GAAR in legislative form in the 2013 Finance Bill. To that end, the consultative document provides an appendix with draft legislation that is to be the basis for consultations. The draft GAAR is broadly consistent with the recommendations of the Aaronson report. Most importantly, the application of the proposed GAAR is intended to be much narrower than what is referred to as a "broad spectrum" GAAR characteristic of those in other countries such as Australia, Canada, New Zealand, and South Africa. In particular, the proposed GAAR is to be targeted at artificial and abusive tax avoidance. This targeting feature is reflected in an "abusiveness" requirement defined generally as arrangements entered into or carried out that cannot reasonably be regarded as a reasonable course of action. The legislative definition of this concept then provides a set of badges or characteristics suggestive of the reasonableness standard. The characteristics concern both conceptions of legislative intent and factual determinations, such as the amount of a tax benefit relative to the income or profits derived from an arrangement. Obviously, much interpretive pressure will be focused on this targeting feature of the proposed GAAR. Another appendix in the consultative document provides some examples of the kind of transactions that are intended to be covered. Most of the rest of the features of the proposed GAAR discussed in the consultative document are standard fare for GAARs generally. One unique aspect of the UK proposals is the proposal to establish an advisory panel that would provide non-binding opinions on the application of the proposed GAAR to particular transactions.

Sulami argues that the GAAR jurisprudence in Australia, Canada, and New Zealand indicates that judicial support for the proposition that taxpayers have the right to plan their affairs to minimize their tax payable undermines the effectiveness of a GAAR, because support for this proposition is associated with a literal or textual approach to statutory interpretation as a means to identify prohibited tax avoidance. The result is further enhanced by an unwillingness to account for economic substance in the analysis of an impugned transaction and the imposition of an unreasonable burden of proof on the tax authorities. He suggests that the codified economic substance doctrine in the United States avoids many of these features simply because of their rejection by the US judiciary in developing the doctrine. Sulami argues, however, that a recent US judicial trend to rely on a textual approach to statutory interpretation in the context of tax-avoidance cases should be negated by a legislative mandate to adopt a purposive approach as well as to consider objective rather than subjective evidence of the purpose of an impugned transaction. Given the author's defensible reading of the Australian, Canadian, and New Zealand GAAR jurisprudence, it might be the case that UK taxpayers would not really have all that much to fear if HMRC adopted a broad-spectrum GAAR rather than the proposed narrowly targeted GAAR.

T.E.

Micael Castanheira, Gaëtan Nicodème, and Paola Profeta, "On the Political Economics of Tax Reforms: Survey and Empirical Assessment"
(2012) 19:4 *International Tax and Public Finance* 598-624

Tax reform is always on the policy agenda of most countries. Yet significant tax-rate changes or reforms occur only periodically. For those who advocate tax changes, it is important to know under what conditions governments will actually implement significant changes to the tax system. The paper by Castanheira, Nicodème, and Profeta is the latest addition to a very short list of papers that analyze the factors that determine the timing of tax reforms.

The authors' main contribution is an econometric analysis of the factors that affect the timing of changes to the taxation of labour incomes in EU countries. They begin with a wide-ranging review of political economy models that have been developed to explain governments' fiscal decisions. The review includes median voter models, probabilistic voting models, and game theory models. On the basis of this comprehensive review, the authors distill the following predictions:

1. Most tax changes will be targeted to particular groups of swing voters, rather than general across-the-board reforms.
2. A larger number of political parties in a coalition government should increase the likelihood of tax reform because they cover a wider range of target groups.
3. Longer periods between elections will reduce the likelihood of reforms by reducing electoral competition.
4. Tax reforms will take place in a gradual and sequenced fashion in order to overcome the status quo bias.
5. Tax reforms should conform to the election cycle with more tax-rate changes occurring prior to an election.
6. Tax reforms are more likely to occur during an economic downturn.
7. Centrist governments are more likely to engage in reforms than ideologically driven left-wing or right-wing governments.

The authors tested these predictions using the LABREF database[10] on the personal income tax and social security tax systems for 27 EU countries between 2000 and 2007. From this database, they identified 86 changes to the income tax system, 23

10 For further information, see http://ec.europa.eu/economy_finance/db_indicators/labref/index_en.htm.

changes to employee social security contributions, and 53 changes to employer social security contributions. Of these 117 tax reform occurrences, 77 were identified as targeted to particular groups of workers or employers, consistent with prediction 1. The authors estimated a simple logistic regression model where the endogenous variable is the probability of a change in labour income and social security taxes on a number of political and economic variables. Their overall conclusion is that politics trumps economics in the sense that the political variables seem to be more important than the economic variables in determining the timing of tax reforms. In particular, the authors found that an increase in the government's share of parliamentary seats had a positive effect (significant at the 10 percent level) on the probability of a tax reform, and a 1 percentage point increase in the government's majority increased the probability of reform by 1.08 percent. Consistent with prediction 3, the longer the period that a government was in power between elections, the less the likelihood of tax reform. Increasing the tenure of a government from four to five years reduced the probability of reform in any given year by 26.2 percent. Consistent with prediction 7, left-wing and right-wing governments were 24 to 30 percent less likely to reform labour taxation than centrist governments. However, contrary to prediction 5, the authors did not find any evidence that the occurrence of tax reforms was linked to the timing of elections; and contrary to prediction 6, reforms were more likely to occur when economic conditions improved. Finally, the number of political parties in a coalition government (prediction 2) was a better predictor of reforms than either the measures of the business cycle, labour market pressures, or other socioeconomic variables.

It would be interesting to see if some of these empirical regularities concerning the occurrence of tax reforms in the European Union might carry over to Canada, especially at the provincial level, although there are obvious differences in political institutions (such as the infrequency of coalition governments in Canada).

B.D.

Michael Greenstone, Dimitri Koustas, Karen Li, Adam Looney, and Leslie B. Samuels, *A Dozen Economic Facts About Tax Reform*, Hamilton Project Policy Memo (Washington, DC: Brookings Institution, May 2012), 28 pages

Hang Nguyen, James Nunns, Eric Toder, and Roberton Williams, *How Hard Is It To Cut Tax Preferences To Pay for Lower Tax Rates?* (Washington, DC: Tax Policy Center, Urban Institute and Brookings Institution, July 10, 2012), 20 pages

These two papers emphasize the complexity of tax reform efforts in the current fiscal and economic climate in the United States. Quite simply, the changed fiscal and economic environment means that a reprise of the 1980s tax reform trend in which the income tax base was broadened and tax rates were lowered is untenable. Revenue targets will inevitably have to be raised in combination with spending cuts. Moreover, tax rates will have to be raised in an effort to begin to address increasing income inequality.

Greenstone et al. take a broad perspective to illustrate the significant constraints presented by the long-run US budget deficit, an increasingly competitive global economy, and rising income inequality. The first part of their paper emphasizes the following five key facts about the US tax system in this challenging environment:

1. the United States collects lower revenues than other industrialized countries;
2. tax expenditures represent a large share of total government spending;
3. the tax system unintentionally subsidizes some activities and penalizes others;
4. the tax system has become less progressive; and
5. virtually all families pay taxes.

Brief discussion of each of these five facts is followed in the second part of the paper by the development of a framework for evaluating tax reform organized around seven further facts. This part of the paper attempts to illustrate the difficult tradeoffs between revenues, rates, and progressivity that will have to be assessed.

Although the focus of the paper by Nguyen et al. is somewhat narrower, the message is much the same: that is, politicians and the electorate must shed the notion that the current fiscal and economic environment is conducive to a tax reform approach that involves lowering tax rates to any significant extent. The authors attempt to determine the extent to which elimination of personal tax expenditures can be used as a reform strategy permitting a lowering of personal tax rates. For illustrative purposes, three different tax-rate scenarios are posited:

1. the tax-rate structure represented by current law scheduled to be in effect in 2012,
2. the tax-rate structure represented by current policy in the form of the law in effect in 2012, and
3. the tax-rate structure represented by current policy with reduced rates.

Nguyen at al. suggest that, under all three scenarios, the magnitude of tax expenditure reform that would be required is politically unrealistic. For example, each scenario would require elimination or substantial curtailment of the home mortgage interest deduction, non-taxation of employer-provided health-care benefits, and relief for charitable contributions. Lower tax rates would additionally require elimination or curtailment of the lower capital gains and dividend tax rates, as well as tax concessions for retirement savings plans and the earned-income tax credit.

T.E.

Nadja Dwenger and Viktor Steiner, "Profit Taxation and the Elasticity of the Corporate Income Tax Base: Evidence from German Corporate Tax Return Data" (2012) 65:1 *National Tax Journal* 118-50

The effect of corporate tax-rate changes on corporate tax revenues is a subject of considerable interest at the present time. Some argue that higher corporate tax rates will generate the additional revenues needed to reduce deficits or fund increased spending on health care or other valuable public services. Others argue, to the contrary, that higher rates will generate no significant (if any) additional revenues because corporations respond to higher tax rates by shifting income to other jurisdictions; increasing their debt financing, leading to higher interest deductions; and, in the long run, reducing their investments, thus lowering total profits and corporate taxes on those profits. The lack of agreement on this issue underlines the importance of careful empirical studies to determine the responsiveness of corporate tax bases to corporate tax-rate changes.

This recent study by Dwenger and Steiner is based on German data for 700,000 corporations in 1998 and 860,000 corporations in 2004. The authors use these data to construct a pseudo-panel of "representative" corporations and to determine the effect of the German tax reform from 1998 to 2001, which reduced the statutory tax rate by 20 percentage points for most corporations and the average effective tax rate (ATR) by 4.25 percentage points. The econometric results indicate that a corporation's tax base, measured by its net profit before loss carryovers, was quite responsive to changes in its ATR. The authors' preferred econometric results indicate that a 10 percent reduction in the statutory corporate income tax rate would increase corporate taxable income by 5 percent, resulting in a tax-base elasticity with respect to the tax rate of −0.50. Put another way, the econometric results imply that the revenue increase from a corporate tax increase would be only half that predicted by assuming no change in reported corporate profits. It should also be noted that the measured responsiveness of the corporate tax base to tax-rate changes occurred over a relatively short period, from 2000 to 2004, and that allowing a longer adjustment period that reflected long-run changes in investment would likely yield even larger estimates of the tax-base elasticity.

While the responsiveness of the entire corporate base is of interest, if only for political reasons, it is also important to determine whether firms in different sectors or with different characteristics respond in different ways to changes in the corporate income tax rate. Dwenger and Steiner found that larger firms, firms in manufacturing, and firms with high levels of foreign direct investment had larger tax-base elasticities (in absolute value) and that firms with more tax shields, such as accumulated losses, had lower elasticities, but none of these differences in estimated tax elasticities were significant at the 5 percent level. These are tantalizing results, at both the aggregate and the disaggregate levels, and further studies for Canada, the United States, and other countries are of considerable importance at a time when many jurisdictions are debating the future direction of their corporate tax policy.

Finally, it should be noted that the study did not indicate the effect of corporate tax-rate increases on total tax revenues. A corporate tax-rate increase may increase or reduce the personal income tax base and also affect the payroll and sales tax bases through effects on wages and employment. From a public finance perspective, it is more important to know the effect of corporate tax-rate changes on total tax revenues than on corporate tax revenues alone, and this is a topic that has not been adequately studied.

B.D.

David Powell and Hui Shan, "Income Taxes, Compensating Differentials, and Occupational Choice: How Taxes Distort the Wage-Amenity Decision"
(2012) 4:1 *American Economic Journal: Economic Policy* 224-47

The distortionary effect of an income tax on individual's location choices when jobs in different regions are associated with different (non-taxable) amenities, such as climate or recreational opportunities, was briefly mentioned above in the review of the Albouy article. This empirical study by Powell and Shan takes up a closely related issue—the effect of an income tax on occupational choice when different jobs have different characteristics or "amenities," such as the working environment, on-the-job safety, and convenience of the work hours. Powell and Shan develop a simple model of occupational choice in which an individual values both wage income and amenities, and faces a tradeoff in the labour market whereby jobs with higher wages offer fewer desirable amenities. This model predicts that when an individual's marginal tax rate on labour income increases, he or she will choose an occupation with a lower wage rate and a higher amenity level.

Powell and Shan investigate the impact of higher marginal tax rates on occupational choice by utilizing the data from the US Panel Study of Income Dynamics[11] for the years 1981 to 1997. They estimated the effects of tax-rate changes on the wages received by workers aged 25 to 55 in 40 different occupational categories. Their econometric results indicated that a 10 percent increase in an individual's net-of-tax rate, which is 1 minus the marginal tax rate, would induce the individual to move to an occupation with a 0.33 percent higher wage rate. Another way of expressing this is that a 1 percentage point increase in the marginal tax rate from 39 to 40 percent would induce individuals to choose occupations with 0.04 percent lower wage rates. Thus, although a tax-rate increase does seem to accept career choices, the economic effect seems to be relatively minor compared with, for example, the effects of tax-rate increases on labour force participation or hours supplied (especially by women). But as the authors note, this is a relatively new area of research. Further study is needed on the effects of the tax system on the provision of amenities by employers, individuals' training and education choices, and workers' effort levels, as well as occupational choices.

B.D.

Michael Keane and Richard Rogerson, "Micro and Macro Labor Supply Elasticities: A Reassessment of Conventional Wisdom"
(2012) 50:2 *Journal of Economic Literature* 464-76

Most of the econometric studies of labour supply based on micro data indicate that changes in after-tax wage rates have little effect on the amount of labour supplied, especially by prime-aged males. Keane and Rogerson argue that with two extensions

11 For information on the panel study, see http://psidonline.isr.umich.edu/.

of the basic labour supply model, the aggregate or macro response to increases in tax rates may be quite large even when the micro-based elasticities are low.

The first extension involves modelling the individual's future wage rates as dependent on current amounts of labour supplied. In this framework, which Keane and Rogerson refer to as the human capital model, an individual who works more today will earn a higher wage rate throughout his career. For example, young lawyers, accountants, and untenured professors work long hours, not to earn more in the current month, but to secure higher earnings over their entire career. In deciding how much to work in the current period, the individual has to trade off the utility of leisure time against the opportunity cost of time, which is his current after-tax wage plus the increase in the expected present value of his future after-tax earnings. Simulation models that incorporate this human capital effect indicate that temporary tax-rate increases can have much smaller effects on labour supply than permanent tax-rate increases, especially for young workers, because permanent increases have a greater impact on the opportunity cost of time. These models also show that the impact of a permanent tax-rate increase on the aggregate or lifetime labour supply of an individual is much larger when the simulations incorporate this human capital effect.

The second extension of the basic labour supply model involves modelling decisions when hours of work have to exceed some minimum amount because there are fixed costs in going to work (such as commuting time) or in employing individual workers (such as administrative costs of preparing payrolls and work assignments). Individuals then either supply more than the minimum number of hours or do not work at all. In simulation models that incorporate the intensive, or hours, decision as well as the extensive, or participation, decision, the impact of tax-rate increases on aggregate labour supply is quite large.

Keane and Rogerson argue that simulations of the effects of taxes on labour supply have to incorporate relevant technological constraints and market imperfections in order to evaluate their size and welfare implications. Other constraints that might potentially influence the impact of taxes on labour supply include credit market constraints, which may force individuals to work more than they would otherwise want to in the current period because they cannot borrow against future incomes, and the need to acquire precautionary savings against future income shocks because of the absence of an insurance market for income risks.

The overall importance of the line of inquiry described by Keane and Rogerson is that we should not necessarily conclude, as Saez, Slemrod, and Giertz have done,[12] that the efficiency cost of labour taxation is low because the static micro data estimates of the labour supply elasticity and estimates of the elasticity of taxable income are low. A reminder of the limitations of the static model estimates is particularly

12 Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review" (2012) 50:1 *Journal of Economic Literature* 3-50, reviewed in this feature (2012) 60:3 *Canadian Tax Journal* 765-91, at 778-81.

important at this time, when some economists are advocating, and some governments are contemplating, an increase in marginal tax rates on earned income to 75 percent.

B.D.

New Zealand Inland Revenue, Policy Advice Division, *Taxation of Foreign Superannuation: An Officials' Issues Paper* (Wellington: New Zealand Inland Revenue, July 2012), 24 pages, ISBN 0-478-39203-6

In terms of country practice, New Zealand is an outlier in its application of the standard income tax treatment of savings to retirement savings. In New Zealand, contributions to retirement savings plans must be made out of after-tax funds, returns to savings held in the plan are fully taxable, and withdrawals are exempt. This treatment has necessitated the application of the foreign investment fund (FIF) rules to interests of NZ residents in foreign retirement savings plans. Returns to savings are thus taxed on an accrual basis using either a market valuation approach or a deemed rate of return. Various exceptions to the FIF rules have, however, been made for certain foreign retirement savings plans, the most important of which is an interest in a locked-in plan. For these plans, accrual-based recognition of the return to savings is not applied and withdrawals are taxable under general income tax principles, which depend on the characterization of the withdrawals.

This officials' paper proposes to replace the existing rules for taxation of an interest in a foreign retirement savings plan with a single set of rules that would be much simpler. Interests in foreign retirement savings plans would no longer be subject to the FIF rules, and instead all periodic withdrawals would be taxed on receipt at the relevant personal tax rates. Lump-sum transfers would be subject to partial inclusion, with the inclusion rate depending on the period between arrival in New Zealand and receipt of the transfer.

T.E.

Alice G. Abreu and Richard K. Greenstein, "It's Not a Rule: A Better Way To Understand the Definition of Income," *Florida Tax Review* (forthcoming) (also available on the Social Science Research Network at http://ssrn.com/abstract=2132534)

The concept of income under US tax law is usually considered to be much broader than that under source-based income tax systems such as Canada's. This "accretion" concept of income was most compellingly articulated by the US Supreme Court as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[13] Despite the potential breadth of this concept of income, there is nonetheless a range of accepted exclusions that are broadly consistent with those under source-based systems. In an earlier article in the *Florida Tax Review*,

13 *Commissioner v. Glenshaw Glass Co.*, 348 US 426, at 431 (1955).

Kahn[14] critically examined one such set of exclusions for services provided in a noncommercial setting, arguing that this and certain other exclusions can be understood when it is recognized that the income tax operates only on commercial transactions.

Abreu and Greenstein use the article by Kahn to re-examine their earlier hypothesis[15] that the concept of income should be understood not as a rule but as a standard that permits social and cultural values to inform the boundary between taxable and non-taxable receipts. They illustrate the application of their earlier hypothesis by considering a number of examples examined by Kahn. Although the article is engaging in its analysis, the difference between the authors' approach and that of Kahn may be somewhat overstated. Indeed, it may be nothing more than a difference in form or framing, with the kinds of non-economic values emphasized by Abreu and Greenstein informing the rule-based divide suggested by Kahn. Moreover, the items that lie along the taxable/non-taxable boundary tend to be marginal in nature, at least in terms of an assessment of status using the standard technical tax policy criteria of efficiency, equity, and simplicity.

T.E.

Binh Tran-Nam and Chris Evans, "Tax Policy Simplification: An Evaluation of the Proposal for a Standard Deduction for Work Related Expenses"
(2011) 26:4 *Australian Tax Forum* 719-35

Australia has always allowed employees to deduct any work-related expenses incurred for an income-earning purpose. At the other extreme, New Zealand does not permit the deduction of any employee expenses. Canada lies somewhere in between these two extremes: employees may deduct a limited set of specifically enumerated expenses, and in addition may claim a tax credit that approximates a standard deduction of $1,000.[16] In response to one of the recommendations of a recent comprehensive review of the Australian tax system,[17] the Australian Treasury has proposed the adoption of an option for employees to claim a standard deduction of $1,000 in lieu of deducting the amount of actual work-related expenses and the costs of managing tax affairs.[18]

14 Douglas A. Kahn, "Exclusion from Income of Compensation for Services and Pooling of Labor Occurring in a Noncommercial Setting" (2011) 11:8 *Florida Tax Review* 683-97.

15 Alice G. Abreu and Richard K. Greenstein, "Defining Income" (2011) 11:5 *Florida Tax Review* 295-348.

16 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"), section 8 and subsection 118(10).

17 Australia, Tax Review Panel, *Australia's Future Tax System: Report to the Treasurer: Part One—Overview* (Canberra: Australian Treasury, December 2009), at 83, reviewed in this feature (2010) 58:4 *Canadian Tax Journal* 1053-68, at 1053-56.

18 Australian Treasury, *Making Tax Time Simpler: Standard Deduction for the Cost of Work-Related Expenses and the Costs of Managing Tax Affairs* (Canberra: Australian Treasury, February 2011).

The authors of this article critique the optional standard deduction for a failure to capture potential simplification gains. The motivation for the adoption of the standard deduction is perhaps apparent in some telling data cited by the authors indicating growth of work-related expense deduction claims that is faster than growth in employment income. A standard deduction can eliminate revenue loss attributable to overstatement of such expenses and provide compliance and administrative cost savings. But as the authors emphasize, these positive features are captured primarily where a standard deduction is provided on a mandatory basis. Provision of an optional standard deduction provides non-itemizing employees with a deduction while still permitting itemizing employees the benefit of claiming actual expenses. The authors suggest that the provision of the standard deduction on an optional basis may be attributable in part at least to the desire of tax return preparers to maintain, for their own business reasons, the ability of employees to claim actual work-related expenses. In the face of an inability to adopt a mandatory standard deduction, the authors suggest that the option be made more attractive by increasing the amount.

T.E.

Cait Poynor Lamberton, "A Spoonful of Choice: How Allocation Increases Satisfaction with Tax Payments," *Journal of Public Policy and Marketing* (forthcoming) (also available on the Social Science Research Network at http://ssrn.com/abstract=2078599)

Earmarking of taxes is an accepted political economy technique intended to address aversion to the payment of taxes. Providing information about the public benefits funded by taxes is another technique used for the same purpose. Both techniques attempt to link the revenue and spending sides of fiscal policy in a positive way. This article goes beyond these accepted techniques and proposes a system in which taxpayers can individually allocate a modest portion of their tax payments to specified spending programs. The focus of the proposal is the same lack of volition and direct linkage to taxpayer spending priorities that are the focus of earmarking and taxpayer-information campaigns.

The article provides the results of three empirical studies designed to examine the effect of the lack of a direct link between a tax payment and the benefit received by a taxpayer, and the lack of volition of tax payments. The author does not attempt to test for a third factor that tends to make taxes unpopular—the imposition of tax payments by a government. The studies are framed in terms of a taxonomy of payments. At one extreme are consumer payments that are entirely voluntary and for which the entire benefit is captured by the consumer. At the other extreme are tax payments that fall into general revenue; this type of payment is mandatory and there is no direct link between the amount of the payment and the benefit received. In between these two extremes are two other types of payments. One type, such as a charitable contribution, is voluntary but the benefit received is indirect and collective in nature. The other type, such as vehicle registration fees, is mandatory but there is a direct link between the payment and the benefit received by the payer.

The three empirical studies test three hypotheses:

1. Tax payments characterized by low volition and the purchase of collective benefits will be less satisfying than payments characterized by perceptions of high volition and/or personal benefits.
2. Allowing consumers to allocate a portion of a tax payment will increase satisfaction with making such payments relative to the situation where no allocation is permitted.
3. The relationship between allocation and satisfaction with tax payments will be jointly explained by
   a. enhancing the value of benefits associated with the payment, and
   b. reducing the sense of lack of volition associated with the payment.

Two of the studies are experimental. One used homeowners' association fees, framing them as either high or low volition and providing either collective or personal benefits for participants. The other experimental study created an explicitly styled tax payment in which participants were allowed to earn varying amounts based on effort with a portion of any payment withheld as a required "lab tax." The third study used a nationally representative sample with survey questions focused on a range of tax rates, filing status, and actual information regarding expenditure categories as allocation targets.

The final section of the article considers some practical constraints of a tailored system of allocation of tax payments. These include the possibility of instability for government spending, the disproportionate power to determine spending decisions that would accrue to high-income taxpayers, the constitutionality of such a program, and the possibility that elected officials could override the effect of taxpayer-directed allocation of tax payments. There is also a frank discussion of the limits of the research results, followed by suggestions for the direction of future research.

T.E.

Micah Burch, Luke R. Nottage, and Brett G. Williams, "Appropriate Treaty-Based Dispute Resolution for Asia-Pacific Commerce in the 21st Century,"
University of New South Wales Law Journal Forum (forthcoming)

This article reviews dispute resolution processes under regional trade and investment treaties, as well as bilateral tax treaties. The authors argue that with all three types of agreements, enhanced transparency can lead to settlements and more efficient dispute management. In the controversial area of investor-state arbitration, the authors suggest that useful lessons may be found in the development of the mutual agreement procedure (MAP), modelled on article 25 of the OECD model tax convention.[19] They recognize, however, that their call for greater transparency in dispute resolution processes is constrained with respect to bilateral tax treaty disputes because

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

of heightened sensitivity to taxpayer confidentiality. They also suggest that a MAP works most effectively where the two signatories to a tax treaty are relatively balanced in their stage of economic development. They caution that with treaties between a developed and a developing state, the inclusion of a MAP can weaken the negotiating position of the latter as against the other treaty partner and taxpayers. The authors believe that this effect holds even for the MAP under the UN model double tax convention,[20] which allows the competent authority of a treaty partner, as well as a taxpayer, to opt out of an arbitrated decision.

T.E.

David H. Sohmer and Suzanne Costom, "Should Taxpayers Be Penalized for Their Accountant's Lack of Due Diligence: A Criminal Lawyer and a Tax Lawyer Both Say No! Part I" (2012) 34:14 *Canadian Taxpayer* 105-7 and **". . . Part II"** (2012) 34:15 *Canadian Taxpayer* 113-16

This article critiques the position of the Canada Revenue Agency that "[t]axpayers are generally considered to be responsible for errors made by third parties acting on their behalf for income tax matters."[21] The authors argue that this administrative position is incorrectly based on a notion of vicarious liability imported from tort law. In particular, the notion of vicarious liability is grounded in notions of compensation and the allocation of risk. The function of tax preparation penalties is, however, more closely analogous to the punishment or deterrence goal of criminal law in the context of strict liability offences. Thus, a defence of due diligence is available to the taxpayer, but an assessment of that defence must be made in terms of the taxpayer's care in hiring a tax return preparer and not in terms of the due diligence exercised by the preparer in filing a return. The authors support their positions with a thoughtful review of some of the relevant non-tax case law. Although all fact patterns are unique, they suggest that the following general factors are relevant in determining whether a taxpayer can successfully assert a defence of due diligence in the face of the imposition of preparation penalties:

- Did the taxpayer hire a reputable and competent professional?
- What verifications did the taxpayer make before hiring the professional?
- Did the taxpayer provide the professional with all relevant and necessary information?
- Did the taxpayer have the opportunity to correct a mistake, and was that opportunity exercised diligently?
- Did the taxpayer rely on the professional's expertise in good faith?

Part II of the article concludes with a brief review of some US and Canadian case law authority in support of the authors' position.

T.E.

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

21 *Information Circular* IC07-1, "Taxpayer Relief Provisions," May 31, 2007, at paragraph 35.