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Current Tax Reading

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Joshua D. Blank and Nancy Staudt, "Corporate Shams,"
New York University Law Review (forthcoming)

Between 1909 and 2011, the US Supreme Court decided 919 cases involving federal taxation issues, 40 percent (364) of which involved a corporate tax controversy. In 38 percent (137) of the corporate tax cases, the government alleged abuse, and it is these cases that are the subject of the empirical study reviewed here. The authors' goal is to understand how and why courts draw the line between legal and fraudulent behaviour and to uncover any important and previously unobserved trends. This ambitious study is the first of its kind.

What is corporate tax abuse? The study uses the following five indicia:

1. the presence of third parties in the transaction;
2. multistep transactions;
3. the lack of a non-tax business purpose,
4. accounting irregularities, such as book-tax differences; and
5. a claim for a tax refund on the initial tax return.

The most important of these indicia is the presence of third parties: it was cited in the government's briefs in 47 percent of the cases. In general, at least one of the five factors was cited in 79 percent of all the corporate tax abuse cases.

The study relies on three statistical models to answer two empirical questions:

1. Does the government have an easier or more difficult time winning corporate tax abuse cases than other types of cases that it litigates in the Supreme Court?
2. What are the factors that are most likely to convince the court to decide in favour of the government when abuse is alleged?

On the first question, the study finds that the government is 18 percent less likely to prevail when it alleges corporate abuse; the court appears to be sympathetic to corporations that adhere to the letter of the tax law, even if the transactions and

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tax positions undermine the revenue-raising potential of the Internal Revenue Code.[1] But still, the government has had a greater than 50 percent chance of winning. In other words, the study finds that even though the government may have a harder time winning corporate tax abuse cases, it is nevertheless more likely to prevail at the Supreme Court.

On the second question, the study considers four groups of factors that may explain the Supreme Court's decision in a particular case:

1. transaction-related factors (such as the presence of a third party, multistep transactions, and the lack of a non-tax business purpose);
2. tax return factors (accounting irregularities and refund claims);
3. personnel factor—Justice Scalia; and
4. the control variables (the effects of defence spending, the party petitioning for review in the Supreme Court, whether the majority of judges were appointed by Republicans, and the business cycle).

The study finds that transaction factors, though widely believed to correlate strongly and positively with corporate tax abuse, are generally not persuasive, and only the presence of third parties seems to have some relevance. When third-party presence is alleged together with other factors, the government is more likely to win:

> The government's actual win rate confirms these findings: the government prevailed in 60 percent of the cases that involved third parties and multistep transactions; it prevailed in 50 percent of the cases involving third parties and the alleged lack of a business purpose; and in just 45 percent of the cases that involved multistep transactions and the alleged lack of a business purpose.[2]

The tax return factors are found to have a significant impact: the government prevailed in 80 percent of the cases in which it pointed to accounting irregularities. When the court observes that corporate taxpayers seek payment from Treasury, and the Internal Revenue Service (IRS) rejects the refund claim, the court is much more likely to find the transaction abusive than in cases where the corporation simply seeks to pay a lower amount of tax than the government deems to be owed.

With respect to the judges on the bench, the study finds that the plain meaning approach to statutory interpretation favoured by Scalia J increases the probability of a pro-taxpayer outcome, but the empirical results are not statistically significant.

As to the control variables, the study finds that in times of war and foreign policy crisis, the government's chances of winning increase at notable levels, and when the government is the petitioner (rather than the respondent), the likelihood of a pro-government outcome increases by 11 to 14 percent.

1 Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

2 Blank and Staudt, at 44-45.

According to the authors, their model is successful since it can predict the probability of a government win that is generally consistent with the actual outcomes generated by the court. They acknowledge, though, that the model suffers from various limitations: the data set may suffer a selection problem; the focus on a particular Supreme Court decision over a long period of time may reduce the relevance of that case to an understanding of the court's decision making today; and it is not clear to what extent the empirical findings with respect to the Supreme Court's decisions can be generalized to lower courts, where most tax abuse cases are decided.

In spite of the limitations, the study provides important insights regarding the US Supreme Court's approach to corporate tax abuse, and it should have implications for practitioners and researchers in the United States. Canadian researchers may be inspired to adopt a similar methodology to examine the Canadian corporate tax cases. It would not be surprising if the Canadian findings proved to be similar to those in the United States. Canadian lawyers litigating corporate tax cases may find ways of exploiting the transaction factors and tax return factors in Canadian courts.

J.L.

Joel Slemrod and Caroline Weber, "Evidence of the Invisible: Toward a Credibility Revolution in the Empirical Analysis of Tax Evasion and the Informal Economy" (2012) 19:1 *International Tax and Public Finance* 25-53

James Alm, "Measuring, Explaining, and Controlling Tax Evasion: Lessons from Theory, Experiments, and Field Studies" (2012) 19:1 *International Tax and Public Finance* 54-77

These two literature surveys nicely complement each other. Slemrod and Weber write about how we can best learn about the size and determinants of tax evasion—what types of studies work best—while Alm discusses what we have learned from this research. Both articles focus on the published literature from academic journals, rather than the "tax gap" estimates produced by the US and UK governments.

Slemrod and Weber criticize research in this area, saying that we need a "credibility revolution" in this area similar to what has been achieved in other areas of applied econometrics. To that end, they advocate more transparency from researchers about their assumptions and methods, and about what can and cannot be inferred from the results. They also advocate more use of longitudinal (time-series) data rather than cross-sectional data (data on many taxpayers at a specific point in time) where it can plausibly be argued that unobserved influences do not change over time.

Alm's article will be the more useful one for practitioners and policy makers. At the end of the article, Alm provides useful summaries of several key issues: one page on the findings from the literature,[3] which are surprising, and go beyond confirming

3 Alm, at 69.

prior expectations; two pages on how this research can be used to design measures to control tax evasion;[4] and three pages on fruitful avenues for future research.[5]

A.M.

Organisation for Economic Co-operation and Development, *Automatic Exchange of Information: What It Is, How It Works, Benefits, What Remains To Be Done* (Paris: OECD, 2012), 25 pages

This publication, though slim, nevertheless contains a good deal of interesting information. Automatic exchange of information is defined by the OECD as "the systematic and periodic transmission of 'bulk' taxpayer information by the source country to the residence country concerning various categories of income (*e.g.*, dividends, interest, royalties, salaries, pensions, etc.)."[6] This contrasts with information exchange on request, which depends on specific requests for particular taxpayers and may be restricted by the source country to situations where proof of evasion can be produced by the residence country (which, of course, is what it wants the information for—a classic Catch-22).

Clearly, automatic information exchange is the gold standard for tax authorities seeking to control tax evasion. However, the report states that the OECD is not suggesting a change in the current international standard—information exchange on request—even though the OECD is actively involved in helping countries to provide automatic information exchange if they so wish.

The most interesting findings from the OECD's review are contained in two graphs showing the extent to which countries are engaged in automatic information exchange. It appears that Canada sends information automatically to 25 countries and receives information automatically from 26 countries.[7] The only automatic information exchanges of which I was previously aware are reciprocal agreements between Canada and the United States and between Canada and Mexico, so I am curious to know which other countries are involved. One clue is that Denmark sends information automatically to 70 countries.[8]

The report advocates that the countries involved should agree on a memorandum of understanding setting out the terms and conditions under which the automatic information exchange will take place. One wonders whether Canada has such agreements, and whether they could be obtained under access-to-information laws.

4 Ibid., at 70 and 72.

5 Ibid., at 73-75.

6 At 7.

7 At 16.

8 At 15.

The report cites two statistics on the effectiveness of automatic information exchange: Denmark and Norway each found that 39 to 40 percent of the income discovered by this means had not been reported.[9]

A.M.

Organisation for Economic Co-operation and Development, *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*
(Paris: OECD, June 6, 2012), 60 pages

The OECD last issued its transfer-pricing guidelines in July 2010.[10] It is now undertaking a revision of that document in respect of the pricing of intangibles. In releasing this discussion draft, the OECD seeks to obtain input from the business community at an early stage in the process. The draft contains two principal elements: a proposed revision of chapter VI of the transfer-pricing guidelines; and a proposed revision of the annex to chapter VI containing 22 examples that illustrate the application of the revised text.

The proposed revision of chapter VI is organized into four sections:

1. identifying intangibles;
2. identifying the parties entitled to intangible-related returns;
3. transactions involving the use or transfer of intangibles; and
4. determining arm's-length conditions in cases involving intangibles.

Notion of "Intangible"

The discussion draft defines the term "intangible" to mean something that is not a physical or financial asset, and is capable of being owned or controlled for use in commercial activities. This two-pronged definition rejects traditional legal, accounting, tax, and treaty definitions of intellectual property or intangible assets. The discussion draft states that

> the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.[11]

The availability and extent of legal, contractual, or other forms of protection is not a necessary condition for an item to be characterized as an intangible for

9 At 20.

10 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2010).

11 Discussion draft, at paragraph 5.

transfer-pricing purposes. Also, intangibles must be distinguished from market conditions or other circumstances that are "not capable of being owned, controlled or transferred by a single enterprise."[12] Examples are group synergies and features of a local market, such as the size of the market and disposable income.

Instead of categorizing intangibles as "trade versus marketing," "soft versus hard," and "routine versus non-routine," the discussion draft describes intangibles as including patents, knowhow, and trade secrets; trademarks and trade names; licences and similar rights in intangibles; and goodwill and ongoing concern value. The draft provides no clear characterization of an assembled workforce. It merely expresses the view that the transfer of an existing workforce may provide a valuable benefit, and that the transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of an intangible.

Parties Entitled to Intangible-Related Returns

The discussion draft makes it abundantly clear that the functions performed, assets used, and risks assumed by the parties determine the transfer-pricing outcomes in cases involving intangibles:

> [N]either legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE [multinational enterprise] group to retain the benefits or returns with respect to intangibles without more.[13]

Legal registrations of intangibles and contractual arrangements among the parties are the starting point for the determination, but are not necessarily the determinant factors. The key factor is the parties' conduct, not the contractual arrangements:

> The parties' conduct should generally be taken as the best evidence concerning the true allocation of entitlement to intangible related returns.[14]

According to the discussion draft, the conduct that entitles a party to intangible returns requires the party to "physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles"[15] and "bearing costs related to [these functions] does not, in and of itself, create an entitlement to intangible related returns."[16] While

12 Ibid., at paragraph 8.

13 Ibid., boxed text at page 12.

14 Ibid., at paragraph 37.

15 Ibid., at paragraph 40.

16 Ibid., at paragraph 47.

these functions may be outsourced to other parties, the party claiming entitlement to intangible-related returns must exercise some oversight over the outsourced activities.

Transactions Involving Intangibles

The discussion draft describes two types of transactions involving intangibles: transactions involving the use of intangibles, and transactions involving the transfer of intangibles. It recognizes that some transactions involve a combination of intangibles and that some of the intangibles may be more valuable as part of the combination than individually. An example is a pharmaceutical ingredient that is protected by patent, approved for sale by a government regulatory authority, and marketed under a well-known trademark. The discussion draft states that in such cases, it is important for a transfer-pricing analysis to take into consideration the synergy effects among groups of intangibles.

In the case of bundled transactions (where a transaction involving intangibles is bundled with a transaction involving other property or services), whether or not to unbundle the transactions will depend on the specific facts of the situation. In certain situations, bundled transactions are sufficiently unique that it may not be possible to identify comparable transactions. In some bundled transactions, intangibles may be so closely intertwined with services that it is difficult to separate the transactions for the purposes of a transfer-pricing analysis. In other cases, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer-pricing consideration.

Arm's-Length Conditions

The special nature of transactions involving intangibles makes it difficult to identify arm's-length conditions for related-party transactions by reference to the general principles set out in chapters I through III of the transfer-pricing guidelines. Accordingly, additional guidance is necessary. The discussion draft offers such guidance on the use of the comparable uncontrolled price (CUP) method, breaks new ground by explicitly endorsing income-based valuation methods, and provides additional guidance on the use of the transactional profit-split method.

In conducting a comparability analysis in transactions involving intangibles, the discussion draft states that the analysis must take into account the options realistically available to both parties. In applying the CUP method, the comparability analysis must consider the uniqueness of many intangibles as well as the specific terms of the transactions, such as the exclusivity of the right to the intangibles; the extent and duration of the legal protection of the intangibles; the geographic scope of the intangibles; their useful life and their stage of development; and the rights to enhancements, revisions, and updates. In addition, the discussion draft states that the actual and potential profitability generated by the use of the intangible as well as the existence of risks related to the likelihood of obtaining future economic benefits from the intangible should be taken into account in the comparability analysis.

When comparable uncontrolled transactions are not available, the discussion draft for the first time explicitly endorses the use of financial valuation techniques, such as discounted cash flow, stating:

> Depending on the circumstances, [financial valuation techniques] may be used either as a part of one of the five OECD approved methods . . . or as a tool that can be usefully applied in identifying an arm's length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions.[17]

The draft cautions, however, that the estimate of value based on such techniques can be highly volatile, because a small change in any of the assumptions underlying a method may lead to extreme variations in the intangible value it yields. The draft emphasizes that the selection of valuation methods must be based on robust and consistent underlying assumptions. With respect to the discounted cash flow method, it expresses concern about the use of financial projections that are extended beyond the point where a business enterprise can reasonably forecast, and questions the reliability of growth assumptions that ignore business cycles or other fluctuations relevant to the experience of the enterprise or the industry as a whole. It also includes observations on other elements of a discounted cash flow analysis, such as discount rates, useful life, and taxes, many of which seem intended to discourage the mechanical application of financial valuation techniques.

With respect to the selection of transfer-pricing methods, the discussion draft states:

> Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances.[18]

The CUP method can be used when, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or services, reliable comparables can be identified. In certain cases, such as those illustrated in example 15,[19] acquisition prices may provide a useful comparable under the CUP method. In example 15, the acquisition price is used to determine the value of the intangibles when other assets of the acquired company are easily valued.

In applying the transfer-pricing method, it is essential to carefully identify "idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship

17 Ibid., at paragraph 109.

18 Ibid., at paragraph 136.

19 Ibid., annex, at paragraphs 250 to 258.

between the parties."[20] The effect of these idiosyncratic aspects on prices and other conditions must be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length. The draft cautions that

> [i]t should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement.[21]

Overall, there is a preference for profit-split methods.

The discussion draft is a work in progress and does not address a number of important topics, such as cost contribution arrangements. The OECD has requested that written comments on the draft be provided by September 14, 2012.

The discussion draft represents an important step forward in tackling transfer-pricing issues in respect of transactions involving intangibles. It provides a broad definition of "intangible," recognizes the use of financial valuation techniques, and emphasizes the importance of economic principles and the actual conduct of related parties. It remains to be seen how these changes, if incorporated into the revised OECD transfer-pricing guidelines, may affect taxpayers and the Canada Revenue Agency in practice.

J.L.

Jens Wittendorff, "Consistency: Domestic vs. International Transfer Pricing Law" (2012) 66:12 *Tax Notes International* 1127-34

In this article, the author provides an overview of some of the recent transfer-pricing cases in OECD member countries to highlight the inconsistency in national approaches to transfer pricing and the inconsistency between national transfer-pricing law and the OECD transfer-pricing guidelines.[22] The cases discussed include *Automotive* (Dutch Supreme Court, 2002);[23] *BP* (Danish Supreme Court, 1988);[24] *DSG* (UK First Tier Tribunal, 2009);[25] *GlaxoSmithKline* (Tax Court of Canada, 2008 and Federal Court of Appeal, 2010);[26] *Roche* (Australian Administrative Appeals Tribunal, 2008);[27] *SNF* (Federal Court of Australia, 2011);[28] and *Shell* (Supreme Administrative Court of Sweden, 1991).[29]

20 Ibid., at paragraph 127.

21 Ibid., at paragraph 141.

22 See supra note 10.

23 Dutch Supreme Court decision of June 28, 2002 (BNB 2002/343).

24 TfS 1988.292.

25 *DSG Retail Ltd. & Ors v. Revenue & Customs (Rev 3)*, [2009] UKFTT 31 (TC).

26 *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324; rev'd. 2010 FCA 201.

27 *Roche Products Pty Limited and Commissioner of Taxation*, [2008] AATA 639.

28 *Commissioner of Taxation v. SNF (Australia) Pty Ltd.*, [2011] FCAFC 74.

29 RÅ 1991, ref. 107.

The author notes several areas of divergence in domestic interpretations. For example, the Dutch and Canadian courts, in *Automotive* and *GlaxoSmithKline* (Federal Court of Appeal) respectively, have adopted an aggregate examination of multiple transactions that is in line with the OECD guidelines, but the tax administration's position treats each transaction separately. Courts in Sweden, Denmark, Germany, and the United States have sanctioned a dynamic examination, whereas the court in Australia adopted a static approach in *Roche*. Similarly, courts in the Netherlands and the United Kingdom, and the Federal Court of Appeal in Canada have adopted the position that the arm's-length principle requires a subjective, entity-specific valuation; but the Australian court in *SNF* reached the opposite conclusion, favouring an objective valuation in which the focus is on the actual transaction and the consideration paid, rather than on the subjective or special factors of the parties involved.

As to the relationship between the OECD transfer-pricing guidelines and domestic law, the author divides the countries into four broad groups based on the approach of their courts:

1. direct and dynamic reference to article 9(1) of the OECD model convention[30] and the OECD guidelines in domestic transfer-pricing law (the United Kingdom, Norway, and proposed law in Australia);
2. linking of OECD materials with domestic law through legislative history (Denmark and Canada);
3. no formal linking of domestic law and OECD materials (Sweden); and
4. autonomous interpretation of the arm's-length principle (the United States).

The author suggests that countries should adopt a direct and dynamic reference approach in incorporating OECD guidelines into domestic law. In addition, the OECD should provide a clear articulation of the arm's-length principle and ensure that its transfer-pricing rules stay within the scope of article 9(1) of the OECD model.

J.L.

Organisation for Economic Co-operation and Development, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD, March 2012), 25 pages

In this short report, the OECD describes hybrid mismatch arrangements in terms of their underlying elements, tax effects, and implications for tax policy. The report draws some important conclusions and makes a number of policy recommendations.

Hybrid mismatch arrangements are defined as "arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more

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

countries."[31] These arrangements pose substantial challenges to revenue authorities and tax policy makers as they attempt to keep pace with complex transactions and to respond to the interaction of national tax systems in an increasingly integrated world economy.

According to the report, hybrid mismatch arrangements generally use one or more of the following underlying elements:

- hybrid entities—for example, entities that are transparent in one country and non-transparent in another country;
- dual-residence entities;
- hybrid instruments—for example, instruments that are treated as debt in one country and as equity in another country;
- hybrid transfers—for example, a transfer that is treated as a sale in one country but as a collateralized loan in another country.

Such arrangements are designed to achieve double deductions (for example, deduction of the same expense in two countries), asymmetrical treatment of the transaction (for example, deduction of an expense, such as interest, in one country without a corresponding inclusion of income in another country), or access to or an increase in foreign tax credits (so-called foreign tax credit generators). The effect is to make income "disappear" between countries as a result of differences in national tax laws.

The report summarizes the key policy concerns raised by the use of hybrid mismatch arrangements as including

- loss of tax revenue (which anecdotal evidence shows to be substantial);
- creation of an unintended competitive advantage for businesses that have access to sophisticated tax expertise;
- distortion of investment decisions and violation of both capital import neutrality and capital export neutrality;
- reduced transparency in the tax system; and
- increasing unfairness, since the opportunity to use such arrangements is typically not available to wage earners or to medium-sized and small businesses.

The main policy issue is that these arrangements appear to be technically compliant with the laws of the two countries involved but result in double non-taxation that was not intended by either country.

To respond to the above issues, the report suggests four policy options. The first, and theoretically the best, option is harmonization of domestic laws; however, it is considered to be practically impossible. ("[T]his option is simply mentioned for the

31 At paragraph 3.

sake of completeness.")[32] A second option is a domestic general anti-avoidance rule (GAAR); however, in practice, domestic GAARs are difficult to apply to cross-border hybrid transactions because of the need to show a direct link between the transaction and the avoidance of that country's tax. In other words, a domestic GAAR may be one-sided and may not apply where another country's tax is avoided. The third and fourth options are, respectively, specific anti-avoidance rules (SAARs) and rules specifically targeting hybrid mismatch arrangements (TAARs). The report suggests that SAARs and TAARs are preferred because the design of these rules can make an explicit link with the tax law of another country. The report states:

> Domestic law rules which link the tax treatment of an entity, instrument or transfer in the country concerned to the tax treatment in another country appear to hold significant potential as a tool to address hybrid mismatch arrangements that are viewed as inappropriate.[33]

The report describes some of the rules enacted in various countries (including New Zealand, the United Kingdom, and the United States) and provides evidence of positive outcomes where these rules have been applied. To strengthen the effect of SAARs and TAARs, the report recommends that countries enhance inter-nation cooperation and information sharing.

This report demonstrates the important role of the OECD in coordinating national tax systems in order to prevent double taxation and double non-taxation. Since MNEs are generally capable of avoiding the use of certain arrangements where they see a risk of double taxation,[34] and the risk of double taxation is minimized through tax treaties and domestic law, the prevention of double non-taxation is becoming a serious issue. Theoretically, the best way of preventing double non-taxation resulting from the abusive exploitation of differences in national laws is to eliminate these differences. As acknowledged in the report, however, formal harmonization is considered to be impossible. Therefore, the second-best solution is "informal" harmonization or coordination through domestic SAARs or TAARs. The OECD is the only international body that is capable of promoting such coordination. Ultimately, however, it is up to Canada and other countries to enact the rules required to combat the problem of double non-taxation.

J.L.

32 At paragraph 30.

33 At paragraph 35.

34 At paragraph 6.

Nicole Fortin, David Green, Thomas Lemieux, Kevin Milligan, and Craig Riddell, "Canadian Inequality: Recent Developments and Policy Options"
(2012) 38:2 *Canadian Public Policy* 121-46

In this article, Fortin et al. review trends in inequality in Canada, their causes, and policy options.[35]

The authors report that inequality has risen sharply in Canada. For example, the share of income earned by the top 1 percent of earners was 8 percent in the late 1970s and has risen to 14 percent in recent years—the highest it has ever been, with the sole exception of the 1930s when it reached 18 percent.[36] This trend in inequality in individual income has been matched by trends in inequality of consumption levels and inequality of family incomes.

These inequality trends are no doubt partly due to skill-biased technical change, which has reduced the demand for skilled workers relative to unskilled workers. However, there seems to be an additional routine-biased technical change, which has reduced the demand for middle-income workers, such as bookkeepers, whose jobs can be replaced by computer technology, and thus has hollowed out (reduced) this part of the employment income distribution. In addition, gender-based trends have played a part. The increased education and income levels of women over recent decades seem to have caused marrying up (for example, nurses marrying doctors) to be largely replaced by "associative mating" (high income earners marrying one another). Thus, the increased incomes of women may have reduced inequality of individual incomes, relative to what they would otherwise have been, but increased the inequality of family incomes.

Many of these causes of inequality may be policy-based, and are not just independently caused economic trends. In particular, the authors note that growth-oriented economic policies such as encouraging trade or spurring investment in new technology may have the side effect of exacerbating inequality.

The authors do not go into detail about the reasons why inequality should or should not be reduced. These reasons could be based on personal values and personal taste regarding redistribution, or could instead be based on the impact of inequality on economic growth and on consumption behaviour, health, and happiness—all of which have been adequately covered elsewhere. Instead, the authors simply assume that there is an interest in policies that could reduce inequality, and then they move directly to canvassing policy options.

Raising the top marginal tax rate from 29 percent to 35 percent is one policy option. (It is discussed further in the review that follows.) Other options considered

35 For readers who are interested in pursuing this topic further in the popular literature, two recent best-sellers are suggested: Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers Our Future* (New York: Norton, 2012) and Edward Conrad, *Unintended Consequences: Why Everything You've Been Told About the Economy Is Wrong* (New York: Penguin, 2012).

36 Fortin et al., at 127-28.

by the authors are to increase transfers and refundable tax credits for individuals at the bottom of the income distribution; to attempt to lower Canada's high-school dropout rate (which is reported to be high by international standards); to increase the minimum wage; and to make it easier for unions to sign up unorganized workers.

A.M.

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

Alexandre Laurin, *Ontario's Tax on the Rich: Grasping at Straw Men*, C.D. Howe Institute e-brief (Toronto: C.D. Howe Institute, June 13, 2012), 7 pages

The link between these articles is fortuitous: the literature review by Saez et al. is particularly relevant in assessing the effects of Ontario's 2012 high-income tax increase, as discussed by Laurin (and, implicitly, by Fortin et al.).[37] This is a case where thorough and insightful academic research can illuminate a current public policy issue. Therefore, the analysis below presents the issues in some detail, focusing on the revenue question.

It has long been recognized that the behavioural response of individuals to taxes is multifaceted. Thus, for example, a change in the marginal tax rate might affect not just the number of hours that an employee works, but also the amount that he or she contributes to retirement savings or invests in tax shelters. As a result, the best overall measure of the response to any particular tax change may be the induced change in taxable income. Thus, a key parameter of the tax system is the elasticity of taxable income (ETI)—the percentage change in declared taxable income in response to a 1 percent change in the net-of-tax rate (1 minus the marginal tax rate).

Saez et al. conduct an extensive review and critique of the empirical studies in this area,[38] and conclude that the best available estimates of the long-run ETI range from 0.12 to 0.40. Thus, taking the approximate midpoint, they suggest that a value of 0.25 would be appropriate.[39] In other words, a 1 percent increase in the net-of-tax rate, under the current tax structure, would increase taxable income by 0.25 percent. This has important implications for the revenue impact of tax changes. When

37 See Fortin et al., reviewed above. A pre-publication version of the article by Saez et al. was reviewed briefly in this feature in late 2009: see (2009) 57:4 *Canadian Tax Journal* 972-85, at 980. A more detailed review is provided here in the context of subsequent research and the recent Ontario tax increase for high income earners.

38 The article reviews only the US studies, but the authors' working paper also covered non-US studies: Emmanuel Saez, Joel Slemrod, and Seth Giertz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, NBER Working Paper no. 15012 (Cambridge, MA: National Bureau of Economic Research, May 2009).

39 Saez et al., at 42.

the marginal tax rate is increased, the "mechanical" increase in tax revenue can be determined by recalculating every individual's tax payable using the new rate and subtracting it from the tax payable under the current rate structure. The key question is what percentage of this increase in tax revenue is lost because taxpayers employ various strategies to reduce their taxable income in response. Plugging in an ETI estimate of 0.25 as well as values for the other key parameters (such as 42.5 percent for the top marginal tax rate), Saez et al. estimate that, under the current tax structure, 27.7 percent of the mechanical increase in tax revenue is lost through various behaviours that taxpayers undertake to reduce taxable income.[40] The size of this change increases with the marginal tax rate; thus, there will exist a marginal tax rate at which the mechanical increase in tax is exactly offset by the revenue lost through the tax-induced reduction in taxable income. Saez et al. estimate that this offset would occur at a top marginal tax rate of 72.7 percent.

These two estimates—that 27.7 percent of potential revenue is lost, and that the revenue-maximizing top marginal tax rate is 72.7 percent—depend critically on the value of ETI (although other parameters also play a role). Thus, Fortin et al. note that if the ETI had a value of 0.6, 100 percent of potential revenue would be lost and the revenue-maximizing top marginal rate would be 49.5 percent.[41] Fortin et al. appear to be more inclined to a higher value for the ETI than Saez et al., since they note that "even a fairly large increase in the top marginal rate would yield at best a small increase in tax revenues."[42] Saez et al. note that there is much evidence to suggest that the ETI is higher for high-income individuals, but they apparently feel that the body of findings is insufficient to draw any quantitative conclusions on the size of the elasticity for this group.[43]

Laurin's analysis is not directly comparable to that of Saez et al. or Fortin et al. because he uses a simulation analysis (calculations using a sample of tax return data) rather than an equation derived from analytic modelling to move from an ETI estimate to a revenue figure. Laurin calculates that with an ETI of 0.7, the 2012 Ontario tax increase for top income earners will see a loss of about 50 percent of potential

40 Ibid., at 9.

41 Fortin et al., at 137. The calculations are not exactly comparable since Fortin et al. are modelling Canada while Saez et al. are modelling the United States. Thus, for the tax rate increase, Fortin et al. are modelling an increase in the top federal marginal tax rate from 29 percent to 35 percent. Also, Fortin et al. use a Pareto (income distribution) parameter of 1.7 for Canada, while Saez et al. use a Pareto parameter of 1.5 for the United States.

42 Fortin et al., at 137.

43 Laurin (see below) uses a figure of 0.7, which is apparently a composite of the Department of Finance's estimates of 0.62 and 0.72 for individuals with over $150,000 of taxable income (depending on the methodology used): Canada, Department of Finance, *Tax Expenditures and Evaluations 2010* (Ottawa: Department of Finance, 2010), at 54. This is not a regular component of the annual tax expenditure report; these estimates were part of a special study entitled "The Response of Individuals to Changes in Marginal Income Tax Rates."

revenue in 2013.[44] However, Laurin goes further, suggesting that over the long run (sometime beyond 2016) the ultimate effect of the tax increase will be to reduce revenue. Thus, Laurin concludes that Ontario is in the counterintuitive situation where tax cuts raise revenue and tax increases reduce revenue (at least for tax changes directed at high income earners, who, as noted above, are most responsive to tax changes). This situation is generally referred to as being on the wrong side of the Laffer curve (a hump-shaped graph that shows tax revenue as a function of the tax rate).

Elasticities for the long run (that is, exceeding a few years), which Laurin uses, are generally agreed to be much more speculative than short-run measures. The view of Saez et al. is that for statistical reasons, "there are no convincing estimates of the long-run elasticity of reported taxable income to changes in the marginal rate."[45] Kevin Milligan (a co-author with Fortin et al.) also appears not to be inclined to specify a separate and higher long-run elasticity; his estimate is that behavioural change will reduce the tax revenue increase by at least half,[46] which broadly agrees with Laurin's finding (cited above) before the long-run elasticity argument is introduced. This loss in potential revenue is nowhere near 100 percent, and thus Milligan would disagree with Laurin's finding that Ontario is on the wrong side of the Laffer curve.

One subtle aspect of a change in the tax rate is its impact on federal and provincial revenues: the mechanical increase in revenue accrues entirely to the government that raised its tax rates, while the loss of potential revenue through behavioural change accrues to both levels of government according to their share of the marginal tax rate of the affected persons. Thus, a level of government that leaves its rate unchanged suffers from a sort of spillover effect from the level of government that raised its rates. In the case of the Ontario rate change, this spillover effect would be perhaps 60 percent of the behavioural change (29 percent/49.53 percent—the new top federal-provincial rate for Ontario for 2012).

The revenue issue is only part of the broader question of the policy implications of these findings. One issue is vertical equity—how the tax burden should be shared across income groups. Although this is fundamentally a question of values, Fortin et al. note that if society does not value very highly an extra dollar of consumption for those at the top of the income distribution, the appropriate tax policy is to push the tax rate up to the revenue-maximizing point.

Other policy implications depend on what sort of behavioural changes are causing the decline in taxable income: Are these "real" changes, such as changes in hours

44 Laurin, at 4. Comparing this result with that of Fortin et al., cited above, might suggest that Laurin's finding on the loss of potential revenue is relatively modest, given that he uses a high ETI estimate. The difference appears to be related to the use of the simulation technique.

45 Saez et al., at 43.

46 Kevin Milligan, "Relax, Fears over Ontario Tax on Rich Are Overblown," *Globe and Mail*, April 26, 2012.

worked or in money invested, or are they changes in avoidance and evasion activities? Saez et al. believe the latter, presumably on the basis of the long history of labour-supply (hours-worked) studies finding minimal effect for workers who are their family's primary income earner. Changes of the latter type are still a type of economic inefficiency, but not one that should be taken as impossible to change or (although Saez et al. do not say this directly) one that would be likely to lead to a reduction in economic growth. Accordingly, Saez et al. conclude that "the best policy response would not be to lower tax rates [or forgo tax increases?], but instead to broaden the tax base and eliminate avoidance opportunities to lower the size of behavioral responses."[47]

This conclusion brings us back full circle in terms of the prescriptions for future economic research. While the notion of the ETI emerged from the belief that existing studies of labour supply, savings, etc., did not capture all of the possible responses to taxation, Saez et al. conclude that future research needs to disaggregate the change in taxable income into its component parts.

A.M.

Niels Johannesen and Gabriel Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown* (Paris: Paris School of Economics, January 31, 2012) (www.parisschoolofeconomics.eu/docs/zucman-gabriel/sub_jan31.pdf), 38 pages

Tax havens provide corporations and individuals with opportunities to avoid or evade taxes. Bank secrecy is crucial to countries in maintaining their tax haven status. In order to prevent tax base erosion in high-income and high-tax jurisdictions (mostly OECD countries), since the late 1990s, the OECD has conducted harmful tax competition campaigns and encouraged tax havens to exchange information with other countries on the basis of bilateral tax treaties or tax information exchange agreements (TIEAs). Until 2008, however, most tax havens declined to sign such treaties. During the financial crisis, the fight against tax evasion became a political priority in high-income countries, and the pressure on tax havens mounted. In April 2009, G20 countries issued a statement urging tax havens to sign tax treaties with at least 12 members of the group; otherwise, they would face economic sanctions. Since then, more than 700 treaties have been concluded by tax havens, "[bringing] about a profound change in the international tax environment."[48]

So does this mean the end of bank secrecy? Have the treaties resulted in a reduction in tax evasion? To answer this question, Johannesen and Zucman exploit a unique panel data set on cross-border bank deposits from the Bank for International Settlements (BIS) in order to assess how the treaties have affected bank deposits in tax

47 Saez et al., at 42.

48 Organisation for Economic Co-operation and Development, Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency 2011: Report on Progress* (Paris: OECD, 2011), at 7 and 29.

havens. The hypothesis is that if taxpayers with cross-border bank deposits in a tax haven were concerned about the increased probability of detection of tax evasion, they would repatriate the funds or move the funds to a haven that has no treaty with the home country. If they were not concerned, they would leave the funds in the haven.

Johannesen and Zucman examined BIS data on bilateral bank deposits for 14 major tax havens (out of a total of about 50), including Switzerland, Luxembourg, and the Cayman Islands. They report that the global level of deposits in these tax havens remained stable between 2007 and 2011. However, there were significant differences in the level of deposits in individual countries. For example, banks in Jersey lost $100 billion of deposits, while banks in Hong Kong gained $65 billion.

To investigate the impact of a specific treaty, Johannesen and Zucman looked at the deposits held by French residents in Switzerland, by German residents in Luxembourg, by US residents in the Cayman Islands, and so on, on a quarterly basis from the end of 2003 to the middle of 2011. They state their research questions with specific country names for the sake of concreteness. For example, they ask: Did French holders of Swiss deposits respond to the new France-Switzerland treaty by repatriating funds to France? Did they relocate funds to other tax havens? Or did they simply leave the funds in Switzerland? On the basis of the data, Johannesen and Zucman report two findings. First, taxpayers responded moderately to the signing of treaties. Only a minority of depositholders appeared to perceive an increase in the probability of detection and transferred funds. Second, the taxpayers who responded to the treaty signing did not repatriate their funds but instead transferred them to havens not covered by a treaty. Tax havens that did not have treaties experienced an increase in deposits, while those that signed more than 12 treaties experienced a decrease. For example, Cyprus signed only 2 compliant treaties and had a 60 percent increase in its deposits, whereas Guernsey signed 19 compliant treaties and experienced a 15 percent decrease.[49]

Johannesen and Zucman conclude that the G20 tax haven crackdown caused a modest relocation of deposits between tax havens but no significant repatriation of funds. They interpret the small relocation as evidence that a minority of taxpayers responded to treaties but that a majority did not. So "[the] era of bank secrecy is not over."[50]

J.L.

Sheldon D. Pollack, "Arenas of Federal Tax Policy"

(2012) 135:12 *Tax Notes* 1499-1514

In this article, Pollack argues that not all tax policies are the same in the United States: some are distributive, some are regulatory, and some are redistributive. Each type is made in a different arena, by different political actors, and for different purposes.

49 Johannesen and Zucman, at 11.

50 Ibid., at 4.

Each arena is characterized by its own distinctive pattern of politics, decision making, and interaction among the participants. The author delineates the characteristics of the three distinct types of tax policy and then links them to the associated politics, political institutions, and political actors.

The article focuses on US public policy relating to the federal income tax. That tax generates over 55 percent of total federal receipts, finances virtually all of the discretionary spending authorized in the federal budget, and is central to US politics. The US constitution requires that all forms of federal taxation be authorized through legislation duly enacted by Congress, and that revenue bills originate in the House. The House Ways and Means Committee has the first opportunity to articulate and define federal tax policy, while the Senate Finance Committee plays a secondary, albeit critical, role in shaping tax policy initiatives.

Distributive tax policy in the context of this article refers to the use of the income tax law by individual legislators in distributing economic benefits to their constituents. Distributive tax policy is thus mainly about the tax preferences of certain taxpayers. The arena for distributive tax policy is congressional tax-writing committees. The political actors are the elected representatives and senators, whose job depends on the election results. For legislators, distributive tax policy is a highly effective means of satisfying the needs of their constituents and, in doing so, improving their own political fortunes. Pollack argues that

> the lawmakers' ability to "customize" the tax code makes it an efficient and attractive tool for distributing particularized economic benefits to constituents.[51]

It is easier to provide those benefits to constituents through the tax code than through direct appropriations included in the annual federal budget. The cost of a tax preference is widely dispersed among many taxpayers, while the tax subsidy is enjoyed by a few targeted beneficiaries. This means that opposition to a special tax subsidy tends to be weak, diffuse, and difficult to organize, while the few beneficiaries of the subsidy are highly motivated to lobby the legislators, especially those on the tax-writing committees. Pollack observes:

> The result is a classic politics of logrolling and vote trading that generates a seemingly endless supply of tax preferences for nearly every organized interest group in America. Democrats and Republicans alike pursue targeted tax preferences for their respective constituents. Sometimes they have the same constituents. Distributive tax policy is nonpartisan as much as it is unprincipled.[52]

A major consequence of the growth of tax preferences is serious erosion of the revenue-raising capacity of the income tax system. Congress is thus under constant pressure to increase tax rates. A distinctive feature of the US income tax in recent years has been high marginal tax rates with an abundance of tax preferences.

51 At 1503.

52 At 1504.

Regulatory tax policy is the means by which "public officials impose *their* policy preferences on private economic interests,"[53] typically through highly technical rules and regulations, many of which are related to anti-abuse. The arena for regulatory tax policy is the professional bureaucracy in Treasury and the IRS, within the executive branch. Unlike the actors in the arena of distributive tax policy, the tax professionals are relatively insulated from the pressures of interest groups and lobbyists as well as the vagaries of partisan politics. As civil servants, they are not required to compete in elections to retain their office. Accordingly, they are less susceptible to the pressures of the electorate or of organized interest groups. In terms of the legislative process, the professional staff routinely propose to the tax-writing committees regulatory policies for ending abusive transactions, loopholes, or technical glitches in the tax code. Congress also commonly delegates substantive legislative rule-making authority to the regulatory authorities. Because anti-abuse rules are revenue raisers, they are typically paired in a single legislative package with unrelated legislation (distributive or redistributive) that reduces tax revenue. Facing massive budget deficits, Congress tends to welcome regulatory tax policy initiatives. Unlike distributive tax policy that bestows benefits on selected beneficiaries, regulatory tax policies impose an economic burden on those affected. Targeted taxpayers might organize resistance or lobby members of the tax-writing committee, but they do not often succeed. As a result, in recent years many of the regulatory policies recommended by the professional bureaucracy have been enacted into law, contributing to the growing complexity of the federal tax system.

Redistributive tax policy involves broad national policies that provoke intense political conflict reflecting deep-rooted cleavages based on class, wealth, and region. The arena is the floor of Congress and national elections. The conflict is ultimately resolved only when a majority coalition successfully imposes its will on the minority opposition. Among redistributive policies, marginal tax rates on the wealthy are the most controversial. Generally, Republicans try to reduce the rates while Democrats try to raise them.

The three distinct tax policy streams are interconnected because all tax policy must ultimately come before Congress and the tax-writing committees for review and approval. At the end of the day, the policy streams

> converge in massive omnibus legislative packages that include a hodgepodge of distributive, regulatory, and redistributive tax policies. What we commonly refer to as federal tax policy is really the amalgamation of the policy outcomes produced in those discrete political arenas.[54]

The result is "complex, incoherent, and unprincipled."[55]

J.L.

53 At 1507 (emphasis in original).

54 At 1513.

55 At 1514.

Philip R. West and Amanda P. Varma, "US Taxation of Cross-Border Enterprise Services" (2012) 66:4-5 *Bulletin for International Taxation* 188-97

This article discusses the US tax rules governing the taxation of cross-border enterprise services, including characterization, source, treaty, transfer pricing, and some emerging issues.

For the purposes of determining the source of income under US tax law, it is important to characterize services provided by a corporation as giving rise to "income from services" or something else. The article presents an overview of the cases and regulations that distinguish services from royalties (*Boulez* [1984],[56] *Karrer* [1957][57]) and services from interest (*Bank of America* [1982],[58] *Container Corp.* [2010][59]). In *Container Corp.*, for example, the courts held that a guarantee fee received by the Mexican parent for its guarantee of notes issued by its US subsidiary was analogous to a fee for the performance of services. This decision was reversed by a specific sourcing rule for "guarantees of indebtedness" in IRC sections 861(a)(9) and 862(a)(9), which deem a guarantee fee to be interest sourced to the residence of the obligor.

Following a brief overview of the general sourcing rule on the basis of place of performance and the famous *Piedras Negras Broadcasting* case,[60] the authors discuss special rules for certain functions that may involve services, such as manufacturing, transportation, space and ocean activities, communications, and software. They note, in particular, the issues raised by electronic transactions and observe that no clear consensus has emerged in this area, despite the focus on these issues by policy makers and commentators over the last several decades and the growing importance of electronic commerce.

The authors also discuss the treaty rules governing the taxation of cross-border services and provide an update on relevant transfer-pricing issues. They refer specifically to the 2007 protocol to the Canada-US tax treaty,[61] which addressed (among other issues) the treatment of a services permanent establishment. The US regulations governing the transfer pricing of intercompany services were revised in 2009 to allow the use of one of the following listed methods to determine arm's-length price: the services cost method, the CUP (comparable uncontrolled price) method,

56 *Pierre Boulez*, 83 TC 584 (1984).

57 *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957).

58 *Bank of America v. United States*, 680 F. 2d 142 (Ct. Cl. 1982).

59 *Container Corp.*, 134 TC 122 (2010); aff'd. 107 AFTR 2011-1831 (5th Cir. 2011).

60 *Piedras Negras Broadcasting Co. v. Commissioner*, 43 BTA 297 (1941); aff'd. 127 F. 2d 260 (5th Cir. 1942).

61 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

the gross services margin method, the cost of services plus method, the comparable profits method, the profit-split method, or an unspecified method. These rules apply not only to controlled services transactions but also to services transactions that include other transactions, such as a transfer of intangible property.

The authors conclude that despite the increasing importance of cross-border services to the global economy and the changing nature of services, there will be no major change in direction in the US taxation of such services in the near future. Novel questions will have to be addressed by the courts or the IRS, and until they are resolved, uncertainty will persist.

J.L.

Peter H. Blessing, "The Debt-Equity Conundrum—A Prequel"
(2012) 66:4-5 *Bulletin for International Taxation* 198-212

The treatment of debt and equity is one of the most globally significant tax issues. This article provides a brief overview of various theoretical, policy, and technical perspectives in dealing with debt and equity, as well as a summary of certain reforms that have been proposed in some countries.

The distinction between debt and equity has major ramifications for the tax and financial systems of many countries. At the domestic level, interest payments are generally tax-deductible to the issuer and taxable to the holder of the debt obligation, while dividends are not tax-deductible and are generally not taxable to the corporate shareholder. At the international level, the treatment of the issuer is the same as in the domestic context (subject to thin capitalization rules), but the taxation of the holder is different: both interest and dividends are subject to withholding tax; in other words, non-resident corporate shareholders cannot receive tax-free dividends. The different tax treatment of debt and equity leads to a tax bias toward the use of debt. A recent study carried out by the International Monetary Fund[62] shows that the cost of equity-financed investment is significantly higher than the cost of debt-financed investment, and there is a correlation between higher corporate tax rates and higher debt-equity ratios.

Blessing's article examines the various commercial and legal factors that may affect the choice between debt and equity for a corporation. One factor, for example, is management's sensitivity to the weighted average cost of capital (WAAC), which is calculated on an after-tax basis in the case of deductible amounts. The percentage of debt financing often determines whether projects that are deemed profitable on the basis of their WAAC should move forward or not. In general, debt financing is standard management practice among corporations. A second factor is leveraged acquisitions by private equity funds. Before 2000, such acquisitions focused on reducing wasteful expenditures, shedding unprofitable assets, and restructuring, as well

62 Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN/11/11 (Washington, DC: International Monetary Fund, May 3, 2011), at 5 (www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf).

as achieving a favourable tax structure; more recent acquisitions tend to focus more on the tax structure to achieve returns. A third factor is the erosion of distinctions in legal rights in the financial marketplace. Derivatives and other financial instruments are created to mix legal rights traditionally found in debt or equity in order to achieve the desired mix of protections, returns, and liquidity. The large pools of capital accumulated in various tax-exempt organizations also presumably affect the choice between debt and equity, since these organizations generally favour debt.

What are the historical and legal reasons for the debt-equity distinction, and to what extent do those reasons remain valid? Blessing notes that tax laws originally followed commercial (debtor-creditor) and corporate law in adopting the separate entity concept and in formulating the rules distinguishing owners and non-owners of the entity. Shareholders were treated as the owners on the basis of factors such as risk, management participation, and the right to residual profit, whereas other interested parties (debtholders, employees, other service providers, etc.) were treated as contractual participants. Commercial and corporate law distinguished the legal rights of debtholders and equityholders on the basis of several factors, such as the seniority of the debt in right of repayment in the event of an insolvency or bankruptcy, and the right to be paid interest and principal when due. The notion that interest was incurred on a contractual obligation was considered relevant for tax-law purposes because interest represented an expense for an asset (money) to be used to earn income and, as such, should be deductible, just like other expenses of earning income. Since income is a net concept, a tax on net income should necessarily be imposed on an amount net of that interest expense. In today's environment, however, the historical justification is undermined "if the corporation purporting to borrow did not have a reasonable expectancy of making payments at the appointed times, regardless of whether a substantial portion of the borrowed funds were lost."[63]

The distinction between debt and equity in commercial law and tax law was found to make no sense from an economist's standpoint. Blessing points out that economists saw no reason to ascribe ownership to one class of instruments as opposed to another. Economically, both a debtholder and an equityholder are entitled to payments on capital, and there are no real differences in potential consequences arising from a failure to make a payment on capital to debtholders or shareholders. For example, holders of preference shares, like debtholders, typically have a reduced downside risk, no residual sharing, and no voting rights. The lack of a meaningful economic distinction between debt and equity is also illustrated by corporate finance instruments that "stray in varying degrees from the traditional distinctions, both unbundling economic and control rights . . . and bundling rights."[64]

Blessing lists a number of factors that raise tax policy concerns, including dramatically different tax consequences based on the form used to finance the business of corporations; the tax bias toward the use of debt; the ability to place debt with

63 Blessing, at 207.

64 Ibid.

tax-exempt organizations; the ability to arbitrage cross-border inconsistencies; and the availability of derivatives and hybrid instruments. Among the tax policy concerns are the welfare costs associated with tax-induced debt bias, or overleverage, including heightened bankruptcy risks and worsening of financial downturns; erosion of the corporate tax base; and concerns that the financial sector may become overly risky and inefficiently large as a result of the moral hazard created by overleverage.

In reaction to the above concerns, various approaches have been proposed to either limit interest deductibility or "equalize" the treatment of debt and equity. Blessing classifies these approaches as either falling within a bimodal debt-equity framework or departing from that framework. Government responses that are within a bimodal framework include thin capitalization rules and earnings-stripping rules. Responses that depart from the bimodal framework are relatively new and can generally be classified as one of four types:

1. *No deduction for debt or equity capital*. One example is the comprehensive business income tax (CBIT) proposed by the US Treasury in 1992,[65] which would subject all businesses to an enterprise-level tax at the same rate, allow no deduction for interest or dividends, and exempt debtholders and equityholders from tax on interest and dividends, respectively. A second example is the growth and investment tax (GIT) proposed by the Bush administration's tax reform advisory panel in 2005,[66] which would deny a deduction for interest and dividends to the corporation and would impose tax at a 10 percent rate on the recipients. A third example is the "interest box" regime adopted in some countries: interest received from members of a corporate group may be taxed at a low rate (say, 5 percent), but the deduction of certain interest expense is disallowed to the payer.
2. *An allowance for cost of capital (ACC) and no separate deduction for dividends or interest*. In essence, an ACC approach would disallow a deduction for interest and dividends, but allow a deduction for the notional risk-free return on all capital, regardless whether it takes the form of debt or equity. As a result, the debt bias would be removed while relief would be provided at the entity level to compensate for normal financing costs.
3. *An allowance for corporate equity (ACE) and a deduction for interest but not dividends*. Belgium implemented an ACE regime in 2006, which allows corporations to deduct interest paid as well as notional interest based on the book value of net equity. The current rate of deduction is 3 percent, regardless of payment. Brazil has introduced a similar regime, but the notional interest deduction on equity is deductible only if interest is paid.

65 United States, Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, DC: Department of the Treasury, 1992).

66 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005).

4. *An unlimited deduction for dividends and interest*. This approach would allow an unlimited deduction for dividends and interest, and tax only retained earnings. It was included in a bill introduced in the US Congress in 1985.

The distinction between debt and equity is a complex subject, and one that touches on some fundamental corporate tax issues. Blessing's article provides an excellent overview of those issues.

J.L.

Bruce Bartlett, *The Benefit and the Burden: Tax Reform—Why We Need It and What It Will Take* (New York: Simon & Schuster, 2012), 271 pages

This short book on the economics of taxation avoids weighty economic and technical analysis and thus is quite suitable for students as well as practitioners of accounting or law. For example, chapter 5, "The Relationship Between Tax Rates and Tax Revenue" presents the issue without showing a Laffer curve or defining elasticity of taxable income. Thus, people who are interested in the Canadian Tax Foundation's recent publication *Tax Policy in Canada*,[67] but find the economic theory used there to be difficult, may find that reading Barlett's book first will make the latter more accessible.

Although the book is American, the US-specific content is mostly concentrated in a few chapters, which can be skipped without loss of continuity—specifically, chapter 1, "A Brief History of Federal Income Taxation"; chapter 2, "How a Tax Bill Is Made"; and most of the chapters in part III of the book ("The Future"), which deal with current US issues such as the Bush tax cuts, the Nordquist no-tax-increase pledge signed by many US politicians, and the large US deficit. Even after omitting those sections of the book, chapters 3 to 17 constitute an excellent self-contained primer on the economics of taxation.

Chapter 9, "How Other Countries Tax Themselves" (an unusual perspective for an American book) compares the United States with various European countries in terms of what items are provided as public services rather than being privately purchased. Wealth taxes, environmental taxes, and taxes on US citizens abroad are briefly discussed. Bartlett claims that other countries tend to have less progressivity than the United States, basing this conclusion on the fact that the top US marginal tax rate takes effect at a higher level of taxable income. I wonder, however, whether his statement would be supported by a more thorough analysis that included tax base issues (such as the US 15 percent maximum tax rate on long-term capital gains) and the effect of low-income tax credits.

A.M.

67 Heather Kerr, Ken McKenzie, and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012).

Adam Chodorow, "Death and Taxes and Zombies" *Iowa Law Review* (forthcoming). [A pre-publication version is posted on the Social Sciences Research Network (ssrn.com).]

Chodorow's article is a welcome addition to the slim genre of humour based on technical tax—which, quite seriously, is an excellent vehicle for teaching tax concepts. It is a short piece (25 pages, with 107 footnotes) and focuses on the US tax context; however, Canada's deemed disposition and spousal rollover on death raises issues similar to those addressed by Chodorow. (Perhaps someone will be inspired to write a Canadian-focused piece in a similar vein.)

A zombie, of course, is one of the "undead"—or, to cite one well-known definition, "a human corpse, who is relentlessly aggressive and biological in origin."[68] The concept raises various tax questions, which Chodorow explores at length. Would a zombie be considered to be deceased for state law purposes, thus triggering probate and a distribution of assets? Would a person who became a zombie be considered a deceased person for federal estate tax purposes, with the associated imposition of estate tax? Would the federal income tax apply to zombies? And what tax-planning issues would be created under both the estate tax and the income tax? In a concluding section, Chodorow describes how the tax issues are different for vampires and ghosts.

A.M.

Canada, 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), 62 pages

The process by which the Parliament of Canada approves the funds required to meet the federal government's financial obligations is known as "the business of supply," and the government's spending plans are known as "the estimates." In January 2012, the Standing Committee on Government Operations and Estimates began a study of this supply and estimates process. After hearing from various witnesses, the committee presented this report in June, in which it sets out 16 recommendations.

The committee notes that expenditures that are mandated by statute (rather than being subject to the discretion of the government) should bear more scrutiny than they are currently given. In particular, the committee suggests that tax expenditures should be reviewed by the various parliamentary committees (defence, agriculture, etc.) at least once every eight years to determine whether they are meeting their objectives, and that they should be included in departments' annual reports on plans and priorities. In a comment made outside the recommendations, the committee

68 At 103, note 5.

notes that some tax expenditures should be included in the report of plans and priorities by the Department of Finance, and thus would presumably be reviewed by the finance committee.[69]

The Liberal and New Democratic parties submitted supplementary reports, included at the end of the full report, which recommend strengthening the office of the Parliamentary Budget Officer (currently directed by Kevin Page) and increasing that office's independence.

The committee has requested that the government table a comprehensive response to this report, but as of mid-August 2012, this had not yet occurred.

A.M.

69 At 35-36.