canadian tax journal / revue fiscale canadienne (2011) 59:3, 687-707

Current Tax Reading

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

Barbara von Tigerstrom, Tamara Larre, and JoAnne Sauder, "Using the Tax System To Promote Physical Activity: Critical Analysis of Canadian Initiatives" (2011) 101:8 *American Journal of Public Health* (http://ajph.aphapublications.org), e.10-e.16

The authors of this article (all at the College of Law, University of Saskatchewan) examine the merits of the federal children's fitness tax credit and related provincial tax measures in Nova Scotia, Manitoba, Saskatchewan, and Yukon. As they note, the cost of these provisions is significant. In particular, the Saskatchewan Active Families Benefit amounts to about $11 per person, with a total annual cost that is almost equal to the entire budget of the provincial department of Tourism, Parks, Culture and Sport. The high cost of the Saskatchewan credit is explained by the fact that it covers the full amount of the fees paid up to a maximum of $150—very different from the federal credit of 15 percent of fees up to $500—and it also covers cultural and recreational activities.

The authors also doubt the effectiveness of these incentives in promoting physical activity. One problem is that the tax saving is separated from the spending decision; the cash benefit is not realized until the filing of the tax return in the following year. The authors suggest that the fitness goal is better promoted by sales tax exemptions, which provide an immediate reduction in the cost of the good and are thus particularly useful for low-income families. Ontario's former sales tax exemption for bicycles[1] is cited approvingly. Overall, though, the authors believe that tax incentives are inferior to direct public funding of fitness-related programs such as spending on recreational facilities, walk/bicycle transportation networks, and physical activity programs in schools.

A.M.

* Bev Dahlby is of the Department of Economics, University of Alberta, and fellow, Institute for Public Economics. Tim Edgar is of Osgoode Hall Law School, York University, Toronto, and the Faculty of Law, University of Sydney; Jinyan Li is of Osgoode Hall Law School, York University, Toronto. Alan Macnaughton is of the School of Accounting and Finance, University of Waterloo. The initials below each review identify the author of the review.

1 The exemption, introduced in 2007, was eliminated with the introduction of the harmonized sales tax in July 2010.

Kenneth J. McKenzie and Natalia Sershun, "Taxation and R&D: An Investigation of the Push and Pull Effects" (2010) 36:3 *Canadian Public Policy* 307-24

Tax incentives that lower the after-tax cost of research and development (R & D) may be described as having a "push" effect on R & D. On the other hand, having a tax system that provides a low tax rate for general production activities rewards successful R & D effort, and thus may be said to have a "pull" effect on R & D. The authors use a dataset of nine member countries of the Organisation for Economic Co-operation and Development (OECD) over a 19-year period to demonstrate that both the push effect and the less well-known pull effect are statistically significant and economically important.

The authors received the Canadian Economics Association's Doug Purvis prize for their article. The award is given for a highly significant written contribution to Canadian economic policy research.

A.M.

Lori J. Curtis and JoAnn Kingston-Riechers, "Implications of the Introduction of the Goods and Services Tax for Families in Canada" (2010) 36:4 *Canadian Public Policy* 503-20

The replacement of the manufacturers' sales tax (MST) with the goods and services tax (GST) in 1991 affected households in complex ways, through both the prices they faced for goods and services and their tax liabilities. An attempt was made to eliminate any regressivity of the tax change by exempting basic groceries from the GST and introducing the GST credit. The commitment was that no Canadian family with a gross income below $30,000 would be worse off with the tax change.

Previous empirical research on the impact of the introduction of the GST considered only the income distribution effects of the change. This study also considers the price effects—both on overall prices and on the prices of particular goods and services—and measures the impact on the indirect utility of each household. The analysis is at the level of individuals rather than the economy as a whole. This allows consideration of differences in consumption patterns of households at different income levels, as well as factors such as the number of children in the household.

The overall result is that the tax change was progressive for households with gross income below $30,000; progressive, but less so, for households with gross income between $30,000 and $50,000; and neutral for households with higher gross incomes. However, these overall statistics conceal much individual variation: one in three low-income households was worse off as a result of the tax change. Generally, the adverse effects were most evident for families living in rental accommodation in urban areas.

A.M.

Brendan Burns, "Do Virtual World Activities Give Rise to Real Canadian Tax Liabilities?" (2010) 10 *Asper Review of International Business and Trade Law* 163-84

Can online multiplayer games (virtual worlds) create taxable income, and should the Canada Revenue Agency (CRA) move to enforce the law in this area? That is the question addressed in this article. Virtual worlds such as Second Life or World of Warcraft are simulated online environments that allow groups of people to interact with one another through fictional representations of themselves (avatars) on the computer screen. Undoubtedly, most players of the game are essentially trading their monthly subscription fees purely into entertainment value. However, some players may have a profit motive since there are several ways of turning in-game activities into Canadian currency.

The simplest way to generate cash is to spend hours building up the in-game resources of a user account, and then sell that account. Game developers often frown on such activities, but can do little to stop them. Similarly, the game environment may just be used as a place of communication where business deals involving real-world goods and services take place.[2] These situations undoubtedly produce taxable income.

The more interesting question arises from the fact that most of these worlds have virtual economies, where users can make, find, or win virtual goods and services and trade them with other users using a game-specific currency, such as Second Life's "Linden dollars." Although one might be tempted to dismiss such in-world transactions as simple entertainment without taxation consequences, as Burns notes in this article, some game developers have created or permitted (or simply not succeeded in eradicating) exchanges where the game currency can be converted into normal currencies. For example, in early July 2011, the rate of conversion on the virwox.com website was 275 Linden dollars per US dollar. Burns points out that simply having the potential to convert may create taxability as a barter transaction, and of course actual conversion into Canadian dollars strengthens the case for taxation. The CRA, to the extent that it has addressed this issue at all, emphasizes the cash-out aspect: "Once they pull the money out and it becomes tangible and real, then they need to report it."[3]

Burns produces some evidence that significant amounts of tax revenue could be raised from attempting to tax this income. He also shows that taxing authorities around the world are investigating this issue, though few, if any, have taken action. Burns's key recommendation is that the CRA should classify online multiplayer games as being either open or closed, and tax the players in open worlds—ones in which the administrators allow players to cash out into real currencies—on profits

2 Curt Cherewayko, "Taxing Events in Your Business Second Life," *Business in Vancouver*, November 6-12, 2007 (issue 941) (www.davis.ca/en/news/David-Spratley-Quoted-in-Business-In-Vancouver-Regarding-Second-Life).

3 Ibid.

from in-world transactions, with an exemption amount to eliminate small gains.[4] Of course, that would put pressure on the CRA to define open worlds, a challenge that no tax authority in the world appears to have yet taken up. Canadian tax authorities—still recovering from the failed attempt to tax as employment income the personal use of frequent-flyer points earned from business travel—are unlikely to want to open this can of worms without more persuasive evidence of a sizable revenue drain.

A.M.

Philip Baker and Catherine Bobbett, eds., *Tax Polymath: A Life in International Taxation: Essays in Honour of John F. Avery Jones*
(Amsterdam: IBFD, 2010), i-xxiv, 1-400

John F. Avery Jones is a leading expert in international tax and UK domestic tax. Until his recent retirement, he served as a Special Commissioner and judge of the Tax Tribunal in the United Kingdom. To celebrate his 70th birthday in April 2010, a conference was held in London. Invited speakers presented essays on many themes, reflecting the diverse areas of interest that engaged Avery Jones in the course of his career, and paying tribute to his contribution in each area. The essays related to UK tax and other issues were published in the *British Tax Review*.[5] Those related to international tax were collected in this book, edited by Philip Baker and Avery Jones's wife, Catherine Bobbett.

Among the 20 essays in the book, 4 deal with general tax treaty issues:

- David A. Ward, "The Use of OEEC-OECD Historical Documents in Interpreting Tax Treaties"
- Henri Torrione, "A Systems-Based Approach to Tax Treaties"
- Jacques Sasseville, "Temporal Aspects of Tax Treaties"
- Philip Baker, "Double Taxation Conventions and Human Rights"

Thirteen essays are devoted to specific tax treaty issues:

- Jean Pierre Le Gall, "The Concept of Dependence in the Definition of Permanent Establishment"
- Carol A. Dunahoo, "Contract Conclusion and Agency Permanent Establishments: Here, There, and Everywhere?"
- Daniel Lüthi, "The Application of the OECD Permanent Establishment Concept to Electronic Commerce"
- Kees van Raad, "New Sources of Tax Revenue for Transit Countries: Can a (Rail) Road Qualify as a Permanent Establishment?"

4 In this recommendation, Burns is following Adam S. Chodorow, "Ability To Pay and the Taxation of Virtual Income" (2008) 75:4 *Tennessee Law Review* 695-752, at 698.

5 "Essays in Honour of John F. Avery Jones" [2010] no. 6 *British Tax Review* 533-743.

- Brian J. Arnold, "Defining the Term 'Business' for Purposes of Tax Treaties"
- Peter H. Blessing, "Divergence of Third Party Pricing from Arm's Length Results"
- Jinyan Li, "Beneficial Ownership in Tax Treaties: Judicial Interpretation and the Case for Clarity"
- Toshio Miyatake, "Japan's Foreign Subsidiaries' Dividends Exclusion"
- Luc De Broe and Katrien Willoqué, "Exit Taxes on Substantial Shareholdings and Pension Claims: The Dutch Supreme Court's Interpretation of Arts. 13, 15 and 18 of the OECD Model"
- Bertil Wiman, "Tax Treaty Override—Swedish Developments"
- Michael Lang, "Does Art. 20 of the OECD Model Convention Really Fit into Tax Treaties?"
- Jürgen Lüdicke, "Exemption and Tax Credit in German Tax Treaties—Policy and Reality"
- Hugh J. Ault, "Recent Treaty Developments in the Arbitration of International Tax Disputes"

Three essays are grouped together to deal with miscellaneous topics:

- Guglielmo Maisto, "The Exercise of Legislative Taxing Powers in Occupied Territories"
- Angelo Nikolakakis, "Tax Law: Rules or Principles—Madness or Genius?"
- Frans Vanistendael, "Can Member States Survive EU Taxation? Can the European Union Survive National Taxation?"

While each essay offers some interesting ideas or insights, there are several that may be of particular interest to Canadian readers.

The essay by Henri Torrione makes the point that a tax treaty is a system or a set of processes or mechanisms. Treaty obligations therefore derive not only from specific articles but also from the overall structure of the treaty. Torrione defends the position taken by the OECD in its partnership report[6] as being consistent with the structure of tax treaties.

The essay by Jacques Sasseville discusses the ambulatory versus static approach in interpreting tax treaties, especially with respect to undefined treaty terms under article 3(2) of the OECD model treaty,[7] the scope of "taxes covered" in article 2, and the definitions of "resident" in article 4 and "dividends" in article 10. Sasseville extends the ambulatory versus static debate to the use of subsequent changes to the OECD commentary. He favours the use of such subsequent commentary and

6 Organisation for Economic Co-operation and Development, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation no. 6 (Paris: OECD, 1999).

7 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2008).

maintains that "courts will act in a practical way when addressing the issue of subsequent changes and additions to the Commentary."[8] In his view, courts will

> consider these changes and additions without agonizing over the reasons for doing so or over the weight to be given to them, even though they might consider that these changes and additions are not as authoritative as the Commentary that existed at the time of the negotiation of the treaty.[9]

Sasseville also discusses the timing for the application of the allocation rules in article VII of the Canada-US treaty[10] and general timing issues associated with the entry into force of a tax treaty.

The essay by Philip Baker considers several issues relating to the compatibility of double taxation treaties with human rights conventions. Some of the human rights issues relate to the right to privacy, the right to a fair trial, the right to property, non-discrimination, and the right to leave a country. Baker reviews a number of European cases and notes that the application of human rights conventions to tax matters is a relatively recent phenomenon. Since tax treaties predate human rights conventions, he wonders if it is time to make changes to the model tax treaties to ensure better conformity with human rights norms.

The current OECD model and UN model[11] do not define the terms "business," "business profits," or "enterprise." Brian Arnold argues in his essay that the lack of treaty definitions for these basic terms is problematic. The domestic-law meaning ascribed to these terms may be significantly different in different treaty countries. Although the contextual limitation in article 3(2) of the OECD model on the use of the domestic-law meaning of undefined terms may apply in specific situations, it cannot be considered to require the use of a treaty meaning generally. Arnold proposes that a treaty definition of "business" should be added to the models and suggests possible wording that might be used for such a definition.

The essay by Peter Blessing addresses transfer-pricing issues in the context of intercompany financings and cost-sharing arrangements. Blessing argues that a stand-alone approach should be used in determining the rate of interest or guarantee fees for intercompany financing, and that the case law supports that approach.[12]

---

8 Sasseville, at 48.

9 Ibid.

10 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 (herein referred to as "the Canada-US treaty").

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

12 See the Tax Court of Canada's decision in *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563 and the US Tax Court decision in *Nestle Holdings, Inc.*, 70 TCM 682 (1995); aff'd., vac'd., and rem'd. in part on other grounds 152 F. 3d 83 (2d Cir. 1998).

The concept of compensation-free passive association is inappropriate because "tax law reflects the same commercial and economic considerations as underlie credit ratings, but has *additional* considerations that make a separate entity approach appropriate, regardless of any deviations from that approach by the rating agencies."[13] One additional tax consideration is the "symmetrical" tax treatment of a transaction to avoid double taxation. Blessing provides the following example. If a company in one country were able to benefit from "implicit" credit support of an affiliate in the other country, that other country could claim that value is crossing the border, and that it should be compensated by a fee. If it were not compensated with a deductible payment, the taxpayer would, in effect, be taxed on the same capital in each country, resulting in double taxation.[14]

The essay by Toshio Miyatake provides a summary and critique of the recently introduced Japanese exemption system for the taxation of dividends from foreign subsidiaries. The exemption is available to a Japanese corporation that has directly owned 25 percent or more of the issued shares of the dividend-paying foreign corporation for six months or more at the time the dividends are determined to be paid. The exemption system is not linked to tax treaties or limited to active business profits. By definition, the exemption system does not apply to portfolio dividends or profits earned through a foreign branch of a Japanese corporation.

The essay by Angelo Nikolakakis is a delightful read. It argues that the cause of "tax rule madness" in common-law countries is not a lack of reliance on principle, as has been suggested by Avery Jones,[15] but "an irreconcilable conflict of principles—grounded in the philosophical underpinnings and historical development of Anglo-American representative democracies."[16] Under a system governed by the rule of law, the judiciary must aim for perfect impartiality and remain within the parameters of the judicial function; it must not cross into the legislative function. In tax-avoidance cases, the judiciary's role is confined to discerning the size and shape of the "gaps" between the purpose of the legislation and its effects, not closing or opening those gaps. In short, the role of the courts is to simply "mind the gaps" (borrowing from an announcement on the London underground, warning riders when they board or leave the train).

J.L.

13 Blessing, at 164.

14 Ibid.

15 John Avery Jones, "Tax Law: Rules or Principles?" (1996) 17:3 *Fiscal Studies* 63-89.

16 Nikolakakis, at 337.

Richard Vann, "Writing Tax Treaty History," in Michael Lang and Ekkehart Reimer, eds., *History of Tax Treaties* (Baden-Baden: Nomos, forthcoming) (http://ssrn.com/abstract=1788603)

There has been increasing interest in the history of tax treaties in recent years. Richard Vann has been a pioneer in this area of study. In this article, he explores two basic questions: How, and why?

Vann premises the answers to the "how" question by noting that we are at an early stage in the writing of tax treaty history. At this stage, he observes, writing the history of tax treaties is mainly about uncovering the sources. It is very much like an archaeological dig, or an antiquarian scholar prowling mediaeval libraries for ancient manuscripts, or collecting inscriptions from monuments and tombs. The distilling and interpretation of the historical materials is mainly a matter for the future. Vann digs out the following sources and describes their availability and potential use:

- *Publications of international organizations.* Notable among these are publications on tax treaties issued by the League of Nations, beginning in 1923, and by the Organisation for European Economic Co-operation (OEEC), the predecessor of the OECD. Some of the materials are now available at a website maintained by the University of Sydney Faculty of Law, where Vann works,[17] and on databases created by commercial publishers.
- *Archives of international organizations.* Some of the archives of the OECD have been made available online.[18] Most archival materials of the OECD, the League of Nations, and the UN are in need of proper indexing and digitization before being made available digitally.
- *Materials related to treaty practice.* These include materials on the interaction between countries' treaty practice and the development of the models; country tax history, especially those countries (such as the United States and the United Kingdom) whose treaty policies tend to influence the evolution of tax treaties; significant persons in tax treaty history; and the language and legal culture of treaty practice. According to Vann, such materials have been referred to in scholarly work, but are not available in any central location.

Vann discusses why we need to write tax treaty history. He first looks at the uses of tax treaty history in assisting with the interpretation of current tax treaties, in developing tax policy, and in matching with theories. He also discusses the historian's point of view about tax treaty history—that is, to show essentially how things happened. According to Vann, there are two issues that have largely been neglected in treaty history efforts to date, and they may prove fruitful to researchers. First, tax treaty history can be more clearly located in the context of economic and political history generally. Second, more attention can be directed to the people involved in

17 http://setis.library.usyd.edu.au/oztexts/parsons.html.

18 www.taxtreatieshistory.org.

the development of tax treaties and their relationships and interactions. He notes that even though tax treaties do not offer the traditional fare of world history—namely, princes and wars—their history is worth knowing for those who are interested in the tax treaty institution.

In addition to the insights about how and why we write tax treaty history, Vann provides detailed footnotes about sources of the historical materials and scholarly work that draws inspiration from tax treaty history in explaining current treaty or tax policy issues.

J.L.

Lawrence Lokken, "What Is This Thing Called Source?"
(2011) 37:3 *International Tax Journal* 25-31

This short article proposes a conceptual framework for source determination for international tax purposes. Lokken notes that the elaborate source rules in the United States do not express any general concept of source, making it difficult to evaluate the sufficiency of a particular rule in the absence of a standard against which it can be measured. The lack of a general concept of source also complicates the process of determining the source of types of income not addressed by the statutory rules.

On the basis of the benefits theory and the ability-to-pay principle, Lokken suggests that a source principle

> apportions a taxpayer's ability to pay among jurisdictions in a way that reflects the governmental services and protections available to the taxpayer in profit-seeking activities. Income originates wholly within a jurisdiction under this principle if services and protections of the government of that jurisdiction are the only governmental services and protections directly utilized in earning the income. If income is earned by processes that are directly aided by services and protections of two or more governments, the income assigned to each jurisdiction should be the income that derives from activities carried on and capital employed under its protection. Relationships between income producing processes and governmental services and protections should, in sum, be the basis of rules that identify the origin of income.[19]

Lokken applies the framework to several types of income, including services, dividends, and interest. The framework suggests, for example, that interest originates where the borrower utilizes the borrowed funds because governmental services and protections at that location are central to the success of the borrower's venture, which generates the capacity to pay interest on the loan. The current source rule for interest, assigning all interest income to the country in which the obligor is resident, is probably the best available approximation of the conceptual framework.

In Canada, source rules are not developed in the statute. The framework suggested in Lokken's article should provide some food for thought for Canadian taxpayers and policy makers in wrestling with the source issue.

J.L.

---

19 At 26-27.

European Commission, *Proposal for Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121/4 (Brussels: European Commission, March 2011), 84 pages (http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf)

On March 16, 2011, the European Commission adopted a proposal for a council directive on a common consolidated corporate tax base (CCCTB). The basic concept of the CCCTB has been around for over a decade. It grew from a reaction to complaints that the compliance costs for corporations operating in the European Union were too high owing to the fact that they have to cope with separate tax systems in each member state. The compliance cost is especially burdensome for small and medium-sized companies, which have traditionally accounted for a high percentage of economic growth and job creation in the European Union. The CCCTB aims to significantly reduce compliance costs by harmonizing the tax base. As proposed, harmonization would allow companies to voluntarily benefit from a one-stop system for filing their tax returns and to consolidate all the profits and losses that they incur across the European Union.

The proposed directive contains 18 chapters and four annexes. Salient aspects of the directive are summarized below.

The CCCTB is a system of rules, designed to apply consistently in EU member states, for computing the tax base of companies that are tax residents of the European Union and of EU-based branches of third-country companies. The consolidated tax base of a group of companies is apportioned to all the members of the group (including EU permanent establishments) on a formulary basis. Each member of the group is then subject to tax on the net profit allocated to it, at the national corporate tax rate in its country of residence or, for permanent establishments, its country of location.

Application of the CCCTB is optional for EU tax residents and EU-based branches. In the case of a group of companies, the option must be made by the "principal taxpayer" and will automatically cover all group members. A company that does not qualify or does not opt for the CCCTB system remains subject to the national corporate tax rules. For member states, the optional CCCTB means that tax administrations will have to manage two distinct tax systems—the CCCTB and their national system. It is expected that the CCCTB system will reduce opportunities for tax planning through transfer pricing or tax arbitrage, and reduce the number of disputes.

For the purposes of the CCCTB, a group of EU-resident companies consists of the principal taxpayer together with

- all of its permanent establishments in the European Union;
- all of its qualifying subsidiaries in the European Union;
- all EU permanent establishments of those of its qualifying subsidiaries that are resident outside the European Union; and
- other EU-resident taxpayers all of which are qualifying subsidiaries of the same company, which is a non-EU-resident company.

For non-EU resident taxpayers, a group comprises all of the non-resident's EU permanent establishments and qualifying EU-resident subsidiaries and their EU permanent establishments. A subsidiary is a qualifying subsidiary of its parent if the parent can exercise more than 50 percent of the voting rights and holds more than 75 percent of the company's capital or profit entitlements.

The main technical rules for the computation of the consolidated tax base can be summarized as follows:

- The tax base of companies will be computed in accordance with autonomous rules for the CCCTB. (Harmonization will not interfere with financial accounts, which remain governed by national rules.)
- The tax bases of the different group members are consolidated (that is, profits and losses are offset on a cross-border basis).
- All profits or losses of transactions between group members are ignored.
- Dealings between associated enterprises (not in the group) are subject to transfer-pricing adjustments, based on the arm's-length test.
- Interest and royalty income received from outside the group is taxable, but a tax credit for withholding tax is shared among the group members.
- A consolidated loss can be carried forward indefinitely (but not carried back) and set off against the next consolidated profit.

A consolidated group profit is shared at the end of the tax year among all group members on the basis of a three-factor apportionment formula (each factor counting for one-third):

1. Assets: the value of fixed tangible assets owned/leased/rented by the group member in proportion to those of the group as a whole.
2. Labour: the payroll costs and number of employees (each accounting for 50 percent) of the group member in proportion to that of the group.
3. Sales by destination: total sales proceeds of the group member in proportion to those of the group. In the case of sales of goods, sales proceeds are allocated to the group member in the EU member state that is the ultimate destination of the goods dispatched or transported to the person acquiring them. In the case of supplies of services, sales proceeds are allocated to the group member located in the EU member state where the services are physically carried out. If the destination under these rules is outside the European Union, then sales are apportioned to group members according to their proportion of the group's labour and assets.

If the standard apportionment does not fairly represent the business activity of a group member in an EU member state, the principal taxpayer and the competent authorities concerned can agree on an alternative apportionment method and notify the European Commission. Special apportionment rules apply in respect of certain industry sectors, such as financial institutions, insurance undertakings, oil and gas, and shipping and transport companies. Business reorganizations or transfers of legal seats within a group are neutral for the consolidated tax base, except in certain cases where the asset factor of the apportionment formula is substantially changed.

The proposed CCCTB also provides for detailed rules for the calculation of the common tax base, procedural rules for filing one consolidated tax return by the principal taxpayer to the tax authority of the EU member state of its residence, and anti-abuse rules.

There have been numerous studies, working groups, consultations, and impact assessments considering the idea of a CCCTB. Unlike previous attempts to introduce a CCCTB system, the formal issuance of the directive, which contains 134 articles, may have a better chance of implementation. On April 6, 2011, the Council of the European Union decided to consult the European Economic and Social Committee on the proposed directive. The committee strongly supports the proposal for a CCCTB as a long-overdue step in the European single market and considers the draft directive a great achievement for the European Commission.

In terms of implications of the proposal for Canadians, Canadian corporations operating in the European Union should clearly be affected if the directive becomes adopted into law. At a policy level, the ongoing debate in Canada about the taxation of corporate groups should benefit from the EU experience. After all, the European Union drew some lessons from the Canadian system of taxing permanent establishments of a corporation, so it is fitting that it now offers a model for taxing corporate groups in general.

J.L.

Edward D. Kleinbard, *Stateless Income*, USC Centre in Law, Economics and Organization Research Paper no. C11-1, USC Legal Studies Research Paper no. 11-6 (Los Angeles: University of Southern California Law School, 2011), 90 pages (forthcoming in the *Florida Tax Review*)

Edward D. Kleinbard, *The Lessons of Stateless Income*, USC Center in Law, Economics and Organization Research Paper no. C11-2, USC Legal Studies Research Paper no. 11-7 (Los Angeles: University of Southern California Law School, 2011), 93 pages (forthcoming in *Tax Law Review*)

These two papers provide a groundbreaking and comprehensive analysis of the phenomenon of stateless income and its policy implications. Kleinbard defines stateless income as

> income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is neither the source of the factors of production through which the income was derived nor the domicile of the group's parent company.[20]

20 *Stateless Income*, at 4.

The first paper focuses on the causes and policy of stateless income. It illustrates the phenomenon by describing the "double Irish Dutch sandwich" structure used by Google. This structure involved the use of a dual-resident company in Ireland as a holding entity (taxed as a resident of Ireland for the purposes of the Ireland-Netherlands tax treaty, but as a resident of Bermuda for Irish tax purposes), another Irish company as the operating company, and a Dutch special-purpose entity sandwiched between the two Irish companies. Google moved intangibles from the United States to Ireland, and the royalties moved to the dual-resident company that was taxed as a resident of Bermuda. Kleinbard describes this as a "fantastic" structure, and suggests that it is easily replicable by others.

Kleinbard argues that stateless income is an inevitable by-product of fundamental international income tax norms, such as the recognition of the separate tax personas of different juridical persons, even when they are commonly owned, and the general practice of treating interest on indebtedness as deductible to the payer. He notes that earnings stripping, transfer pricing, tax arbitrage, and treaty shopping are common techniques for generating stateless income. The policy implications of the stateless income phenomenon are severe:

> As the example of Google's Double Irish Dutch Sandwich structure implies, it destroys any possible coherence to the concept of the geographic source of income, on which all territorial tax systems rely. It erodes the tax base of high-tax countries in which multinational firms are domiciled through debt-financed tax arbitrage. It privileges multinational firms over domestic ones by offering the former the prospect of capturing . . . "tax rents"—low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. And it leads to deadweight loss.[21]

The second paper continues the analysis begun in the first. It considers the implications of the pervasive presence of stateless income for standard economic efficiency benchmarks by which international tax policy proposals are judged. Kleinbard demonstrates that the current US tax rules governing income from foreign direct investments often are misapprehended. While in name a "worldwide" system of taxation, in reality the system is "an ersatz variant on territorial systems,"[22] with hidden benefits and costs as compared with standard territorial regimes. Kleinbard criticizes the economic efficiency arguments, especially capital ownership neutrality, for territorial tax systems in the real world with pervasive stateless income. Because the capital ownership neutrality arguments assume that source-country taxation is fully capitalized into the prices of firms operating in the source country, stateless income tax planning vitiates the plausibility of this critical assumption. If, as a result of stateless income tax planning, income is not actually taxed in the foreign-source country, non-taxation of such income in the residence is no different from "export

21 Ibid., at 17.

22 *The Lessons of Stateless Income*, at 15.

subsidies." Of course, the issue of export subsidies to multinational corporations involves an altogether different analysis from that undertaken in advancing capital ownership neutrality as a tax reform option.

In conclusion, Kleinbard states that "unless the stateless income phenomenon is eradicated, the adoption by the United States of a territorial tax system would both distort corporate investment behavior and deplete domestic tax revenues."[23] Eradicating stateless income is unlikely, since it would require unprecedented levels of international cooperation and substantive agreement on novel tax norms. The solution that Kleinbard suggests is a worldwide tax consolidation system, coupled with a corporate tax rate in the range of the world median for comparable economies and strong thin capitalization rules.

In these two papers, Kleinbard presents persuasive arguments as to why the territorial system should not be adopted unless the stateless income problem can be addressed. These arguments point in a direction opposite to the current trend in international tax policy in Japan and the United Kingdom, both of which have recently moved to a territorial system of taxation, and in Canada, where the final report of the Advisory Panel on Canada's System of International Taxation recommended expansion of the exemption system for income earned in foreign affiliates.[24]

J.L.

Kim Brooks, Åsa Gunnarsson, Lisa Philipps, and Maria Warsig, eds., *Challenging Gender Inequality in Tax Policy Making: Comparative Perspectives* (Oxford: Hart Publishing, 2011), 306 pages

This is a collection of 14 papers authored by a group of leading feminist tax scholars. The volume focuses on the dynamic relationship between equality and tax policy by exploring how gender has shaped tax law and policy in various countries, and how taxation in turn affects the possibilities for equality along gender, race, class, sexuality, and other lines. The papers are organized into four parts in the following order:

- Part I: Gendering the Fiscal State
  Kathleen A. Lahey, "The 'Capture' of Women in Law and Fiscal Policy: The Tax/Benefit Unit, Gender Equality, and Feminist Ontologies"
  Ann Munford, "Tax, Markets, Gender and the New Institutionalism"
  Miranda Stewart, "Gender Equity in Australia's Tax System: A Capabilities Approach"
  Åsa Gunnarsson, "Challenging the Benchmarks in Tax Law Theories and Policies from a Gender Perspective—The Swedish Case"

23 Ibid., at 89.

24 Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008), at 23-26 (recommendation 4.1) and 28-30 (recommendation 4.3).

- Part II: Bases and Rates: Structural Choices in Tax Policy Design
  Bridget J. Crawford, "Taxing Surrogacy"
  Paloma de Villota, "A Gender Perspective Approach Regarding the Impact of Income Tax on Wage-Earning Women in Spain"
  Bernadette M. Wanjala and Maureen Were, "Gender and Taxation in Kenya: The Case of Personal Income and Value-Added Taxes"
- Part III: The Family in Tax Policy
  Anthony C. Infanti, "Dismembering Families"
  Casey Warman and Frances Woolley, "The Tax/Benefit Implications of Recognizing Same-Sex Partnerships"
  Kirsten Scheiwe, "Income Redistribution Through Child Benefits and Child-Related Tax Deductions: A Gender-Neutral Approach?"
  Maria Warsig, "Overcoming the Gender Inequalities of Joint Taxation and Income Splitting: The Case of Germany"
- Part IV: Savings, Wealth and Capital Gains
  Lisa Philipps, "Income Splitting and Gender Equality: The Case for Incentivizing Intra-Household Wealth Transfers"
  Ulrike Spangenberg, "Indirect Discrimination in Tax Law: The Case of Tax Deductions for Contributions to Employer-Provided Pension Plans in Germany"
  Marjorie E. Kornhauser, "Gender and Capital Gains Taxation"

This review focuses on the three papers authored by Canadian scholars. In the first paper, Kathleen Lahey argues that the fundamental source of women's inequality in tax law is that women are not treated as true subjects of fiscal policy, but instead are "captured" in relationships with men and children. She notes that the last 10 years have witnessed a dramatic erosion of women's status in Canada. For example, the World Economic Forum Gender Gap Index ranked Canada 14th in 2006, 18th in 2007, and 31st in 2008.[25] Tax policy plays a certain role in causing such erosion. In Lahey's view,

> [the] unrelenting focus on gender-neutral categories like "the poor" or "single parents" or "children living in poverty" has made it seem as if women, whether contained in the couple, in the social assistance system or in parenting, do not matter unless they and their containers are "poor" and serve worthy purposes.[26]

So, she argues, the greatest challenge may be to find ways to reveal the artificiality of the containers and to imagine women as full subjects in fiscal policy. This is not going to be easy because, according to Lahey, such profoundly gendered ontology of tax law can be traced to pre-Roman times and the unstated assumptions that frame contemporary tax policy debate.

25 Lahey, at 12.

26 Ibid., at 29-30.

In the second of the Canadian contributions, Warman and Woolley examine the tax implications of the recognition of same-sex partnerships in Canada. They use cross-sectional data from Statistics Canada's Canadian Community Health Survey to create a profile of self-identified gays and lesbians. The following are some of their interesting findings:

- Gays and lesbians are highly educated and more urban than the heterosexual population. Gay men earn less, on average, than heterosexuals. Partnered lesbians have the highest average earnings of any group of women, enjoying a substantial earnings premium over heterosexuals and unattached lesbians.
- While gays and lesbians have diverse economic experiences, on average married and common-law same-sex couples have household income as high as, or higher than, their heterosexual counterparts, and they are less likely to be in a dependant/provider relationship. In other words, their relationship is more egalitarian.
- Legal recognition of same-sex marriage has relatively few tax consequences in terms of tax benefits (such as claiming a same-sex partner as a dependant in order to transfer tax credits or to transfer capital assets on a rollover basis), as well as tax costs (such as the loss of eligibility for child tax benefits). The reason is that gay and lesbian partners typically have fairly similar income levels. This finding is similar to the Australian research results, but in stark contrast to the results in the United States, where the tax recognition of same-sex marriage would generally decrease the tax liabilities of homosexuals.
- There is a significant low-income and middle-income homosexual population who are at risk of losing benefits as a result of formal recognition of same-sex relationships. For lesbians and for single parents, legal recognition of relationships can lead to a substantial loss of tax benefits.

The third Canadian contributor, Lisa Philipps (who is also one of the four coeditors of the volume), discusses the problem of income splitting and makes the case for incentivizing intrahousehold wealth transfers. Her position deviates from the typical feminist stance that income splitting is always bad for women because it is a back door to joint taxation, and creates disincentives for the secondary earners—who are mainly women—to enter the labour market. Her proposal emphasizes that income splitting should be coupled with a legal requirement that the split income (or the underlying assets) actually be transferred to the lower-income spouse. Recognizing that no single tax reform can achieve significant progress toward gender equality, Philipps proposes a set of complementary reforms:

> (1) repealing the pension income splitting rules; (2) repealing the attribution rules, subject to anti-avoidance provisions designed to catch transfers that have no economic substance and subject to the transferor realizing any accrued gains at the time of transfer; (3) replacing spousal dependency credits with a new refundable credit or transfer for caregivers who individually have low incomes; and (4) creating new tax or direct-spending

> measures to reduce the fiscal and other cost barriers that discourage secondary earners from undertaking paid labour.[27]

J.L.

Christoph Sommer, *Separate Accounting or Unitary Apportionment? The Fairy Tale of Arm's Length Pricing and General Equilibrium Analysis of Multinational Enterprise Behavior Under the Formulary Taxation Alternative* (Brandsberg, Germany: Eul Verlag, 2011), 264 pages

This book is an economic treatise on the subject of separate accounting or unitary apportionment as the basis for allocating income of multinational enterprises (MNEs). It is one of the most recent studies in the area. After a careful review of the literature and previous economic analyses of MNEs, in which the author weighs the pros and cons of each approach, the book concludes with the following statement:

> Clearly, in order to deal with the profound implications of globalization, a change in the income taxation method for MNEs to some form of unitary apportionment is not only desirable but imperative. In the end, the question is: What are we waiting for?[28]

Readers who want find a reasonable catalogue of research materials on this topic should be happy to see a 32-page bibliography, a list of transfer-pricing cases, and a list of reports, legislation, and regulations at the end of the book.

J.L.

Andrew D. Appleby, "Leveling the Playing Field: A Separate Tax Regime for International Athletes" (2011) 36:2 *Brooklyn Journal of International Law* 605-46

Most countries around the world tax international athletes on income earned in their jurisdiction, even during short visits. The reason is that the earnings are high and have a high public profile, so it is hard to justify leaving all taxation rights to the residence country. However, disparate systems of taxation abound. Appleby demonstrates this fact with a comparison of the athlete-tax regimes in the United States, the United Kingdom, Germany, Spain, Brazil, and China, and recommends the adoption of an international code for taxing visiting athletes. If Canada adopted this code, it would presumably apply only to non-league athletes, since athletes in Canada-US leagues are exempted from source-based taxation by article XVI(3) of the Canada-US treaty.[29]

A.M.

27 Philipps, at 250.

28 At 199.

29 Supra note 10.

Cristobal Young and Charles Varner, "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment"
(2011) 64:2, part 1 *National Tax Journal* 255-83

About 10 years ago, there was a lot of publicity in Canada about the possibility that high Canadian personal income taxes were causing a brain drain from Canada to the United States. Although that concern seems to have subsided for now, questions are still raised about a similar drain of talent through internal migration, perhaps from Ontario to low-tax Alberta. Deficit-fighting increases in taxes on high income earners are certainly a possibility in the move out of the recession.

Some evidence relevant to the debate is provided by this study of migration out of New Jersey in response to a tax rate increase in 2004 of 2.6 percentage points, from 6.37 to 8.97, on taxable income in excess of $500,000. Using a complete set of high-income tax returns for New Jersey for 2000 to 2007, the authors demonstrate that the migration rate of the group just below the high-income cutoff is similar to that of the group above the cutoff (the "millionaires"). Changes in migration account for only 3 percent of the typical year-to-year fluctuation of the millionaire population.

Part of this effect could be due to income dynamics, since those earning over $500,000 in a given year might well not expect their earnings to remain at the same level the next year. Thus, separate calculations were done for "supermillionaires"—those earning over $3 million per year. Even in that group, a 1 percentage point increase in the effective tax rate led to less than a 0.1 percent drop in population numbers.

This evidence is particularly striking in that the distance between New Jersey and several other lower-tax states is relatively small, so that out-migration is much less costly in personal and work-connection terms than most moves between Canadian provinces.

A.M.

Rosanne Altshuler and Robert Dietz, "Reconsidering Tax Expenditure Estimation" (2011) 64:2, part 2 *National Tax Journal* 459-89

As this article points out, the US government estimates tax expenditures in a very different way from revenue estimates of actual tax changes. Estimation of tax expenditures does not incorporate any change in taxpayers' economic behaviour, while revenue estimates of actual tax changes include expected changes in consumption, investment, and other actions in response to the tax change (although changes in gross domestic product as a result of the tax change are not considered). For example, consider the abolition of the US tax exclusion for employer-paid life insurance; the tax expenditure for 2011 is approximately $2.7 billion, while the revenue estimate is just $2.3 billion.[30] The explanation of this difference is that abolishing the tax

30 At 483.

exclusion would presumably decrease the use of this employee benefit, resulting in a lower tax revenue change than would be assumed in the no-behavioural-change case.

It is interesting to consider this analysis in the context of Canada's approach. Tax expenditure estimates for Canada are made in the same way. The explanation offered is that "[i]ncorporating these [behavioural] factors would add a large subjective element to the calculations."[31] However, the federal budget generally does not disclose whether any allowance is made for behavioural change. It is my understanding that this factor is generally not taken into account, and thus Canada's projections for the revenue effects of tax changes are made on a different basis from those in the United States.

A.M.

Deena Ackerman and Gerald Auten, "Tax Expenditures for Noncash Charitable Contributions" (2011) 64:2, part 2 *National Tax Journal* 651-87

Given that the CRA has been having a great deal of trouble policing charitable donations in recent years, particularly in regard to so-called buy-low, donate-high schemes, it is interesting to read about a tax-avoidance scheme for charitable donations in the United States that, so far, has not been a problem in Canada. In Canada, charities are generally required to engage a valuator in order to issue a charitable receipt; as a result, receipts are not issued for relatively low-value non-cash donations such as used clothing and automobiles. In the United States, valuations are often not required. This article shows evidence of abuse in the donation of used vehicles by comparing the value of donated vehicles to the value in online auctions. After increased restrictions enacted in 2004, donations of vehicles declined substantially.

A.M.

Derek K. Oler, Mitchell J. Oler, and Christopher J. Skousen, "Characterizing Accounting Research" (2010) 24:4 *Accounting Horizons* 635-70

This article reviews publications in six top accounting journals over the past 48 years. The main trend is an increasing proportion of financial accounting articles, increasing from 49 percent in the 1960s to 61 percent since 2000. Tax articles increased initially from 3.9 percent in the 1960s to 6.7 percent in the 1990s, but have since declined to 5.9 percent.[32]

Accounting research has also moved strongly away from normative research and toward positive (describing the world as it is) research: the number of publications involving normative research declined from 488 in the 1960s to 92 in the 1980s and

31 Canada, Department of Finance, *Tax Expenditures: Notes to the Estimates/Projections 2010* (Ottawa: Department of Finance, 2010), at 17.

32 At 659.

just 23 since 2000.[33] Although this is not mentioned in the article, the decline in normative research has led to a decline in interest in tax policy topics within accounting, even though interest in this area remains strong in economics.

A.M.

John Shon and Stanley Veliotis, "Is There a December Effect? Strategic Prepayments of Deductible State Income Tax"
(2010) 32:2 *Journal of the American Taxation Association* 53-71

In the United States, state income taxes are an itemized deduction in computing federal income tax. The amount that is deductible is the amount paid in the year. One of the four due dates for the payment of instalments of state income tax is January 15. Thus, a taxpayer who is concerned about the time value of money might wish to prepay this instalment by a little more than two weeks in order to get the federal tax saving one year earlier. The authors produce evidence of a substantial prepayment effect that is not observed around the other three instalment due dates in the year. This is consistent with the general belief, based on Slemrod's hierarchy of behavioural responses to taxation, that the timing of transactions or tax payments is relatively easy for taxpayers to change.

A.M.

Andrew Johns and Joel Slemrod, "The Distribution of Income Tax Noncompliance" (2010) 63:3 *National Tax Journal* 397-418

Underreporting, which can be either deliberate tax evasion or accidental noncompliance, has consequences for whether the different income groups bear their proper share of the tax burden. Plausible stories can be told as to whether underreporting should be concentrated at the lower or the upper end of the income distribution. This article uses audit data from the Internal Revenue Service to answer this question for the United States. The data used are from the national reporting program, which uses a pattern of random audits designed to produce statistically valid results.

Overall, the result is that misreporting of income decreases vertical equity. When taxpayers are arrayed by their "true" income, the ratio of aggregate misreported income to true income generally increases with income, peaking among taxpayers with adjusted gross income between $500,000 and $1 million, but remaining at an elevated level for incomes above that range.

The differences in misreporting percentages are not small. Dividing taxpayers into just two groups, for adjusted gross incomes above and below $100,000, the misreporting percentage is 7.0 percent for the lower-income group and 15.2 percent for the upper-income group. Put another way, the misreporting percentage is

33 At 653.

11 percent or less for all income groups below the 95th percentile of adjusted gross income, but at or above 15 percent for all groups in the top 5th percentile.[34]

One reason for this pattern is familiar: high-income taxpayers are much more likely to receive their income in a form that is difficult to audit (that is, business income, capital gains) and thus have relatively high misreporting percentages. More surprisingly, within categories of income that are subject to relatively high misreporting percentages, the misreporting percentage is higher for the high-income groups. Thus, higher-income groups appear more inclined to misreport their income.

A.M.

34 At 404.