Current Tax Reading

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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), 132 pages, ISBN 92-64-17077-4

Richard L. Doernberg and Kees van Raad, "Hybrid Entities and the U.S. Model Income Tax Treaty" (August 23, 1999), 19 *Tax Notes International* 745-57

Some of the more difficult issues of tax treaty interpretation involve the application of standard articles to partnerships. Even more difficult issues arise with entities that are hybrids in the sense that they combine private law features conventionally associated with a corporation or a partnership. The OECD report reviews and attempts to resolve some basic issues that arise in the application of the OECD model tax convention to partnerships. The article by Doernberg and van Raad examines the application of the US model income tax convention to hybrid entities.

The OECD report is the result of a six-year study. The issue of the appropriate application of treaty provisions to partnerships has proven to be particularly thorny. Very different and often irreconcilable results occur depending on the treatment of a partnership under the domestic law of a treaty partner as either a taxable entity separate from the partners or a flowthrough vehicle with no separate taxable capacity. The OECD report provides an excellent review of these basic treaty issues in the context of the OECD model tax convention. The report also provides some important recommendations for the amendment of certain articles of the model convention and some of the related commentary. Those recommendations are scattered throughout the text of the report and collected together in the first of three appendixes. Appendix two describes the reservations of certain countries (France, Germany, the Netherlands, Portugal, and Switzerland) to some of the recommendations. Appendix three is a chart

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that summarizes the treatment of partnerships under the domestic law of selected OECD countries, including Canada.

The text of the OECD report consists of two principal parts. The first part examines various interpretive and application issues from the perspective of the country in which income is sourced. The second part focuses on the major issues for the country of residence of the partners of a partnership. Each part begins with a review of the general nature of the issues. The more significant discussion centres on specific fact examples described in the text. The examples are followed by excellent discussions of the treaty issues raised by the particular examples and possible alternatives for resolution of those issues, including recommended amendments to the model convention and commentary. Some examples include "bilateral" circumstances in which the source of income, the residence of the partners, and the location of the partnership are attributable to one of two contracting states. Other examples involve "triangular" structures in which a partnership is organized in a country other than either of the two contracting states in which income is sourced and the partners are resident.

The OECD report is limited explicitly to the application of the OECD model convention to entities that are considered partnerships as a matter of private law. There is no discussion of other entities that are treated as flowthrough vehicles for income tax purposes. This broader topic is the subject of the article by Doernberg and van Raad.

As noted above, Doernberg and van Raad focus on the application of the US model tax convention to "hybrid entities." They define "hybrid entity" to mean any entity that is treated, for income tax purposes, as a flowthrough vehicle ("a transparent entity") under the domestic law of one country and as a separate taxable entity ("a non-transparent entity") under the domestic law of another country.[1] A "partnership" is defined as any entity that is treated as transparent by both treaty countries and therefore does not give rise to a "classification conflict."

Like the OECD report, the article begins with a brief review of the general issues raised by hybrid entities, but most of the text is devoted to illustrating these issues with specific factual examples in the context of the US and OECD model conventions. Unlike the OECD report, the article uses triangular examples on the basis that they are a "superset of bilateral situations,"[2] and "[m]ost of the analysis in the triangular situations will apply equally in these bilateral situations."[3] Doernberg and van Raad do not discuss the OECD report but promise to do so in a subsequent article. They conclude generally that the approach in the US model convention, which is reflected to some extent in the recommendations

1 At 745.

2 At 748.

3 Ibid.

of the OECD report, effectively addresses many issues for source countries. However, they also note that the US model convention fails to deal adequately with issues for the country of residence and, in particular, to determine the appropriate approach to the application of methods for relief of double taxation. The OECD report suggests some alternative approaches to many of these issues.

T.E.

Lawrence Zelenak, "The Selling of the Flat Tax: The Dubious Link Between Rate and Base" (November 29, 1999), 85 *Tax Notes* 1177-95

Neil Brooks, of Osgoode Hall Law School, has been a persistent and vigorous critic of flat tax proposals.[4] He has consistently argued that there is no necessary link between a flat tax rate and the base on which such a rate structure is applied. He has suggested on many occasions that the linkage of these two unrelated tax design issues is a conscious ploy by proponents of a consumption tax base to help sell this unpopular concept to an unwilling Canadian public. It is surprising that this line of argument has been largely ignored in the United States, where flat tax proposals applied to a consumption tax base have enjoyed particular prominence as an alternative to a progressive income tax. In this article, Lawrence Zelenak of the Faculty of Law, University of North Carolina, advances much the same thesis that Brooks has been propounding for some time.

After a brief introduction, Zelenak describes various proposals for a consumption tax that have enjoyed some political currency in the 1990s. His principal focus is the flat tax proposal originally developed by Stanford University economists Robert E. Hall and Alvin Rabushka;[5] it is this version of a consumption tax that most confuses the rate and base issues. The proposal received considerable attention in the popular press in the mid- and late 1990s in the wake of its championing by Congressman Dick Armey and the former Republican presidential candidate Steve Forbes. Zelenak follows his description of this flat tax proposal with an interesting discussion of the politics of the proposal and, in particular, how confusion of the rate and base issues has allowed a potentially unpopular base to achieve a degree of prominence in public discourse.

The three most important parts of the article examine critically the possible technical arguments for linkage of the rate and base issues. Zelenak concludes that no defensible case for such linkage can be made on either efficiency or simplicity grounds. Although he accepts that there may be a case for linkage as a means of achieving horizontal equity in the taxation of lifetime earnings, Zelenak believes that concerns about vertical equity probably overwhelm the desirability

4 See, for example, Neil Brooks, "Flattening the Claims of the Flat Taxers" (Fall 1998), 21 *Dalhousie Law Journal* 287-369, reviewed below.

5 Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Stanford: Hoover Institution Press, 1995).

of a flat rate tax applied to personal consumption. He concludes that there really is no defensible technical tax policy case for linkage of a flat rate structure and a consumption base. He suggests that the particular form of consumption taxation under the Hall-Rabushka model will ultimately be exposed as an unpopular one once the rate structure choice is uncoupled from the base choice. Zelenak even suggests that opponents of the income tax would be more successful advocating a different form of consumption tax, such as the "USA Tax," under which savings would be expensed in full and taxed only when consumed at either a flat or a progressive rate.

T.E.

"Special Issue: Tax Reform" (September 1999), 21 *The Sydney Law Review* 337-522

The Australian tax system is currently undergoing significant reform, including the introduction of a goods and services tax (GST) and extensive changes to business income taxation. This issue of *The Sydney Law Review* consists of the following five articles on selected aspects of tax reform:

1) Graeme Cooper and Richard Vann, "Implementing the Goods and Services Tax";

2) Patricia Apps, "Tax Reform, Ideology and Gender";

3) Miranda Stewart, "Domesticating Tax Reform: The Family in Australian Tax and Transfer Law";

4) Claire Young, "Taxing Times for Women: Feminism Confronts Tax Policy"; and

5) Binh Tran-Nam, "Tax Reform, Tax Simplification: Some Conceptual Issues and a Preliminary Assessment."

Each of the articles by Apps, Stewart, and Young considers the concept of the family and related gender issues in the tax reform debate. Young's article is the text of a lecture based on an earlier article by the author.[6] Young provides an excellent review of a growing feminist literature focused on certain areas of tax policy that have always had a significant impact on women. Stewart's article is more or less in the legal-feminist tradition described by Young. Stewart argues that conventional concepts of the family have constrained or "domesticated" the tax policy debate. She believes that the Australian tax and transfer systems should be based on a functional approach under which issues of dependency are determined without any preconceived notions of the family as the usual nexus for relations of dependency. Apps's article is similar to Stewart's in its subject

6 Claire Young, "Taxing Times for Women: Feminism Confronts Tax Policy," in Richard Krever, ed., *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate* (London: Kluwer Law International, 1997), 261-92.

matter but is much different in its methodological approach. Apps attempts to identify and measure the distributional and efficiency consequences of various proposals for reform of the Australian personal income tax and certain transfer programs. These proposals are based generally on a conventional view of the family in which one spouse (usually the husband) works in the paid workforce, while the other spouse (usually the wife) performs household work and provides child-care services.

The articles by Tran-Nam and Cooper and Vann examine entirely unrelated subjects. In a relatively brief article, Tran-Nam continues some of his earlier joint work on compliance costs.[7] He concludes, rather pessimistically, that compliance effects have generally been ignored in the reform process and any simplification of the Australian tax system is unlikely to result. The article by Cooper and Vann is an extensive technical and policy analysis of virtually every aspect of the Australian GST. One of the authors' most important and interesting themes is the many parallels between design issues under a GST and an income tax. Cooper and Vann argue that the identical problems in many areas mean that the highly touted simplification aspects of a GST tend to be exaggerated. Indeed, they believe that many design issues are more effectively resolved under an income tax system.

T.E.

John J. Ensminger, "The Broad but Porous Net of the Straddle Rules: How Long Will the Fish Continue To Swim Through?" (Spring 1999), 18 *Virginia Tax Review* 709-80

Some of the more complex provisions in the US Internal Revenue Code ("the Code") are the "straddle rules" in section 1092. Enacted in 1981, these rules are intended to prevent the use of straddle transactions to manipulate the realization-based recognition of gains and losses. As the author of this article argues, the straddle rules were effective in addressing certain abuses that arose from particular trading strategies in the late 1970s. This result was achieved by limiting the deduction of realized losses on actively traded property to the excess of any such losses over unrealized gains on offsetting positions. However, the straddle rules have evolved legislatively to address specific financial structures in excruciating detail. These specific applications contrast with the vagueness of the rules for other structures that should, in principle, be equally subject to the legislation. The result is a confused morass of rules that many taxpayers cannot comply with and the Internal Revenue Service (IRS) cannot administer.

7 See, for example, Chris Evans, Katherine Ritchie, Binh Tran-Nam, and Michael Walpole, *A Report into Taxpayer Costs of Compliance* (Canberra: Australian Government Publishing Services, November 1997), reviewed in this feature (1998), vol. 46, no. 5 *Canadian Tax Journal* 1160-71, at 1171.

After discussing many of the technical problems in the application of the straddle rules, Ensminger concludes that the IRS probably lacks the required software to detect unreported straddles. He seems to suggest that the only sensible solution is expanded mark-to-market reporting for a wider range of financial instruments.

T.E.

Daniel M. Schneider, "Interpreting the Interpreters: Assessing Forty-Five Years of Tax Literature" (1999), vol. 4, no. 7 *Florida Tax Review* 483-536

This article reviews a sampling of articles from four US tax journals: *Journal of Taxation*, *Taxes: The Tax Magazine*, *Tax Law Review*, and *The Tax Lawyer*. The review covers articles published in these journals from 1954 to 1998. The sample consists of 1,500 articles, which together constitute 20 percent of the total number of articles published in the selected journals over the relevant period. Schneider classifies the articles according to several variables, such as gender and professional status of the author, subject matter, and style. The apparent purpose of the classification process is an attempt to discern trends in the tax literature as a reflection of "tax culture." After a brief explanation of his methodology, Schneider examines the data in terms of his selected classifications. He draws three general conclusions, noted in the introduction to the article. First, female lawyers and professors have published at lower rates than their numbers in the profession would indicate, but the trend has been reversed recently among professors. Second, despite the greater presence of the accounting profession in tax practice, professional writing remains dominated by the legal profession. Third, doctrinal writing remains dominant, with very little change in the subject matter of articles over time.

T.E.

Jack M. Mintz, *Why Canada Must Undertake Business Tax Reform Soon* (Toronto: C.D. Howe Institute, 1999), 11 pages. Available on the Web at http://www.cdhowe.org.

Having chaired the Technical Committee on Business Taxation, Jack Mintz is continuing to advocate corporate tax reform. In this paper, Mintz makes the argument that the need for substantial business tax reform has become more urgent since the release of the technical committee's report in the spring of 1998.[8]

Mintz argues that Canadian corporate tax rates and the tax burden on capital are not competitive, and that they are becoming even less so as rates continue to decline in other countries. To improve competitiveness in the business sector,

8 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998).

Mintz recommends the following: reduce the corporate income tax levels; improve the neutrality of the business tax system; reduce reliance on profit incentive taxes that do not correspond to the costs of services provided; and lower the tax burden on business. To illustrate the urgency for reform, Mintz examines recent changes in other industrialized countries. He demonstrates that Canada is essentially standing still as our competitors are making fundamental changes.

In conclusion, Mintz asserts that high corporate tax rates have decreased productivity and slowed economic growth in Canada. The cure, in his view, is to change our business tax strategy to create a significant advantage over our primary competitor, the United States.

G.F.

Amy Taylor, Mark Jaccard, and Nancy Olewiler, "Environmental Tax Shift: A Discussion Paper for British Columbians" (Ministry of Finance and Corporate Relations, Victoria, British Columbia). Available on the Web at http://www.fin.gov.bc.ca

Amy Taylor, Mark Jaccard, and Nancy Olewiler, all of Simon Fraser University, prepared this discussion paper on environmental tax shifting for the government of British Columbia. The term "environmental tax shifting" combines two concepts—the levying of environmental taxes and the use of the revenues from these taxes. When goods and services are purchased, environmental costs (such as air and water pollution, loss of habitat, and depletion of natural resources) are generally not incorporated in the prices we pay. It is generally argued that the application of environmental taxes allows prices to better reflect the true costs. Yet, as noted in the discussion paper, there appears to be little willingness in Canada to accept additional taxes. The claim of revenue neutrality is often made to lessen this unwillingness. However, as is argued in this paper, how the revenue is distributed is also important.

In examining how to distribute the revenue from environmental taxes, the authors classify tax shifting into three categories. First, the revenue may be returned directly to the class of people who pay. This would include deposit-refund systems, and feebate systems for vehicles (whereby, in effect, those who buy less efficient cars will subsidize those who buy more efficient cars). Second, the revenue may be used to lower other charges and taxes (such as personal income tax rates). Third, the revenue may be used for other purposes such as paying down the debt or increasing expenditures in areas such as education or health. The authors argue that this third category may not in fact be tax shifting since expenditures may actually increase.

The authors outline the benefits and challenges of environmental tax shifting. They then examine methods for distributing revenue, focusing on reductions to income and capital taxes, the provincial sales tax, and payroll taxes. After briefly discussing environmental taxes that may be appropriate for tax shifting, they provide some specific examples.

The discussion paper does a reasonable job of introducing the reader to the area of environmental tax shifting. Very little of the content of this discussion paper is specific to British Columbia; it should therefore be of equal interest, and applicability, to readers across Canada, from Halifax to Victoria. A few limitations of the paper are worth noting. It is not exhaustive of the topic and provides little in the way of a literature review. Further, the authors do not recommend specific policies. However, the discussion paper serves a very useful purpose in helping one think about how government should use the revenue from environmental taxes.

G.F.

Joel Fried and Ron Wirick, *Assessing the Foreign Property Rule: Regulation Without Reason* (Toronto: C.D. Howe Institute, 1999), 31 pages. Available on the Web at http://www.cdhowe.org.

In the last issue of the *Canadian Tax Journal*, I reviewed an article by David Burgess and Joel Fried related to the foreign property rule.[9] This article, again co-authored by Joel Fried, but with Ron Wirick, is consistent with the prior article in its findings and recommendations. Again, it is argued that the 20 percent foreign property limit on retirement savings should be lifted. The primary addition of this article to the previous one lies in the greater depth of analysis. In particular, discussion on the cost of retaining the foreign property limit, and limits to its effectiveness, is well articulated and insightful.

G.F.

Finn Poschmann, *Revenue Canada Redux* (Toronto: C.D. Howe Institute, 1999), 7 pages. Available on the Web at http://www.cdhowe.org.

The Canada Customs and Revenue Agency (CCRA) was born on November 1, 1999. In an well-articulated article, Finn Poschmann looks at the promise (enhancing our economic union), and potential risks, associated with the birth of the new revenue agency.

Poschmann focuses analysis on the relationship between the CCRA and the provinces. The agency will administer, free of charge, any provincial tax measure compatible with federal measures, and, for a fee, most non-standard taxes and benefits. If provinces hand over administrative responsibility to the CCRA, they should save money. Poschmann asserts that the CCRA will be beneficial to the extent that it achieves efficiencies in managing tax collections. However, Poschmann also sees two main risks. By reducing their involvement in tax administration, provinces may find it difficult to maintain expertise and to

9 See David Burgess and Joel Fried, "Canadian Retirement Savings Plans and the Foreign Property Rule" (September 1999), 25 *Canadian Public Policy* 395-413, reviewed in this feature (1999), vol. 47, no. 6 *Canadian Tax Journal* 1573-85, at 1581.

develop tax policy targeted to their specific needs. Poschmann also sees danger in provinces choosing, conversely, to assert autonomy through non-standard taxes and benefits. His concern is that the CCRA may allow delivery of economically inefficient taxes, since it may now be significantly less costly to implement such policies.

G.F.

D.S. Hamermesh and W.D. Scoones, "Policy Equilibria in a Federal System: The Effects of Higher Tax Ceilings for Unemployment Insurance" (November 1999), 74 *Journal of Public Economics* 191-213

Under federal systems, such as those in Canada and the United States, superior agencies (the federal government) can sometimes impose constraints on the policies set by lower-level agencies (provincial or state governments). Hamermesh, an economist at the University of Texas at Austin, and Scoones, an economist at the University of Victoria, study the effects of such constraints.

The example studied in this article involves unemployment insurance in the United States. Under the Federal Unemployment Tax Act (FUTA), each state must choose rates within a specified range. In addition, the FUTA requires that states tax at least a minimum amount of wages—the "minimum ceiling." The effect of raising the minimum ceiling is that more earnings are taxable by states. As discussed in the paper, one would expect that if the minimum ceiling were raised, tax rates would be reduced commensurately by the states such that net revenues would be unchanged. However, Hamermesh and Scoones find that states have restructured benefits and taxes such that total spending and total amount of taxes have been altered. Although the states are not compelled to increase total taxes, the total does rise (rates fall, but not by enough to offset the effect of a higher ceiling). To explain this result, Hamermesh and Scoones model state policy formation in a bargaining setting.

This article is highly relevant to Canada. For example, changes in the federal tax system have a direct impact on most provinces. The article starts to explore the types of reactions that can be expected with such changes. Although it is written primarily for academic economists, all sections of the article, except for the development of the bargaining model, should be readily understandable by a broader audience.

G.F.

C. Bryan Cloyd and Brian Spilker, "The Influence of Client Preferences on Tax Professionals' Search for Judicial Precedents, Subsequent Judgments and Recommendations" (July 1999), 74 *The Accounting Review* 299-322

Tax professionals reduce taxpayer uncertainty through researching applicable authorities and reporting their findings to the client. As argued in this article, tax professionals have a strong incentive to make an accurate assessment of the taxpayer's position. The authors find, however, that there is a significant bias in that searches by the tax professional (the study used tax professionals from the Big Five accounting firms in an experimental setting) emphasize cases consistent with the client's desired outcome. Further, this study indicates not only a bias in the search, but also a resulting "overly aggressive" recommendation.

The article is well written and convincing. The results of this study should be troubling to taxpayers, the revenue authority (the CCRA), and tax professionals.

G.F.

Richard Kasten, David Weiner, and Thomas Woodward, "What Made Receipts Boom and When Will They Go Bust" (September 1999), 52 *National Tax Journal* 339-47

Ann Parcell, "Challenges and Uncertainties in Forecasting Federal Individual Tax Receipts" (September 1999), 52 *National Tax Journal* 325-38

Leonard Burman, "Surplus Tax Policy" (September 1999), 52 *National Tax Journal* 405-11

These three articles address issues related to the forecasting of surpluses and the tax policy implications of surpluses. Although the context under discussion is the United States, these articles are equally relevant to Canada.

Richard Kasten, David Weiner, and Thomas Woodward, all of the Congressional Budget Office, examine the growth in revenue from individual income tax receipts (the primary component of the surge in federal revenues). In particular, they explain why the increase in receipts exceeded the growth in gross domestic product (GDP) for the period 1994-1997. To analyze this "boom," they looked at the growth in specific tax components. For example, they examined the effect of income being applied at a higher effective tax rate ("real bracket creep"). They found that each of these specific tax components moved in the same direction over the period—that is, each component increased tax receipts. In discussing the likelihood of a "bust," the authors argue that although some of these specific tax components might turn, it is unlikely that others would. The implication is that it is unlikely that a bust will occur. A further observation made by the authors is worth repeating—taxable personal income cannot grow faster than GDP in the long run.

Ann Parcell, of the Department of the Treasury, discusses the difficulties in forecasting federal individual income tax receipts. As she notes, one must first use a microsimulation model to forecast income tax liability. She further argues that in times of revenue surges, collections exceed the estimate of tax liability given by models using historical data. The issue is then how to integrate these surges through adjustments to the model. The difficulty is in determining whether these surges reflect a timing change, are one-year surges, or are surges that will last for several years. To the extent that a surge is temporary, it should have little effect on future years. The difficulty, as noted by Parcell, is in separating out the temporary and permanent components of the growth. Parcell then examines the effects of tax law changes with an emphasis on changes in the taxpayer's optimal decision concerning the timing of tax payments.

Leonard Burman, of the Department of the Treasury, discusses the implications for tax policy of surpluses. The analysis he provides is extremely interesting and thought provoking (this article is fun to read). Burman discusses whether there is a tax policy paradigm shift in moving from budget deficits to surpluses. He ultimately argues that the same basic tax principles of fairness, simplicity, and economic growth that were applied in times of budget deficit should continue to motivate tax policy in times of surplus.

Each of these three articles is informative, well written, and accessible. Reading the articles in combination is a worthwhile exercise. Having read these articles, one is left with the thought that it would be beneficial to perform some of the same analysis in Canada.

G.F.

Neil Brooks, "Flattening the Claims of the Flat Taxers" (Fall 1998), 21 *Dalhousie Law Journal* 287-369

This extensive article describes the case against flat tax proposals. The author, who is a tax professor at Osgoode Hall Law School, argues that the introduction of a flat tax would simply redistribute income from poor and middle-class individuals to the rich without any compensating benefits. He states that the difference between the flat taxers and the people who support a progressive income tax is their respective views on the ethical justification for the market distribution of income. The flat taxers believe that the way the market works is just and, therefore, there is no ethical justification to take away income. Brooks believes that the market distribution of income is unjust and that a progressive income tax is a defensible means to reduce inequality in society. He concludes that the introduction of a flat tax would be bad economic policy, perverse social policy, and immoral.

The article begins with a review of the history of flat tax proposals in the United States from the mid-1980s to the early 1990s. These proposals are nothing more than variations of the paradigm of the Hall-Rabushka flat tax, which consists of two rate bands (a zero-rate band and a positive flat rate) applied to a consumption tax base. Brooks argues that political interest in the flat tax in Canada follows the same interest in the United States and is attributable to a sense that Canada must remain competitive. He illustrates this point by reviewing the debate over a flat tax in Canada. The Canadian debate has generally occurred concurrently with the debate in the United States. The most vociferous proponent of a flat tax in Canada has been the Fraser Institute, which proposed a model similar to the Hall-Rabushka paradigm. Other proponents include the Liberal MP Dennis Mills and Reform Party MPs Herber Grubel and Jim Silye.

The next part of the article reviews and critiques the normative claims of proponents of a flat tax. The flat taxers claim that a flat tax would simplify the tax system, decrease tax evasion, and reduce administrative and compliance costs. They argue that these effects would, in turn, encourage Canadians to work harder, save more, and remain in Canada. Flat taxers also claim, somewhat vaguely, that a flat tax is the fairest system. Brooks characterizes all these claims as "dead wrong." He states that they are based on faulty logic, that their factual premise is not supported by empirical evidence, that the normative judgments of flat taxes are perverse, and that a flat tax is contrary to the basic principles of an equitable tax system and to the social goals of Canadians. He suggests, in fact, that the introduction of a flat tax would benefit only the top 30 percent of income earners, and that proponents purposely muddle the issues surrounding a flat tax in order to gain broad political support for an income tax cut for the rich.

Brooks argues that a flat tax would not simplify the tax system, since it would provide only a simple rate structure and would not address the source of tax complexity—that is, tax base issues. He illustrates this point with a thorough review of the base design issues that would remain unchanged under a flat tax. Furthermore, all the administrative rules that are necessary to collect and administer a tax applied to a particular base are required regardless of the rate structure.

To refute the claim that a flat tax would reduce tax evasion, Brooks relies on several recent studies. He argues that these studies support the view that any realistic account of why people evade taxes places little weight on tax rate changes largely because of other factors that influence their decision. Indeed, Brooks concludes that there is absolutely no evidence that suggests a connection between lower tax rates and reduced evasion.

Perhaps the most significant claim in support of a flat tax is the notion that such a tax would encourage individuals to work harder, save more, take more entrepreneurial risks, and remain in Canada. As in the case of other normative claims for a flat tax, Brooks concludes that these economic effects are exaggerated, with little evidence that high taxes stunt economic growth. He reviews historical time-series correlations and cross-country data that imply that the opposite is true and that economic growth in many countries has occurred in an environment of high taxes. It is therefore difficult to conclude with any certainty that there is a positive correlation between lower tax rates and economic growth. In this respect, Brooks notes that the impact of lower tax rates on labour and savings behaviour is mixed because of the offsetting "substitution" and "income effects" of taxes. Many studies indicate that labour supply and savings rates are relatively insensitive to tax rates and have remained relatively constant throughout the last century. Brooks also argues that flat taxes will not stem the "brain drain," in view of the simple fact that the main reason people leave Canada is not to escape high tax rates, but to pursue better job opportunities.

Tamara Fedchun

Kimberly N. Varma and Anthony N. Doob, "Deterring Economic Crimes: The Case of Tax Evasion" (April 1998), 40 *Canadian Journal of Criminology* 165-84

Several studies[10] have explored deterrence theory by examining responses to a variety of criminal offences. The theory assumes that there are intelligent, informed individuals who calculate the costs and benefits of undertaking one choice or another. As well, it assumes that individuals consciously assign a value to certain factors, such as the possibility of apprehension, expected penalties, effect on reputation, and one's own personal beliefs, when deciding to engage in a criminal activity. The subject of tax compliance and evasion is one area in which the optimal conditions for the application of deterrence theory are likely to exist. In particular, tax evasion provides an ideal context to examine the behaviour of individuals faced with the opportunity to reap monetary gains from deviant behaviour, and with the time to contemplate fully the consequences of such behaviour. This article examines tax compliance and evasion within the framework of deterrence theory. More specifically, Varma and Doob examine the impact of four factors on the decision to evade taxes: (1) the risk of apprehension, (2) expected penalties, (3) effect on reputation, and (4) an individual's personal beliefs. They conclude that personal beliefs are the most important factor in the application of the theory.

Varma and Doob derive their conclusions from an assessment of data consisting of random English-speaking households familiar with the personal income tax return. These households were categorized as either tax evaders or non-tax evaders on the basis of their answers to a series of questions regarding the reporting of income and deductions. Using this categorization, the two groups were compared in the areas of apprehension, expected penalties, effect on reputation, and personal beliefs. Respondents were asked a number of questions in each area. In the area of apprehension, the questions focused on the respondent's estimates of the probability of apprehension when evading taxes. The questions for the expected penalties consisted of inquiries into the respondent's knowledge of the legal penalties for tax evasion of various amounts. In the area of reputation, the questions attempted to elicit the respondent's perceptions of how other people would perceive the respondent if he or she were recognized as a tax evader. The questions for personal beliefs attempted to assess the level of obligation that the respondent felt to file income tax returns honestly.

10 See J. Casey and J. Scholz, "Beyond Deterrence: Behavioural Decision Theory and Tax Compliance" (1991), vol. 25, no. 4 *Law and Society Review* 821-43; Dick J. Hessing et al., "Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies," in Joel Slemrod, ed., *Why People Pay Taxes: Tax Compliance and Enforcement* (Ann Arbor: University of Michigan Press, 1992), 291-305; and Steven Klepper and Daniel Nagin, "Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution" (1989), vol. 23, no. 2 *Law and Society Review* 209-40.

Varma and Doob surmise that the difference between those who evade tax and those who do not may be attributable more to personal beliefs than to the expectation of penalties or risk of apprehension. As compared to tax evaders, non-evaders were generally unsure of the expected penalties or the risk of apprehension. Varma and Doob suggest that honest taxpayers are less likely to consider tax evasion at all. Therefore, compliance may have more to do with an individual's moral character in being honest when filing an income tax return. In this respect, Varma and Doob emphasize that higher expected penalties do not appear to have a deterrent effect. They conclude that, if heavier criminal penalties are imposed, the penalties are seen only as affecting the reputation of an individual. These findings suggest that deterrence theory is misleading. However, given that tax evaders have learned from experience that they can escape apprehension, Varma and Doob believe that their results cannot be relied on to deter individuals who are already evading tax.

Varma and Doob propose that part of the problem of tax evasion may be that it is not seen as an offence like most other criminal offences. They suggest that tax evaders may justify this type of crime on the basis of governmental fiscal mismanagement and/or the perceived unfairness of governmental action. Varma and Doob believe that if this proposition is correct, effective responses to tax evasion must be found outside the criminal justice system.

Leila Dabir

Mea Culpa

In the (1999) no. 5 issue of this feature, I noted an article by John F. Avery Jones et al. entitled "The Definition of Dividend in the Double Taxation Relief Article" [1999], no. 3 *British Tax Review* 163-73. The authors have drawn my attention to my misstatement of the argument developed in their article. In fact, the authors argue that the definition of a dividend in the dividend article of a tax treaty should not apply generally in interpreting other references to a dividend. In this respect, the authors support the decision of the UK Court of Appeal in *Memec PLC v. IRC*, [1998] STC 754, and disagree with the dissenting judge, who suggested that continental European courts would use the definition of dividend in a dividend article throughout a tax treaty. I apologize to the authors and readers of this feature for my error.

T.E.