Current Tax Reading

Co-Editors: Tim Edgar and Glenn Feltham*

F. Barry Gorman, *Canadian Income Taxation: Policy and Practice*
(Scarborough, Ont.: Carswell Thomson Professional Publishing, 1999), 776 pages, ISBN 0-459-57657-7

There is no shortage of texts devoted to the general features of the Canadian income tax system. This latest book, written by an accounting professor at Saint Mary's University, adopts an approach that is sufficiently different to distinguish it from other texts. Gorman identifies three approaches that are commonly used in tax texts: (1) a legal or compliance perspective; (2) a policy-oriented approach; and (3) economic analysis. He describes the first approach as one that concentrates on "the calculation of taxable income and taxes payable, the preparation of tax returns, tax planning, the decision-making aspects of taxation, and the administration and enforcement of the law."[1] The second approach is characterized by a more conceptual or theoretical perspective that concentrates on the process by which tax law is formulated, the rationale for particular provisions, and the use of tax law as an instrument of public policy. The third approach studies the impact of the tax system on the economy and compares that impact with various reform alternatives in a search for an "optimal system." As Gorman correctly points out, most existing texts focus on one of these three approaches to the exclusion of the other two. His text, in contrast, attempts to integrate a legal or compliance perspective with a policy perspective, and also to provide a deeper understanding of the structural features of the Canadian tax system that tend to endure over a succession of budget cycles. Gorman's approach is largely successful, and the book should be recommended reading for his intended audience—accounting students who are taking their first taxation course at the undergraduate or graduate level. The text should also serve as a useful reference source for junior tax practitioners in the first few years of professional training.

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1 At v.

The text is quite comprehensive in its coverage. The first three chapters provide some general policy background, including a description of Canadian tax history, the choice of tax bases, the economic effects of taxation, normative criteria for evaluating tax systems, and the use of tax expenditures. Chapter 4 examines the concept of residency and jurisdiction to tax. The basic division between source and residence jurisdiction is reviewed primarily in the context of their modification by tax treaties. Chapters 6 to 8 discuss the personal income tax, including the rate structure, personal tax credits, deductions for personal expenses, the calculation of employment income, and certain miscellaneous income inclusions enumerated in subsection 56(1) of the Income Tax Act.[2] Chapters 9, 10, and 11 cover the rules for calculating income from property and income from a business; chapter 11 specifically focuses on the treatment of eligible capital property and depreciable capital property. Chapters 12 and 13 review capital gains taxation: chapter 12 covers the basic rules, and chapter 13 deals with a number of specialized rules. The corporate income tax is the subject of chapters 5, 14, and 15. The focus is primarily on the regime applicable to the Canadian source income of resident corporations, although there is also some brief discussion of the foreign affiliate rules. Discussion of the treatment of corporate reorganizations is limited to the rollover relief provided under section 85 on a transfer of property to a taxable Canadian corporation. Chapter 16 provides an overview of the administration and enforcement provisions of the Act. Chapter 17 introduces the basic analytic framework of tax planning, with a focus on tax shelters and certain legislative responses to their use. There is also a discussion of policy responses to tax avoidance and of the general anti-avoidance rule (GAAR) in section 245. Chapter 18 concludes the text with a review of the budget process in Canada.

Each of these subjects and the relevant provisions of the Act are presented within a basic policy context that sharpens the focus of some of the general points presented in the first three chapters. Where appropriate, Gorman also refers to selected administrative publications of the Canada Customs and Revenue Agency ("the CCRA," formerly Revenue Canada). Mathematical examples are provided throughout each chapter to illustrate the application of certain statutory provisions, and each chapter ends with problems and questions for discussion. Within the various chapters, there are very few references to secondary literature on the subject under discussion; and, perhaps more important, there is only limited reference to relevant case law and the role that the courts have played in interpreting and applying the Act. The limited amount of this material is probably due to Gorman's decision to write the book primarily for accounting students and to leave more detailed discussion of the case law to tax

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

texts and case books used in law schools. Nevertheless, an appendix includes some useful notes on the structure of the Act, the importance of cases generally, the role of the CCRA, and some important sources of secondary literature. A second appendix summarizes the personal tax credit amounts.

T.E.

(1999), vol. 12, no. 1 ***Canadian Petroleum Tax Journal*** 1-240

This issue of the *Canadian Petroleum Tax Journal* consists of 10 articles on a wide range of topics. The following is a list of the authors and titles:

- Brian R. Carr, "A Potpourri of Resource Tax Issues";
- Dave Van Dyke and Claire Fragomeni, "The New Alberta Royalty Tax Credit Program";
- Kevin Hinz, "International Financing Developments—Section 17 Amendments";
- Roch J. Martin, "Selected Change of Control Issues";
- D. Blair Nixon, "Cross-Border/International Operational Issues (1999 Update)";
- Murray J. Lee and Christy L. Palmer, "US Oil and Gas Taxation for Canadians";
- Edward C. Rowe, "Recent Cases of Interest to Resource Tax Practitioners";
- Monika Siegmund, "Planes, Trains and Automobiles: A Journey Through Employee Benefits";
- Stephen C. Doyle, "Selected Revenue Canada Assessing Issues"; and
- Michael J. Flatters, "General Anti-Avoidance Rule Update."

Several of these articles should be of interest to tax practitioners generally, and not just those with a practice focused on the oil and gas industry. They are briefly reviewed here.

Nixon's article is worthwhile reading for practitioners advising on cross-border issues. The author provides a useful update of transfer-pricing practices under the recently enacted legislative regime in section 247. He also reviews source jurisdiction issues for non-residents employed in Canada, including the significance of the recent Tax Court of Canada decision in *Dudney v. The Queen*.[3] The article concludes with a review of the availability of foreign tax credits in the context of production-sharing agreements.

3 99 DTC 147; [1999] 1 CTC 2267 (TCC).

Hinz provides an accessible overview of the somewhat confusing amendments to section 17 of the Act. Like the authors of some other articles on the same topic,[4] he highlights the apparent intent and impact of these amendments for offshore financing structures. Unlike them, however, he offers very little discussion of various planning structures that might be implemented as a response to the possible application of the amended provision.

Martin's article briefly reviews some selected planning considerations associated with an acquisition of control of a corporation, including triangular foreign mergers.

Doyle reviews some of the CCRA's assessing practices affecting the oil and gas industry, as well as certain other areas. He covers an eclectic set of issues, including questions of corporate residency focused on the location of a corporation's central management and control, and the characterization of a presence in Canada as a permanent establishment in the wake of the *Dudney* case.

Siegmund's article reflects the wide variety of subjects covered in this issue. It provides a comprehensive update of the taxability of various forms of employer-provided benefits under the CCRA's assessing practice, recent case law, and the recent introduction of specific provisions governing relocation payments. Siegmund focuses principally on recent developments in the area of employer-provided vehicles, employee relocations, employer-provided special events, and the payment of training and professional dues. Stories in the popular press periodically offer startling examples of the CCRA's attempts to tax the value of employer-provided benefits, such as Grey Cup rings and employer-provided coffee. Perhaps the apparently burdensome nature of these assessments prompted the reference in Siegmund's title to the comedy "Planes, Trains and Automobiles," which starred the late John Candy as the unwanted companion of Steve Martin's travel-weary character. Readers who have seen that movie can probably find in it many other analogies to the CCRA's assessment of the tax-weary employee.

Flatters, in his article, provides an obligatory GAAR update. He includes a review of the GAAR arguments and analysis in the recent decisions in *Husky Oil Limited v. The Queen*[5] and *Nadeau v. The Queen*.[6]

T.E.

4 See, for example, Penny Woolford-Marshall, "Amendments to Section 17: Imputed Income to Canadian Resident Corporations on Certain Loans to Non-Residents," International Tax Planning feature (1999), vol. 47, no. 3 *Canadian Tax Journal* 640-62; and Evelyn P. Moskowitz, "The New Rules Under Section 17," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, forthcoming).

5 99 DTC 308; [1999] 4 CTC 2691 (TCC).

6 99 DTC 324; [1999] 3 CTC 2235 (TCC).

Eugen Trombitas, "Tax Reform Issue—No Need for a General Anti-Avoidance Provision in the Income Tax Act 1994" (November 1999), 5 *New Zealand Journal of Taxation Law and Policy* 121-46

The author of this article argues that a general anti-avoidance rule (GAAR) is unnecessary in New Zealand and should be abandoned in favour of (1) specific anti-avoidance rules, (2) legislative responses that attempt to address structural deficiencies that are the source of avoidance opportunities, and (3) an activist judiciary that employs a purposive approach to the interpretation and application of tax legislation. The apparent impetus for the article is the comments on the New Zealand GAAR provided in a recent committee report on tax compliance commissioned by New Zealand's treasurer and minister of revenue.[7]

Trombitas defines tax avoidance as arising "when the law does not expressly require payment of tax even though the policy of the law would say that tax should be paid, or not reduced."[8] Unlike some tax practitioners, he accepts that any civilized society has an important stake in controlling tax avoidance. The question as framed by Trombitas is how best to control tax avoidance without leaving taxpayers subject to undue discretion on the part of the tax authorities. Indeed, he criticizes the New Zealand GAAR as being too imprecise and leaving too much discretion in the hands of the Inland Revenue. Although Trombitas sees the judiciary as performing an important role in controlling tax avoidance, his view of the appropriate approach to statutory interpretation in tax-avoidance cases is a fairly conventional one based on UK and New Zealand jurisprudence. This approach has not proven to be especially effective in some other countries, including Canada. It is perhaps for this reason that Trombitas also recommends the use of specific anti-avoidance rules as a way of striking an appropriate balance between the need for taxpayer certainty and the need to control tax avoidance. In the absence of repeal of the New Zealand GAAR, Trombitas advocates certain amendments that would limit its potential application. Some of these suggested amendments are, in fact, incorporated in Canada's GAAR, in section 245 of the Act.

T.E.

Darren Heil, "Comment: The Tax Implications of Catching Mark McGwire's 62nd Home Run Ball" (Summer 1999), 52 *The Tax Lawyer* 871-79

Sometimes tax administrators say the darndest things. Baseball fans may recall the public outrage when, in the heat of the race to break Roger Maris's single-

7 New Zealand, *Tax Compliance: Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance* (Wellington, NZ: New Zealand Government Printer, December 1998).

8 At 125.

season mark of 61 home runs, an Internal Revenue Service (IRS) spokesman stated that any fan who returned the magical ball to the record breaker (Mark McGwire of the Saint Louis Cardinals) would be liable to income and gift tax on the transfer. The outrage led the IRS to reverse its position. In a press release issued after the initial statement, the IRS stated that it would consider the transaction analogous to the declining of a prize or the return of unsolicited merchandise, which are considered non-taxable transactions. The author of this comment in *The Tax Lawyer* questions the legal basis for this position and argues that it is a specific example of the kinds of unintended consequences that general legislative rules may have. He concludes that the IRS had no authority to adopt the position that it did. Instead, responsibility lay with the US Congress, which should have been required to write a specific exemption for Tim Forneris, the man who caught McGwire's 62nd home run ball and returned it to the slugger. Despite the less-than-compelling nature of its subject, the comment is good fun and worth reading if only for a respite from the standard tax literature.

T.E.

Jeffrey L. Yablon, "As Certain as Death—Quotations About Taxes (Expanded 2000 Edition)" (January 10, 2000), 86 *Tax Notes* 231-68

Yablon's expanded edition of tax quotations is a boon for all those individuals who must deliver lectures, after-dinner speeches, and various other talks on taxation. There is something here for any subject. As with previous collections published in *Tax Notes* in 1994, 1995, and 1997, Yablon has usefully compiled the quotations by subject matter under eight headings: (1) taxes generally, (2) the legislative process, (3) government, (4) progressivity and equity, (5) exemption, (6) collection and administration, (7) the power to tax, and (8) avoidance, evasion, and planning. Humour apparently remains an important criterion for inclusion. Many of the quotations will make readers laugh out loud—not the usual response when reading a tax journal.

T.E.

Keith E. Engel, "Importing Assets into Domestic Taxing Jurisdiction: Learning from Canada" (Winter 1999), 52 *The Tax Lawyer* 275-333

The author of this article compares and contrasts the US and Canadian tax regimes that apply on importation of foreign assets into the domestic tax jurisdiction. Foreign assets can be imported as a result of (1) a change of residence of the owner; (2) a transfer from a non-resident branch to its resident headquarters; (3) a transfer from a non-resident subsidiary to a resident parent corporation; (4) an acquisition of a non-resident corporation by a resident taxpayer; or (5) an acquisition of foreign property by a resident taxpayer from a non-resident. Engel reviews the current US treatment of these transactions, which are generally non-recognition events. That treatment is contrasted with the Canadian approach, which generally deems the affected assets to have been disposed of for proceeds equal to fair market value. Engel prefers the Canadian approach because it limits residence jurisdiction to gains and losses that accrue after the transfer. However, he would provide an exception from this fair market value rule for repatriation of assets from a foreign branch or subsidiary. In these instances, the assets would be repatriated at their historical cost with appropriate adjustments to ensure that foreign tax credits are available on sale. Non-recognition treatment would apparently be provided to avoid tax barriers to the repatriation of assets with accrued gains.

T.E.

Lorraine Eden, "The Arm's-Length Standard in North America"
(February 7, 2000), 20 *Tax Notes International* 673-81

This brief article traces the historical development of the application of the arm's-length standard to resolve transfer-pricing disputes in Canada, Mexico, and the United States. Eden argues that transfer-pricing regulations in these three countries have developed in the context of an "international regime" that reflects certain principles, norms, rules, and decision-making procedures. This regime was implemented first in the United States, with Canada and Mexico following its lead. Eden provides three detailed tables. The first table summarizes the norms, principles, and procedures that are seen to underlie the transfer-pricing regime. The second table summarizes the historical development of the transfer-pricing regime in North America from 1917 to 1999. The third table provides a snapshot of the principal elements of the existing transfer-pricing regime in North America. The text of the article elaborates briefly on the content of each of these tables.

T.E.

Jack M. Mintz and Thomas A. Wilson, *Capitalizing on Cuts to Capital Gains Taxes*, C.D. Howe Institute Commentary no. 137 (Toronto: C.D. Howe Institute, February 2000), 27 pages. Available on the Web at www.cdhowe.org/.

The 2000 federal budget cut the inclusion rate on capital gains from three-quarters to two-thirds. This reduction represents a significant change in Canadian tax policy. Why was the inclusion rate reduced? Writing before the budget, Jack Mintz and Thomas Wilson, both professors at the University of Toronto, provide a rationale for lower capital gains rates. Their arguments are compelling.

Mintz and Wilson first examine the cases for and against the taxation of capital gains, and the different approaches that could be applied. They then discuss the pressures for reform. These pressures include an imbalance between the taxation of capital gains and other forms of income, the existence of tax disincentives for risky capital and entrepreneurship, effects of non-symmetric treatment of losses, and the implications of significant differences between US and Canadian rates.

Mintz and Wilson then provide a series of recommendations, two of which deal directly with the inclusion rates for capital gains. They recommend an immediate reduction in the inclusion rate from three-quarters to two-thirds. They argue that, in addition to the general benefits of a reduced rate, this reduction would bring the effective tax rate more in line with the rate on dividends. They further recommend that with more comprehensive tax reform, the inclusion rate for capital gains should be reduced to one-half, and the dividend tax credit increased from 20 percent to 25 percent.

The article is both well written and persuasive. It is also quite comprehensive and provides a sound analysis of the various perspectives. The article is, of course, of particular interest because one of its primary recommendations was implemented in the 2000 federal budget. Mintz and Wilson provide the justification for that change. It will be interesting to see whether their recommendations for a further reduction in the capital gains rate, as part of a comprehensive tax reform, will materialize in the coming years. As a final comment, the article is accessible to a wide spectrum of readers whether their background is law, accounting, economics, or government.

G.F.

Ronald D. Kneebone and Kenneth J. McKenzie,
"The Characteristics of Fiscal Policy in Canada"
(December 1999), 25 *Canadian Public Policy* 483-501

Ronald Kneebone and Kenneth McKenzie, both economists at the University of Calgary, attempt to determine the nature of discretionary fiscal policy in Canada. In recent years, the federal and provincial governments have attempted to reduce or eliminate budget deficits. This can be accomplished by reducing expenditures, by increasing taxes, or through a combination of the two. Kneebone and McKenzie attempt to determine which of these tools—reducing expenditure or increasing taxes—was actually used. It is important to note that they are examining discretionary fiscal policy; that is, effects such as output, interest rates, and inflation are removed.

Kneebone and McKenzie find that in periods of deficit reduction, there tends to be a balance between expenditure reduction and tax increases, while in periods of deficit increase, increased expenditures are more pronounced than tax reductions. There is, however, an important exception. In the recent retrenchment period (1993-1996), expenditure cuts played a larger role. In short, Kneebone and McKenzie find that the recent reductions in deficits have occurred primarily through spending cuts, not through increases in taxes.

This article is well worth reading. It both confirms, and contradicts, one's beliefs about Canadian fiscal policy. For example, at variance with my prior beliefs, the authors find that Saskatchewan has recently relied primarily on expenditure cuts rather than tax increases to get its financial house in order (with greater emphasis on expenditure cuts than is true of its neighbour to the west, Alberta).

G.F.

Andrew Kosnaski, "The Spending While Saving Conundrum"
[February 2000] *Fraser Forum* 4-7. Available on the Web at www.fraserinstitute.ca

Andrew Kosnaski asserts that the recent reduction in the federal deficit was accomplished primarily through revenue increases and not expenditure reductions. Kosnaski comes to this conclusion by comparing the change in the level of taxation to the change in spending over the period 1993-1998. His findings differ from those of by Ronald Kneebone and Kenneth McKenzie (discussed above) over a similar period (1993-1996). An important distinction between these studies is that Kneebone and McKenzie remove non-discretionary effects—that is, they examine discretionary fiscal policy. It is worthwhile to read both studies.

G.F.

David Altig and Charles T. Carlstrom, "Marginal Tax Rates and Income Inequality in a Life-Cycle Model" (December 1999), 89 *The American Economic Review* 1197-1215

David Altig and Charles Carlstrom, both of the Federal Reserve Bank of Cleveland, examine whether changes in the US marginal tax rate in 1996 increased income inequality. They find that they did. Of particular interest, they find that there was both a labour supply and a savings response that increased the magnitude of income inequality.

In examining these results, one should be somewhat cautious: there are many assumptions underlying the general equilibrium model developed in this article. However, the underlying message is important. Responses to marginal tax rate changes can significantly affect income inequality. It is important, in this time of significant Canadian tax reform, that both direct and secondary responses be considered.

G.F.

Gideon Yaniv, "Tax Compliance and Advance Tax Payments: A Prospect Theory Analysis" (December 1999), 52 *National Tax Journal* 753-64

It has been argued in past studies that tax compliance is greater where a taxpayer is in a refund position than where the taxpayer is in a payment due position. Gideon Yaniv develops a model that formally applies a behavioural theory, prospect theory, to this issue. He finds that an increase in withholdings may increase compliance, but if taxpayers have realistic beliefs about the probability of detection, it will not eliminate non-compliance.

G.F.

Finn Poschmann and John Richards, *How To Lower Taxes and Improve Social Policy: A Case of Eating Your Cake and Having It Too*, C.D. Howe Institute Commentary no. 136 (Toronto: C.D. Howe Institute, February 2000), 18 pages. Available on the Web at www.cdhowe.org/.

The central issue that Finn Poschmann and John Richards examine is how our tax system treats families with children. More specifically, Poschmann and Richards focus on the effect of credit reductions associated with the National Child Benefit System (NCBS) and the goods and services tax credit. Above a certain family income threshold, benefits are reduced until they are entirely eliminated. An equivalent way to state this is that effective tax rates are increased over this reduction range; these rates are often about 70 percent in the $21,000-$34,000 income range. Should we care? Poschmann and Richards believe we should. While they acknowledge that in the short run there may be a small reduction in work effort, they assert that the longer-term effects will be significantly larger.

How can these high rates for low- to middle-income families be reduced? Poschmann and Richards claim that several strategies could be adopted, but each involves either lowering the level of benefits or reducing the clawback rate (in the limit, having a universal program). Poschmann and Richards set out a proposal that has a number of elements. First, they recommend the introduction of a non-refundable tax credit of $2,000 per child. This credit would not affect an individual's effective tax rate in the current reduction range. Poschmann and Richards further justify this credit on the basis that all families with children incur costs that families without children do not, independent of the family's level of income. They argue that these costs should be recognized. Second, Poschmann and Richards argue that the threshold should be reduced (to take into account the introduction of the non-refundable amounts) and, in general, clawback rates should be reduced (they provide recommended rates). The effect of these rate reductions is that most families with income in a reduction range would have significantly lower effective tax rates. The third recommendation is administrative in nature: child tax benefits should be netted against income taxes (to the extent that income tax is paid). The difficulty with this recommendation lies with the tax unit—whom do you deduct taxes from?

This is a well-written and thought-provoking paper. It both describes the problem of high effective tax rates that result from a reduction in benefits and proposes a solution. This paper takes on increased importance given the 2000 federal budget, which has again increased the level of payments and the number of families receiving benefits. Poschmann and Richards demonstrate that this might be the appropriate time to re-examine this policy direction.

G.F.

Donald I. Price and E. Shawn Novak, "The Tax Incidence of Three Texas Lottery Games: Regressivity, Race, and Education"
(December 1999), 52 *National Tax Journal* 741-51

Lottery games were introduced in Texas in 1992, partially to offset a decline in other revenue sources (in particular, oil). Donald Price and Shawn Novak study the incidence of the introduction of three lottery games in Texas—that is, they examine who plays these games.

Prior studies had tended to find that lotteries are regressive. In addition, Price and Novak note that claims are frequently made that lotteries are played disproportionately by minorities and by those with less education. They studied three different types of lotteries: Lotto (where the participant must correctly pick 6 numbers from 1 to 50, much like Lotto 6/49 in Canada), Pick3 (where the player must pick a three-digit number to win a fixed prize), and Instant (a scratch game). The three games were all significantly regressive; however, there were large differences in level, with Lotto being the least and Instant the most regressive. Black and Hispanic populations tended to spend a larger amount on the most regressive game, Instant, than the general population but a smaller amount on the least regressive game, Lotto. This latter result differed from that of prior studies. Price and Novak found that the level of education was negatively related to Instant, the most regressive game, but positively related to Lotto, the least regressive game.

What are the implications of this study for Canada? Both the federal government and provincial governments have expanded gambling greatly over the last decade, and there are signs that this trend will continue. The effects discussed in this article are likely also to exist in Canada. In making the decision to introduce a particular game, it is important to understand how regressive that game is, and which population that game will affect the most.

G.F.

James Dow and Rohit Rahi, "Should Speculators Be Taxed?"
(2000), vol. 73, no. 1 *The Journal of Business* 89-107

Many prominent economists have promoted the adoption of taxes on speculation in financial markets, primarily because it is perceived that this activity produces little or no economic benefit. Should there be a transactions tax on speculation? James Dow and Rohit Rahi address the question through modelling the equity market (assuming that competitive agents have rational expectations). They find that a tax on speculation may in fact increase speculators' profits. The logic is as follows. The existence of a speculation tax reduces the information in prices (as the speculator performs fewer trades). As prices are less informative, the trader can make more money on each trade. When the profits are balanced against the additional tax, the speculator may actually come out ahead.

This article challenges the view that a speculation tax would make speculators unambiguously worse off—a view that I held before I read the article. The story, set out in the first four pages of the article, is well written and relatively easy to follow (although the model is mathematically complex).

G.F.

Gilbert E. Metcalf, "A Distributional Analysis of Green Tax Reforms" (December 1999), 52 *National Tax Journal* 655-81

It is generally believed that most environmental taxes are regressive. Therefore, when the introduction of environmental taxes is being considered, distributional concerns are important. Gilbert Metcalf examines how a tax system can be designed to reduce or eliminate the regressive properties associated with environmental taxes. The primary message in this article is that environmental tax changes should be part of a larger package of reform. In effect, if a regressive environmental tax is introduced, the overall level of regressivity in the tax system does not need to increase. Other existing taxes can be made commensurately more progressive. Metcalf attempts to demonstrate how this can work in practice in the United States.

Metcalf starts by assuming a reduction in the payroll and income tax base of 10 percent, which is replaced with environmental taxes (taxes on carbon emissions, gasoline consumption, air pollution, and the use of new materials). The key to his analysis is in choosing the appropriate changes to payroll and income taxation. He proposes an exemption from payroll taxes (on the first $5,000 of OASDI tax base), a refundable $150 tax credit, and an across-the-board tax cut of 4 percent. The net impact of this proposal is almost neutral. Metcalf demonstrates, however, that with other adjustments (for example, tying the size of the payroll tax exemption to family size), the change can in fact be progressive.

This article demonstrates an important point: the introduction of green taxes does not necessary imply that our system will become less progressive. It would be an interesting exercise to determine, along with specific proposals for environmental change, what changes in Canada's tax system could be implemented to preserve the overall level of progressivity.

G.F.

Calvin H. Johnson, "Stock Compensation: The Most Expensive Way To Pay Future Cash" (October 18, 1999), 85 *Tax Notes* 351-68 and (Spring 1999), 52 *SMU Law Review* 423-54

The provision of stock-based compensation is a common corporate practice. Many companies, especially high-tech startups, embrace stock compensation as a supposedly effective and costless form of incentive-based compensation. In this article, Calvin Johnson, of the Faculty of Law of the University of Texas, argues that employee stock compensation is, in fact, expensive and flawed as an incentive mechanism. He concludes that corporate employers are almost always better off issuing debt in the form of corporate bonds or deferred compensation plans (DCPs).

Johnson concludes that stock compensation is expensive relative to debt for two principal reasons. First, the higher discount rate associated with equity imposes a significant drain on expected corporate cash flows. Johnson explains at great length the reasons for the high discount rate on stock. In essence, he argues that the discount rate on stock is high because of greater price volatility and a mistrust of management distribution policy. Johnson offers the example of a $1,000 stock bonus with a 28 percent return. Over $100 billion of the company's accumulated earnings must be committed to this stock bonus over a period of 73 years. The second reason why stock is expensive relative to debt is that dividends are not deductible for the issuer and must be paid out of after-tax dollars. Interest payments are generally deductible for the issuer and avoid the corporate-level tax.

Given that companies can save large amounts of money by compensating employees with debt instead of stock, Johnson argues that the decision to ignore debt is irrational, particularly when it is recognized that the supposed incentive effects provided by stock compensation are illusory. Although the issuance of debt provides employees with stronger creditor rights, Johnson believes that the associated remedies are relevant only in extreme situations. As evidence of the inefficient incentive effect associated with stock compensation, Johnson cites studies that show that 80 percent of variations in a stock price are correlated with overall market or industry movements and not with the specific company whose shares are issued as part of the compensation package. Importing uncontrollable stock volatility into an incentive device such as stock options destroys the motivational value of the compensation.

Johnson also argues that stock ownership does not cause the interests of management and shareholders to converge. Because of the limited amounts of stock ownership by management, the benefits of self-interested managerial behaviour (such as excessive executive compensation) will always exceed any losses from that behaviour (such as decreased stock value). Johnson acknowledges, however, that the concept of linking compensation to corporate performance is a good one. To this end, DCPs offer flexibility if tailored to suit different interests—for example, plans for management that reward dividend distributions and plans for departmental heads that reward improved departmental output.

The dubious nature of the non-tax benefits attributable to stock-based compensation seems to be exacerbated by preferential tax treatment. Even on this point, Johnson challenges conventional wisdom and argues that the tax benefits associated with stock-based compensation are generally overstated. As compared to cash compensation, stock-based compensation is commonly seen to be preferable because of preferential capital gains treatment. However, the deductibility of cash payments means a greater after-tax return on a given amount of after-tax compensation from the employer. In effect, because a company can deduct compensation under a DCP, it can gross up the amount it would otherwise have provided in stock. For a broad range of corporate tax rates, the employee's higher tax rate on income is more than offset by the receipt of a larger grossed-up amount from the employer. Johnson explains this point in the US context with an example of a $1,000 employee stock bonus that appreciates over 10 years. As only the initial $1,000 can be deducted by the company as compensation, only this amount is grossed up (to $1,538 at a 35 percent corporate tax rate). The employee pays tax (at a 44 percent personal tax rate) on the $1,538 by selling some of the stock and is left with $862. Once the stock is redeemed in 10 years for its fair market value of $8,615 ($862 × 10 years at an annual appreciation rate of 26 percent), the employee pays capital gains tax (20 percent) on the capital gain of $7,758 ($862 × 9 years of 26 percent annual appreciation), ending up with $7,064. With a DCP, the company can deduct the entire $10,000 ($1,000 appreciated over 10 years) in the 10th year. Thus, the grossed-up amount the company would be willing to pay would be $15,385 [$10,000/(1 minus the 35% corporate tax rate)]. The employee would pay tax at 44 percent on this amount and would be left with $8,615 after tax. As Johnson notes, this amount is the same as the return on the stock compensation before tax.

Using algebraic models that compare the return on stock compensation with the return on DCPs, Johnson illustrates that even with a zero capital gains tax rate, DCP compensation is equal to capital gains compensation whenever the corporate tax rate is 30 percent and the employee personal tax rate is 30 percent. As the corporate rate increases or the employee rate decreases, DCP compensation is better than capital gains compensation without capital gains tax.

Brennan Debbo

David A. Weisbach, "Line Drawing, Doctrine, and Efficiency in the Tax Law" (September 1999), 84 *Cornell Law Review* 1627-81

The author of this article is an associate professor at the University of Chicago Law School. He argues that boundary lines in the tax law should be drawn on the basis of considerations of economic efficiency rather than doctrinal concerns. Efficiency is measured largely in terms of the costs associated with the substitutability of functionally similar transactions that are taxed differently because they lie on opposite sides of a particular boundary line.

The article is divided into three parts. Part one describes examples of line drawing in US income tax law and shows how these distinctions cannot be supported by traditional doctrinal analysis. As specific examples, Weisbach examines the distinctions between (1) debt and equity instruments, and (2) realization and non-recognition transactions. He admits that some distinctions, such as that between business and personal expenses, can be made on the basis of criteria defined in terms of specified norms. However, no matter whether a distinction is made either arbitrarily or on some normative basis, line drawing has the same basic structure: there are two defined points between which there is a range of transactions with considerable uncertainty. Weisbach suggests that the need to characterize transactions in the middle is the source of most tax problems.

Part two defines the concept of "efficiency" and applies that concept as the basis for drawing boundary lines. Efficiency is equated with "deadweight loss," defined as the loss in consumer and producer surplus when comparing a no-tax to a tax world. Weisbach argues that the goal of line drawing should be the minimization of deadweight loss and the realization of an appropriate distribution of the tax burden. In this respect, he considers "optimal tax theory" as first articulated by Frank Ramsey in the context of commodity taxation.[9] Optimal tax theory posits that the most efficient tax policy is one that raises the necessary revenue with the least deadweight loss. This result is realized when the marginal deadweight loss (that is, the change in deadweight loss caused by a change in the tax on a commodity) is equal for all commodities, and taxes vary inversely with the elasticity of demand for a commodity. Weisbach goes on to discuss subsequent refinements of the Ramsey model in the income tax context and concludes that there are two basic factors at play: substitution costs and direct costs. He concludes that we should tax similar things similarly to minimize substitution costs, but not too much at the expense of direct costs. In the final section of part two, Weisbach applies his efficiency criterion to particular problems of line drawing. He cites the US check-the-box regulations, which govern the classification of certain entities for income tax purposes, to demonstrate that the marginal efficiency of a tax can be measured using the MECF (marginal efficiency cost of funds). The MECF is the ratio of revenue that would be raised absent any behavioural distortions, to the actual revenue raised.

Part three argues that assessment of the efficiency consequences of legislative alternatives is the most appropriate way to solve problems of line drawing in the tax law. Weisbach states that welfare consequences can and should be measured even if it is necessary to keep arbitrary rules in place. Furthermore, he believes that the usual objections to the paramountcy of efficiency considerations in non-tax law do not apply as rigorously in tax law. In this respect, Weisbach discusses the argument developed by Kaplow and Shavell[10] that the tax system is a more efficient way to redistribute income than private law regulatory regimes. In particular, once a tax base is defined, tax rates can be adjusted to achieve a desired distribution of the tax burden. If implemented appropriately, these rate adjustments can generate welfare gains.

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9 F.P. Ramsey, "A Contribution to the Theory of Taxation" (March 1927), 37 *Economics Journal* 47-61.

10 Louis Kaplow and Steven Shavell, "Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income" (June 1994), 23 *Journal of Legal Studies* 677-81.