Current Tax Reading

Co-Editors: Tim Edgar and Glenn Feltham*

Angelo Nikolakakis, *Taxation of Foreign Affiliates* (Scarborough, Ont.: Carswell Thomson Professional Publishing) (looseleaf), ISBN 0-459-28584-X

Working with the foreign affiliate rules in the Income Tax Act[1] is a challenge, even for the most skilled of tax practitioners. Although a new generation of practitioners has come to take this regime for granted as an accepted part of the legislative landscape, it is worth remembering that its introduction in 1972 was somewhat controversial, because of the revolutionary nature of the changes proposed. This controversy and the eventual enactment of the foreign affiliate regime in 1976 generated a considerable literature devoted to an explication and technical analysis of the rules. Much of this literature was synthesized in a useful text last published in 1985.[2] Since that time, however, a second generation of significant legislative amendments, introduced in the 1994 federal government budget, has made this text outdated. Indeed, these later legislative changes have generated a second generation of discursive and analytical literature on the foreign affiliate rules.

This new text is an exhaustive review and comprehensive technical analysis of the current foreign affiliate regime. It is a highly accomplished compilation undertaken single-handedly by a relatively young tax lawyer with the Toronto office of Stikeman Elliott. We believe it will quickly become the primary resource both for practitioners with relatively little experience in working with the foreign affiliate rules and for seasoned practitioners working exclusively in the area. The text will be valued not only for its scope and the quality of its analysis, but also for the helpful selected bibliographies of secondary literature provided at the end of each of the six chapters.

Chapter one is an overview of the historical development of the foreign affiliate rules and the associated policy considerations. Much of this material should be

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1 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.

2 K.J. Dancey, R.A. Friesen, and D.Y. Timbrell, *Canadian Taxation of Foreign Affiliates*, 4th ed. (Don Mills, Ont.: CCH Canadian, 1986).

familiar to practitioners working in the area. For those less familiar with this background material, the first chapter provides a context that makes the description and analysis of the technical details of the foreign affiliate regime in the other five chapters much more accessible. Although the policy discussion is not particularly deep or intensive, it is sufficient to provide the reader with a sense of the general purpose and policy stakes underlying many of the foreign affiliate rules.

Chapter two is also introductory in nature. It reviews the basic concepts that are the core features of the foreign affiliate rules, including the concepts of a corporation, residence in a designated treaty country, "equity percentage" in a foreign affiliate, "participating percentage" in a controlled foreign affiliate, and "surplus entitlement percentage" and a "qualifying interest" in respect of a foreign affiliate. The discussion goes well beyond a simple narrative of the relevant legislative provisions defining some of these concepts. Nikolakakis thoroughly reviews relevant case law, treaty provisions, and administrative statements of the Canada Customs and Revenue Agency ("the CCRA"). He also uses examples effectively to illustrate the application of the more technical of the basic concepts.

Chapters three and four consider the foreign accrual property income (FAPI) regime as it affects Canadian resident shareholders of a controlled foreign affiliate. Chapter three describes and analyzes the critical distinction between FAPI and income from an active business. The focus of this long chapter is the new categorization approach and related rules that were introduced in the 1994 budget. The chapter is organized clearly around the five general categories created by the new legislative regime: (1) income from property; (2) income from a business other than an active business; (3) taxable capital gains; (4) miscellaneous components of FAPI; and (5) income from an active business. Chapter four is a brief chapter devoted to the rules governing the imputation of FAPI to Canadian resident shareholders of controlled foreign affiliates. In addition to a discussion of these basic rules, Nikolakakis includes a brief section that notes the problem created by the use of flowthrough entities in an attempt to provide relief for foreign taxes paid on FAPI. He highlights the administrative response of the CCRA to this problem as presented, in particular, by the US limited liability company.

Chapter 5, the longest in the text, describes the complex rules governing the tax treatment of distributions from a foreign affiliate. Following a short discussion of the intercorporate dividend deduction rules in section 113 and the treatment of payments in reduction of capital, chapter 5 reviews in detail the determination of the surplus accounts of a foreign affiliate, the ordering rules for surplus distributions, and the calculation of underlying foreign tax payable on taxable surplus. It also includes a section on the determination of surplus accounts in the context of corporate consolidation and group relief.

Chapter six reviews the non-recognition rules applicable on certain reorganizations of foreign affiliates. These rules include those applicable on the transfer of shares of a foreign affiliate by a Canadian resident taxpayer to another foreign affiliate, on certain foreign mergers, and on the liquidation of a foreign affiliate.

The chapter concludes with a discussion of various specific rules that adjust the surplus accounts of a foreign affiliate to account for certain share transactions, mergers, or liquidations.

The text is presented in a looseleaf format so as to accommodate timely updates. These are critical in the foreign affiliate area, which is subject to frequent adjustments in both the legislative and the administrative framework. In this respect, Nikolakakis explains that the text is "intended to be and remains a work in progress."[3] In addition to updates of the existing text, he promises to incorporate new chapters devoted to "a more focused analysis of the relevant rules as they apply to specific industry sectors."[4] Other chapters also may be incorporated which would be devoted to specific subject areas affected by the foreign affiliate rules, including the tax treatment of foreign exchange gains and losses, interests in foreign affiliates held through partnerships or other flowthrough entities, and record-keeping and reporting requirements. Even without these promised changes, the text is a commanding and authoritative work.

T.E.

Claire F.L. Young, *Women, Tax and Social Programs: The Gendered Impact of Funding Social Programs Through the Tax System* (Ottawa: Status of Women Canada, October 2000), 81 pages, ISBN 0-662-65028-X

This study is a well-written and lucid analysis of the impact of certain provisions of the Act on women. It builds on a body of previously published research by the author,[5] who is a professor in the faculty of law at the University of British Columbia. The study was funded by Status of Women Canada's Policy Research Fund.

The study focuses on the provisions of the Act related to child care, dependence, retirement savings, disabilities, and certain other caregiving obligations. Young assesses the impact of these provisions on women, using tax expenditure analysis. The assessment is necessarily qualitative and goes beyond the limited usefulness of the quantification of tax expenditures provided annually by the Department of Finance in its tax expenditure account. Young describes this qualitative focus in general terms in chapter one. The chapter reviews briefly the general features of tax expenditure analysis as developed in the academic literature. These general features are then particularized by a discussion of the socioeconomic context for women in different circumstances.

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3 At v.

4 Ibid.

5 See Claire F.L. Young, "Child Care—A Taxing Issue?" (1994), vol. 39, no. 3 *McGill Law Journal* 539-67; Claire F.L. Young, "(In)visible Inequities: Women, Tax and Poverty" (1995), vol. 27, no. 1 *Ottawa Law Review* 99-127; and 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.

The most detailed analysis is found in chapter two, which critiques the child-care expense deduction and the child tax benefit. Chapter three examines the impact of the consumption tax treatment under the Act for qualifying retirement savings. Chapter four considers an eclectic set of tax deductions and tax credits that are currently provided in respect of dependence, disability, and caregiving obligations. After a description of the relevant provisions of the Act, each chapter includes some tentative recommendations for reform that are intended to eliminate or mitigate the adverse impact of the provisions on women.

One of the more significant of these recommendations is Young's suggestion that the consumption tax treatment of qualifying retirement savings be eliminated, and that the increased revenue be used to support a more robust and generous system of public pension income. Young recognizes that, although this recommendation is defensible in theory, in practice it is unlikely to be adopted, and she suggests several more modest alternative reforms that would improve the access of women to tax expenditures for retirement savings. Young's other recommendations are more limited in their impact on the income tax system generally and, therefore, probably more realistic options for the short to medium term. She suggests, for example, that the subsidy for child-care expenses should be enriched and the current income deduction be converted to a refundable tax credit. She also suggests that the child tax benefit should be converted to a direct subsidy program in an effort to improve access for women. Finally, she recommends that the eclectic set of provisions affecting dependent relationships be reconsidered to eliminate the disincentive that these provisions create for the entry of women into the paid labour force.

A brief appendix to the study describes a general framework that is intended to be used in the tax policy-making process to ensure a proper evaluation of the impact on women of a proposed tax provision. The framework includes an interesting set of questions for the use of policy makers in making this necessary assessment.

T.E.

David G. Duff, "Disability and the Income Tax" (2000), vol. 45, no. 4 *McGill Law Journal* 797-889

Tax relief for individuals with disabilities has developed incrementally, with an accelerated pace of development over the last five years. This approach has created a maze of provisions that are not especially well integrated. More specifically, the provisions seem to be designed without clear articulation of specific policy goals, other than the simplistic notion that the circumstances of individuals with disabilities and their supporting family members merit tax relief. This important article addresses a subject that has received relatively little attention in the tax literature. Duff examines in depth the relevance of disability to tax policy and the necessary translation of such relevance into a sensible legislative agenda.

The article first provides a thorough review of the existing provisions of the Act affecting individuals with disabilities and their supporting family members. Duff usefully divides these provisions into three analytical categories: (1) provisions intended to recognize the costs of disability; (2) provisions designed to integrate individuals with disabilities into the paid labour force; and (3) provisions intended to provide income support for individuals with disabilities. Duff then analyzes these provisions in terms of their apparent policy rationale. This analysis leads to specific recommendations for reform of income tax provisions that satisfy both traditional equity concerns and more general social policy considerations.

T.E.

Lisa Philipps, "The Supreme Court of Canada's Tax Jurisprudence: What's Wrong with the Rule of Law" (2000), vol. 79, no. 2 *Canadian Bar Review* 120-44

Recent decisions of the Supreme Court of Canada on the interpretation and application of certain provisions of the Act have become a lightning rod for commentators with differing views of the proper role of the judiciary in ensuring the integrity of tax legislation. This article reviews this familiar territory, but with a new twist. The occasion for the article is a special edition of the *Canadian Bar Review* commemorating the 125th anniversary of the Supreme Court. Philipps finds little to celebrate in the court's record of decisions in tax cases, viewed in relation to the role it could play in countering tax avoidance.

Philipps contends that the Supreme Court's tax decisions remain infused with a traditional view of the rule of law that is entirely procedural in nature and leads to an emphasis on the protection of taxpayer liberty, defined as protection from the arbitrary confiscation of private property. She contrasts this view of the rule of law with a "thicker version" that is characterized by the attempt to articulate and preserve substantive concepts of justice. This alternative view has clearly infused the Supreme Court's activist role in areas of law other than taxation.

Philipps supports her characterization of the Supreme Court's attitude in tax cases with a review of selected decisions that she categorizes in relation to the court's decision in *Stubart Investments Limited v. The Queen*.[6] She suggests that the pre-*Stubart* decisions reflect a strict constructionist approach to the interpretation of the Act. This approach is the apparent manifestation of the Supreme Court's adoption of the traditional concept of the rule of law. In contrast, the *Stubart* decision and a handful of subsequent cases reflect a more activist approach to statutory interpretation in tax cases. This approach is the apparent manifestation of the Supreme Court's application of a more substantive view of the rule of

6 84 DTC 6305; [1984] CTC 294 (SCC).

law, which would involve the court in an attempt to control tax avoidance. Philipps correctly observes that this promise of a more activist approach has evaporated in the light of a series of Supreme Court decisions in the 1990s, culminating in the outrageous decision in *Shell Canada Limited v. The Queen et al.*[7] In these decisions, the court has refused to accept any significant role in controlling tax avoidance and appears to have accepted the more traditional concept of the rule of law in support of its refusal.

Philipps suggests that the general anti-avoidance rule (GAAR) in section 245 of the Act may prove to be the legislative impetus that will force the Supreme Court out of its “strict constructionist mode.” This view may be overly optimistic, given recent decisions of the Tax Court of Canada involving the application of GAAR.[8] These decisions generally are based on the kind of reasoning that one suspects will ultimately appeal to the Supreme Court’s view of its limited role in controlling tax avoidance.

Perhaps the most interesting part of the article is a brief quantitative overview of the tax cases heard by the Supreme Court since 1875, which presents the results of these cases in the simplistic terms of a taxpayer win or loss. The results are somewhat surprising given the attitude of the court as reflected in much of its reasoning. As Philipps notes, these counterintuitive results may be explained by factors other than the attitude of the court to its role in tax cases.

T.E.

Nils Eriksen and Kelvin Hulsebos, “Electronic Commerce and VAT—An Odyssey Towards 2001: The World Is Getting Smaller, the VAT Implications Are Getting Bigger” (2000), vol. 11, no. 4 *International VAT Monitor* 137-43

This article provides an overview of the problems presented by electronic commerce for the application of value-added tax (VAT). The article also reviews a recent proposal of the European Commission (EC) on some of these problems. This proposal, which was presented by the EC on June 7, 2000, includes significant amendments to the place-of-supply rules in the VAT legislation of member states of the European Union (EU). For a wide range of services and technology, these amendments would require a business customer in the EU to self-assess

7 99 DTC 5669; [1999] 4 CTC 313 (SCC).

8 Philipps cites the GAAR decision in *OFSC Holdings Ltd. v. The Queen*, 99 DTC 1044; [1999] 3 CTC 2649 (TCC), as indicative of a possible shift in judicial attitude to tax avoidance. Any optimism engendered by this decision is largely offset by other decisions of the Tax Court that indicate a preference for the status quo undisturbed by the introduction of GAAR. See, for example, *Canadian Pacific Limited v. The Queen*, 2000 DTC 2428 (TCC); and *Jabs Construction Limited v. The Queen*, 99 DTC 729; [1999] 3 CTC 2556 (TCC).

VAT when supplied by a non-EU business. In addition, the amendments would require a non-EU supplier to register for VAT purposes when supplying a non-business consumer resident in an EU state. The registration would be required even though the non-EU supplier operates electronically and neither maintains a permanent establishment nor carries on business in an EU state. This particular proposed change has generated strong resistance from US businesses and the possibility of retaliation from US state governments, which could begin to subject EU-based electronic businesses to state retail sales taxes.

T.E.

Jeffrey M. Lang, Robert B. Stack, Steve Charnovitz, and Joshua T. Brady, "What Tax Lawyers Should Know About Trade Law" (2000), vol. 29, no. 10 *Tax Management International Journal* 566-81

The motivation for this article is the recent ruling of the appellate body of the World Trade Organization ("the WTO") that the provisions of the US Internal Revenue Code ("the Code") for foreign sales corporations (FSCs) constitute a prohibited subsidy under the WTO's Agreement on Subsidies and Countervailing Measures. The authors do not limit themselves to the strict confines of this ruling, but instead use it as a vehicle to speculate on the relationship between trade law and tax law generally. They argue that the impact of the former on the latter will become increasingly important and, as a result, tax lawyers must become more familiar with trade law.

After a brief description of the WTO agreements, the authors examine the decision on the US FSC rules. The examination includes an important review of the predecessor domestic international sales corporation (DISC) regime in the Code and its similar characterization as a prohibited subsidy under the General Agreement on Tariffs and Trade ("the GATT"). This earlier challenge ultimately resulted in the development of a blueprint for the amendment of the Code to conform with the GATT rules. The blueprint was developed by the GATT Council in an effort to preserve the integrity of the territorial income tax systems of France, Belgium, and the Netherlands, which were successfully challenged by the US government in response to the challenge to the DISC legislation.

Against this background, the authors analyze the WTO decision on the characterization of the FSC regime for the purpose of the Agreement on Subsidies and Countervailing Measures. This analysis is followed by a discussion of some of the general lessons of the decision.

The authors also discuss briefly the impact for tax law of the General Agreement on Trade and Services and the Agreement on Trade-Related Investment Measures. The former agreement is considered in terms of its impact on the taxation of services. The latter agreement is considered in terms of its impact on tax rules for investment.

T.E.

Malcolm Gammie, "International Tax Avoidance: A UK Perspective" (2000), vol. 28, no. 8-9 *Intertax* 267-78

This thoughtful article focuses on features of the concept of income that are the principal causes of tax avoidance in the domestic context and describes how those same features lead to tax avoidance in the international context. Readers should not be misled by the title. Although Gammie draws on UK income tax experience and legislation for illustrative examples, the general lessons are universal and therefore of interest for income tax systems in all countries.

Conceptually at least, Gammie's text draws on a classic article on tax avoidance by John Kay.[9] Gammie is particularly concerned with the weaknesses that necessarily arise in any attempt to translate the concept of income into legislative language. He illustrates this point in the domestic context with a review of the different tax treatment of debt and equity, the tax-avoidance opportunities that those differences have created, and some of the legislative responses to avoidance adopted in the United Kingdom. Gammie then shows how these same problems in the domestic context manifest themselves in the international context, and how they are compounded in that different context. He concludes with some comments on the OECD initiative in the area of harmful tax competition. Because this initiative requires a degree of multilateral cooperation that appears unlikely to be achieved in the short to medium term, Gammie argues that the more promising alternative is to move away from the income base and toward a greater reliance on consumption taxes.

T.E.

Wolfgang Schon, "Tax Competition in Europe—The Legal Perspective" (2000), vol. 9, no. 2 *EC Tax Review* 90-105

Tax competition is currently an issue of great interest and topicality, in part because of the OECD's initiative in addressing its harmful effects. This article examines tax competition in the EU. It begins with a review of the general economic goals underlying the creation of the European common market, the phenomenon of tax competition, and various attempts to harmonize particular aspects of the tax systems of EU member states. The article then examines the impact on national tax systems of the following three normative regimes established by the EU: (1) the realization of fundamental freedoms as prohibitions on discrimination; (2) the rules of competition as a constraint on tax subsidies; and (3) the realization of tax harmonization as required for the establishment of a common market.

T.E.

9 J.A. Kay, "The Economics of Tax Avoidance" [1979], no. 6 *British Tax Review* 354-65.

Peggy A. Hite and Adrian J. Sawyer, "The Impact of Verbal and Numerical Reporting Standards on Inland Revenue Department Investigators' Judgment" (2000), vol. 6, no. 1 *New Zealand Journal of Taxation Law and Policy* 3-23

Standards for the application of a requirement to report questionable filing positions to the revenue authorities may be expressed qualitatively or quantitatively. In effect, a questionable filing position must generally be defined in terms that require an assessment of the likelihood of the taxpayer's success if the position is challenged. A qualitative standard does not refer to a numerical figure or bright-line in establishing "likelihood," while a quantitative standard does, of course, refer to a number, specifically a percentage. As the authors of this study point out, earlier studies have suggested that the use of either expression of the relevant standard has no impact on the rate of reported filing positions, since the assessment is ultimately a qualitative one that practitioners will tend to resolve in favour of taxpayers.

In this article, Hite and Sawyer ask the related but different question of what impact the use of a qualitative or quantitative standard has on the inclination of revenue authorities to impose penalties for a failure to report questionable filing positions. In contrast with studies on the behaviour of tax practitioners, Hite and Sawyer conclude that there is some evidence that revenue authorities are more likely to impose penalties under a quantitative standard, depending on the level at which the standard is drawn. The study is an original and important contribution that ideally will lead to further research on this question.

T.E.

Michael M. Megaard and Susan L. Megaard, "Employer's Deduction for Noncash Fringe Benefits Not Limited to Recipient's Income" (2000), vol. 93, no. 3 *Journal of Taxation* 142-48

This article reviews a recent decision of the US Tax Court holding that the deduction for employers of expenses associated with the provision of non-cash fringe benefits to employees is not limited to the amount of any income inclusion for the employees.[10] Although the review is necessarily focused on the relevant provisions of the Code and the development of the administrative position of the Internal Revenue Service, much of the underlying reasoning may be relevant to the resolution of the same issue in other jurisdictions. The case involved the provision of the use of a company aircraft for vacations of certain employees.

T.E.

10 *Sutherland Lumber-Southwest, Inc.*, 114 TC no. 14 (2000).

David P. Hariton, "Tax Benefits, Tax Administration, and Legislative Intent" (2000), vol. 53, no. 3 *The Tax Lawyer* 579-614

One of the inevitable pressure points in the delivery of tax expenditures is the restrictions or conditions that attempt to target the availability of the expenditures. These targeting features tend to focus on the nature of the particular activity or taxpayer that is the desired object of the tax expenditure. Not surprisingly, taxpayers and their advisers often structure transactions with the intention of expanding the availability of particular tax expenditures beyond the range of targeted activities or taxpayers. These transactions usually provoke a challenge from tax policy makers or administrators, who respond by attempting to deny the supposed benefits.

This article reviews certain attempts in the United States to deny tax benefits associated with the ownership of financial assets. Hariton draws an important conceptual distinction between tax benefits that are provided for targeted investment behaviour and tax benefits that are provided for specific persons in specific circumstances. He argues that the availability of the first type of benefit is limited by the volume of the targeted behaviour undertaken by taxpayers. This type of incentive is abused if taxpayers attempt to extend it to non-targeted behaviour. In contrast, Hariton does not characterize as abusive those attempts to transfer benefits associated with the targeted behaviour from one taxpayer to another. Availability of the second type of benefit is not limited by the volume of investment behaviour. Abusive transactions are those that attempt to transfer the targeted benefit from a privileged taxpayer to a non-privileged taxpayer.

Hariton argues that the nature of transactions intended to transfer tax benefits should be characterized on the basis of legislative intent, which supports a categorization of the particular benefits within one or the other of his two general groups. Once properly categorized on the basis of legislative intent, the transactions that attempt to transfer the associated tax benefits can be categorized as abusive or not, using the analysis suggested by Hariton. Hariton illustrates the application of his general approach by reviewing various transactions designed to transfer tax benefits and the response of US tax policy makers and administrators to those transactions. His review includes leveraged lease transactions, borrowing to acquire tax-exempt state or local government bonds, constructive share sales, equity investments disguised as debt, and trading of the intercorporate dividend deduction and foreign tax credits.

T.E.

Joseph M. Dodge, "Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the 'Claim of Right Doctrine' to Found Objects, Including Record-Setting Baseballs" (2000), vol. 4, no. 10 *Florida Tax Review* 685-729

One of the fascinating aspects of taxation is its significance for a broad range of transactions and events ranging from the banal to the unique and the sublime.

The categorization of the retrieval of a record-setting home-run baseball in terms of this continuum probably depends on one's affinity for sports in general and baseball in particular. Whatever categorization one prefers, it is clear that the retrieval of Mark McGwire's 62nd home-run ball in the 1999 baseball season captured the imagination of a worrisome segment of the popular press. This attention focused on the associated US tax issues, which have spawned a modest academic literature. Indeed, we previously reviewed a short article devoted to this subject.[11]

This much longer article uses the tax controversy surrounding the retrieval of the McGwire home-run ball to examine some fundamental US tax doctrines critical to the concept of income as applied to in-kind receipts in the form of "found objects" or "windfalls." Dodge argues that receipt of an in-kind windfall should be taxable as realized, subject to a subsequent deduction in the event that the found object must be returned. He concludes that the realization principle should be interpreted to exclude taxability only in those instances in which the current enjoyment rights of the finder are significantly contingent. In effect, immediate realization should be the norm. The probability of forfeiture would be irrelevant except in extreme circumstances.

The impetus for Dodge's article is an earlier article that questioned the characterization of found objects as realized income for US tax purposes.[12] To some extent, Dodge develops his arguments as a response to the arguments in that article. However, he goes further in undertaking to explore all aspects of US tax doctrine relevant to the treatment of found objects.

T.E.

Kenneth Klassen and Amin Mawani, "The Impact of Financial and Tax Reporting Incentives on Option Grants to Canadian CEOs" (2000), vol. 17, no. 2 *Contemporary Accounting Research* 227-62

Executive stock options are, on average, an important component of compensation for chief executive officers (CEOs) in Canada. However, the extent to which stock options are provided varies across corporations. Kenneth Klassen and Amin Mawani examine the effects of corporate tax rates and financial reporting costs on the compensation mix—the relative amounts of options and cash.

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11 Darren Heil, "Comment: The Tax Implications of Catching Mark McGwire's 62nd Home Run Ball" (1999), vol. 52, no. 4 *The Tax Lawyer* 871-79, reviewed in this feature (2000), vol. 48, no. 2 *Canadian Tax Journal* 544-58, at 548-49.

12 Lawrence A. Zelenak and Martin J. McMahon Jr., "Taxing Baseballs and Other Found Property" (1999), vol. 84, no. 9 *Tax Notes* 1299-1308.

The stories this article tells are relatively straightforward. Let's start with the tax story. Firms cannot deduct the CEO's option benefit for tax purposes, while they can deduct salary and bonuses. Therefore, the larger a corporation's marginal tax rate, the less likely it is to offer options, because of their greater relative tax cost. The financial reporting story is as follows. Options do not affect the corporation's income. Conversely, salary and bonuses reduce accounting income. Therefore, to the extent that reducing accounting income is costly, one may expect that the corporation would prefer the use of executive options. For example, if through reducing income a firm breaches debt covenants, this may be costly to the firm.

Klassen and Mawani find support for their stories. They find that option grants are negatively associated with tax rates; that is, the higher the firm's marginal tax rate, the less likely it is to issue options. They also find that short-run financial reporting incentives provide a strong influence on CEOs' compensation mixes; the greater these financial reporting costs, the more likely the firm is to grant options.

This article provides valuable insights into tax and non-tax factors that affect the compensation mix for Canadian CEOs. It makes worthwhile reading for corporate finance officers, CEOs, and their tax advisers.

G.F.

Anthony J. Laramie and Douglas Mair, *A Dynamic Theory of Taxation: Integrating Kalecki into Modern Public Finance*
(Northhampton, Mass.: Edward Elgar Publishing, 2000), 208 pages,
ISBN 1-85898-668-0

This academic book provides a new perspective on public finance. Laramie and Mair integrate Michael Kalecki's theories of taxation, income distribution, national income determination, investment, and the business cycle to provide a macroeconomic theory of taxation. Kalecki's beliefs differed significantly from those of neoclassical economists. For example, he believed that capitalist economies were monopolistic or partially monopolistic; he did not believe that the market was or would be "in equilibrium"; and he rejected standard tools of economics, including utility functions. These beliefs are reflected in the assumptions used in the models developed by Laramie and Mair.

There are several implications that flow from the theory developed in this book. For example, Laramie and Mair demonstrate that under a balanced budget constraint, an increase in the wage tax increases the level of national income in a Kaleckian world. The book provides models that have different policy implications from those developed under either supply-side or Keynesian fiscal policy.

In reading this book, I was forced to re-examine some of my basic beliefs about public economics. This text should be of interest to public economists, policy analysts, and government.

G.F.

John R. Graham and Beverley A. Robson, "Prescription Drug Prices in Canada and the United States—Part 1: A Comparative Survey," *Public Policy Sources* no. 42 (Vancouver: Fraser Institute, August 2000); available on the Web at http://www.fraserinstitute.ca

John R. Graham, "Prescription Drug Prices in Canada and the United States—Part 2: Why the Difference?" *Public Policy Sources* no. 43 (Vancouver: Fraser Institute, August 2000); available on the Web at http://www.fraserinstitute.ca

John R. Graham, "Are Prescription Drugs More Expensive in the US Than in Canada?" [October 2000], *Fraser Forum*; available on the Web at http://www.fraserinstitute.ca

This series of articles reports and analyzes the results of a survey that examined the difference in prescription drug prices between Canada and the United States. The first article, "Part 1" by Graham and Robson, confirms that drug prices are, on average, lower in Canada than in the United States. However, the authors find that these price differences are not constant across categories of prescription drugs. For example, they find that generic drugs are on average more expensive in Canada.

The second article, "Part 2" by Graham, attempts to explain why there is a difference in the price of prescription drugs between Canada and the United States. In Canada, there are price controls on patented drugs, applied and administered through the Patented Medicine Prices Review Board (PMPRB). It has been previously contended that this board has contributed to the lower prices in Canada. Graham addresses this contention. He notes that patented drugs have a smaller Canadian discount than branded, non-patented drugs—the opposite of what one would expect if one believed that the effect of the PMPRB was to reduce prices. Graham provides an interesting rationale for this result. He argues that the PMPRB may in fact keep prices high because its guidelines discourage patented drug manufacturers from using price reductions as a competitive strategy.

How does Graham explain the overall lower level of prescription drug prices? He asserts that the difference arises through market forces and legal liability. Graham notes that the average price of goods and services is 25 percent lower in Canada than in the United States, driven by products with low marginal production costs. For these products, the manufacturer can earn profits by charging low prices where consumers cannot pay the higher prices necessary to recover the sunk costs of research and development. Graham asserts that prescription drugs are examples of this type of product. He therefore argues that, as long as the United States continues to be the wealthiest country, its drug prices will continue to be higher than they are in other countries. Graham asserts that an additional factor contributing to high US prices is legal liability costs. He claims that a high level of legal liability in the United States may account for one-third to one-half of the difference in patented pharmaceutical prices.

The third article, "Are Prescription Drugs More Expensive in the US Than in Canada?" by Graham, summarizes the results of the two studies. For readers who are interested in the topic, I recommend starting with this short discussion.

The three articles are intuitive in style and easy to read. Whether or not one agrees with the authors' conclusions, these papers provide interesting analysis. The work is also timely, since the price of prescription drugs has recently played an important political role in both the Canadian and US elections. The broader debate over how to control the cost of prescription drugs and the overall cost of our health system will not go away. Further analysis of the type done in these papers will be necessary. Graham is a senior analyst with the Fraser Institute and Robson is a health care researcher.

G.F.

Harry Kitchen, *Municipal Finance in a New Fiscal Environment*, C.D. Howe Institute Commentary no. 147 (Toronto: C.D. Howe Institute, November 2000), 24 pages; available on the Web at http://www.cdhowe.org.

This paper presents recent research in the area of municipal finance by Harry Kitchen, a professor of economics at Trent University.

The paper first examines revenue sources for municipalities in Canada. Kitchen illustrates the relative importance of various revenue sources across provinces between 1988 and 1998. For all provinces, property taxes are the single largest source of municipal revenue. However, the percentage varies greatly across provinces, with a high of 70.4 percent in Nova Scotia and a low of 42.6 percent in Alberta in 1998. This percentage has increased in all provinces except Quebec from 1988 to 1998. For the nation, property taxes as a percentage of municipal revenue increased from 48.6 percent to 56.7 percent over this period. Therefore, property taxes are a very large, and growing, component of municipal government revenue in Canada. Further, Kitchen demonstrates that there has been increasing reliance by cities and regions on own-source funding. Total grants declined significantly in percentage terms from 1988 to 1998.

Kitchen then proposes a method for analyzing the state of municipal finance—the application of a benefits model. The underlying principle of this model is that the person who benefits from a service should pay for that service. It may be argued, and Kitchen does argue, that this principle is consistent with the goal of economic efficiency. Under a benefits model, local governments should be responsible for funding services where the benefits are primarily local.

Kitchen focuses his analysis largely on property taxes and user fees. He finds that in each province, property tax is based on an assessed value that is some percentage of market value. However, he finds both intentional and unintentional deviations from market value. For example, he finds that in each province non-residential properties are taxed at a higher rate than residential properties, yet residential properties receive the majority of local benefits. He proposes that property taxes should be more closely aligned with the level of services, reducing both distortions and inequities.

Kitchen further proposes the continued use of user fees where a clear link can be made between the services received and the fees paid. He notes, however, that governments do not tend to set these fees correctly. Kitchen more specifically analyzes the provision of water supply and sewage treatment, public transit, public recreation, library services, waste collection and disposal, police services, and fire services. He acknowledges that for services of a collective nature, such as roads and street lighting, user fees would not be appropriate.

To counteract the increasing reliance by cities and regions on own-source funding, Kitchen recommends that municipalities be given access to local fuel taxes and sales taxes (both of which could piggyback provincial taxes).

This paper provides a useful framework for thinking through the issues of municipal finance. Kitchen makes a fairly convincing case that there is a need for reform. The paper is very easy to read and comprehend.

G.F.