The practice of tax law comprises many areas of specialization. One of the more arcane is the taxation of the insurance industry. Tax legislation applicable to this industry is typically very complicated and, in order to be understood, requires knowledge of the business and regulatory structures associated with property, casualty, and life insurance. Given these conditions, it is perhaps not surprising that there is only a small body of literature on the income tax treatment of the insurance industry. Although there is some excellent descriptive and analytical writing on this subject, very few writers have attempted to provide a comprehensive overview from a tax policy perspective. This study commissioned by the Organisation for Economic Co-operation and Development (OECD) admirably fills this critical gap in the literature. The two principal authors, David Holland and Denis Normand, worked for the Tax Policy branch of the Department of Finance, where they had primary responsibility for the development of many aspects of the current regime in the Income Tax Act applicable to insurance corporations. Their knowledge of the industry is extensive. Yet they are able to describe and analyze the issues involved in a manner that is accessible to the non-specialist.

The study begins with an overview of the role of insurance in the financial sector and the basic features of non-tax regulatory regimes applicable to this sector. Although these regulatory regimes are an important source of information for tax policy makers, the study cautions against uncritical reliance on regulatory practice as the basis for the design of income tax rules.

The study then presents an overview of the general timing and valuation issues affecting the calculation of income of insurance corporations. International income tax issues also are briefly reviewed. The timing and valuation issues include basic
accrual principles, the treatment of doubtful and bad debts, and accounting for reserves. The international tax issues include the allocation of income and expenses among taxing jurisdictions, the use of captive insurance corporations, and the application of tax treaties to insurance corporations operating in different jurisdictions. This particular discussion is fairly basic, but it provides a useful framework for the remainder of the study.

The greater part of the study consists of separate chapters on the income taxation of property and casualty insurance corporations, reinsurance arrangements, life insurance corporations, and life insurance policy holders. There is also a final chapter describing several alternative methods of taxing financial institutions, including insurance corporations. These alternative tax structures include alternative minimum taxes, capital taxes, premium taxes, and taxes on reserves. In addition to a description of the role and application of each method, the study includes a brief discussion of the interaction between that method and the income tax.

The principal focus of the two chapters on property and casualty insurance corporations and life insurance corporations is the appropriate treatment of various reserves, which is a central element in the design of an income tax regime applicable to insurance corporations. Because of the different nature of the risks assumed by property and casualty insurers and life insurers, the types of reserves are very different and are therefore addressed separately in the study. Readers who are unfamiliar with the tax treatment of reserves in the context of insurance corporations will find this discussion particularly useful. The role of each type of reserve for financial accounting and regulatory purposes is explained. In addition, tax policy reasons are given for the modification of these reserve amounts for income tax purposes, and methods for recalculating these amounts are discussed. The chapter on life insurance corporations also includes a very brief review of approaches to the allocation of income and expenses of non-resident insurance corporations doing business in a country through a branch.

The chapter on reinsurance arrangements also will be useful to readers unfamiliar with the insurance industry. It includes a rather superficial discussion of the tax-avoidance opportunities created by these arrangements; a more detailed treatment would have been more helpful. In contrast, the chapter on the taxation of policy holders covers ground that should be familiar to many tax practitioners. An interesting aspect of this chapter is the overview of different approaches that selected OECD countries have taken to the taxation of the savings element (referred to as the “inside build up”) associated with most life insurance policies. To the extent that the accrued return to savings is not attributed to policy holders and is not taxed currently in their hands, tax may be imposed on the investment income of the life insurance corporation as a proxy for taxation to the policy holder.

The study makes effective use of numerical calculations to illustrate particular income tax issues. At the end of each of the chapters on the taxation of property and casualty insurance, reinsurance, life insurance corporations, policy
holders, and alternative methods of taxation, a table is presented that summarizes the treatment under the tax regimes of selected OECD countries. The text of the study draws on the experience of these various countries to illustrate possible policy approaches, without recommending any particular one.

T.E.


The inquiry undertaken in this book is a monumental one that only an individual of the experience and stature of Cedric Sandford could entertain without being seen to be overreaching in his or her ambition. Apparently based on a series of lectures delivered at the University of Bath in the Master of Science in Fiscal Studies program, the book distils much of Sandford’s public finance wisdom accumulated over a distinguished career as a teacher and researcher. His analysis focuses on general trends and features of the mix of taxes in fiscal systems of both OECD countries and the developing countries of Eastern Europe, Asia, and Latin America. The details and second-order policy design choices of the various tax bases are either ignored or examined in a very general manner.

Sandford succinctly describes the nature of his inquiry in the book’s opening paragraph:

The book seeks to answer questions such as the following: “Why do developing countries rely for revenue more on indirect taxes and advanced countries more on direct taxes?” “Why are the tax systems of developing and developed countries converging?” “Why do some countries have more tax expenditures than others?” “Why have so many countries adopted VAT [value-added tax] as their general sales tax?” “Why do only one third of OECD countries have an annual wealth tax and the remainder do not?”

Sandford warns the reader that the book is not “an essay in tax theory. Theory is introduced, but only in so far as it explains similarities and differences.”

The book is divided into three parts. The first part begins with a brief introduction, followed by a chapter in which Sandford compares the mix of taxes in developed and non-oil developing countries. He defines developed countries generally as the group of 15 OECD member countries with the largest economies in 1994 (Australia, Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States). In some areas of the book, however, Sandford uses data for all 24 OECD member countries in 1994. More recent members (Mexico, the Czech Republic, Hungary, Poland, and Korea) are excluded on the basis that they do not provide appropriate data for earlier years of comparison (that is, pre-1994). Where statistical comparisons are made, Sandford is always clear about the data set he is using.
The next chapter reviews the taxing powers and taxes used by subnational or local governments. In contrast with the inquiry elsewhere in the book, the discussion here is more prescriptive and attempts to articulate a set of normative criteria for determining the most appropriate tax base for local governments.

The second part of the book reviews the range of taxes used by developed and developing countries. Separate chapters assess general trends in personal and corporate income taxation, consumption taxes, and capital and wealth taxes (including capital gains taxes). Sandford’s inquiry with respect to income taxation focuses on why the personal income tax has assumed dominance over the corporate income tax. He also examines various broad features of the personal income tax, such as certain base definitional issues, the rate structure, and the choice of the individual or the family as the basic tax unit. In an attempt to explain the dominance of VAT systems, the chapter on consumption taxes reviews various alternatives to the VAT (retail sales taxes, turnover taxes, and manufacturer and wholesaler sales taxes). Sandford argues that administrative weaknesses and economic distortions associated with these alternatives explain the ascendancy of the VAT.

The last part of the book considers issues of tax compliance, administration, and the policy-making process. To some extent, the discussion summarizes Sandford’s pioneering work on compliance costs, tax administration, and tax evasion. The final chapter is arguably one of the more interesting in that it tackles the vexing problem of the effect of the political process on policy making.

Although Sandford’s focus is on broad trends in national tax systems, he usefully draws on the UK experience for two case studies on changes in local taxation and the choice of the tax unit. These case studies provide a change of pace from the broader focus of the rest of the book and offer some important lessons in the areas they address.

T.E.


Unlike Canada, New Zealand provides very few tax expenditures for research and development (R & D). In fact, until recently, New Zealand provided very little in the way of public spending on R & D. In this respect, a recent initiative provides public funds for qualifying activities but is delivered in the form of a direct grant program and not a tax credit. The principal tax expenditure remains the current deduction of certain capital expenses incurred in the R & D process.

This discussion paper describes a proposal that attempts to clarify the category of R & D capital expenses eligible for current deduction. The interesting aspect of the proposal is the explicit adoption of financial accounting practice as determinative for income tax purposes. More particularly, the discussion paper
proposes that all R & D expenses, other than the cost of fixed asset inputs such as buildings and vehicles, would be currently deductible unless the expense gave rise to “an identifiable and valuable asset” as determined by applying the criteria articulated for capitalizing R & D expense under financial reporting standards. Indeed, the discussion paper proposes that this result be realized by explicitly incorporating by reference the relevant financial accounting statement in the income tax legislation. Although only a limited example of reliance on financial accounting practice for income tax purposes, the proposal in the discussion paper reflects an approach that many tax practitioners have suggested be applied more broadly in defining the business income tax base generally. The discussion paper is probably more compelling, therefore, not for its resolution of the narrow characterization issue presented by R & D expenses, but rather for the broader possibilities of the approach taken to resolve that issue. The point of legitimate debate is whether the rationale underlying the proposed approach in the discussion paper should be confined to the narrow issue it attempts to resolve.

T.E.

David A. Weisbach, “Ironing Out the Flat Tax” (2000), vol. 52, no. 3
Stanford Law Review 599-664

In the 1970s, there was considerable debate in the US academic literature over the perceived benefits of a cash flow personal expenditure tax as a substitute for the personal income tax. In a classic article published in the Harvard Law Review in 1979, Michael Graetz described in great detail how much of the simplification claimed for a personal expenditure tax disappeared in the effort to translate the general principles of the tax into a workable system, with all of the associated technical design issues.4

Now fast-forward to the mid-1990s. The flat-rate personal consumption tax described by two Stanford University economists, Robert Hall and Alvin Rabushka,5 has become all the rage with many members of the US Congress, who are eagerly flogging variations of the Hall-Rabushka proposal. This article by David Weisbach of the University of Chicago Law School performs much the same function as Graetz’s earlier article. It is required reading for all those politicians and academics who expound incessantly on the perceived simplicity features of the Hall-Rabushka flat tax and its variants. The lesson is a simple one: when comparison shopping, consumers should be sure that they are comparing the prices of similar commodities. When comparing a flat-rate personal consumption tax with a personal income tax, one must be sure to take into account all of the messy technical issues that complicate system design. These features of the personal income tax are well known. The same features of personal consumption tax proposals are not so well known, because they are only proposals, and advocates tend to gloss over the messy details. Weisbach’s article allows policy makers to comparison-shop in an informed manner.
Weisbach concludes that the purported simplicity gains associated with the Hall-Rabushka flat tax are overstated once various technical design issues are examined. He supports this characterization with a thorough analysis of six different design issues: (1) financial transactions; (2) losses and the structure of the business tax; (3) accounting methods; (4) international transactions; (5) small businesses; and (6) the distinction between consumption and investment. In each area, Weisbach focuses on likely gaps and loopholes that would have to be addressed and that, in the process, would introduce complexity on a par with the complexity of the income tax. At a general level, he attributes these complexities to the complexities of the economy, some of the unique features of the flat tax (particularly its international aspects), and the vexing problems of taxing small businesses. These conclusions hold even given Weisbach’s premise that the implementation of a flat tax would not be undermined by political concessions and the complexities that they would entail. Even given that assumption, Weisbach argues that reform of the income tax and introduction of a VAT are more desirable alternatives to the flat tax, in the sense that they would avoid many of its complexities and still realize many of the equity and efficiency gains claimed by its proponents.

T.E.


This article thoroughly reviews the policy aspects of the debt-equity distinction in US income tax law and certain proposals intended to reduce the significance of that distinction through reform of the corporate income tax. Part one of the article traces the origin and development of the different tax treatment of debt and equity and the associated boundary between these two forms of investment. Pratt argues that the basic premises underlying the distinction no longer hold in a world of financial innovation, which has increasingly blurred the boundary between debt and equity by permitting the free transfer of exposure to risk associated with a particular financial instrument. She concludes that the continued attempt to maintain the boundary imposes costs associated with the resultant uncertainty and tax-avoidance opportunities. A tax bias in favour of corporate debt also imposes inefficiencies in the form of overleveraging of corporations and under-investment in risky projects.

Part two of the article reviews the debt-equity distinction in the context of the US classical corporate income tax, which subjects equity investors to tax on their returns both as earned at the corporate level and as distributed to the investors. Pratt argues that the recent check-the-box regulations have reduced the corporate income tax in the United States to a tax on public corporations only. She believes that this state of affairs highlights the need for a deduction for the cost of equity capital of public corporations.

Part three of the article considers this question in detail through an examination of various proposals to reform the corporate income tax and, in the process,
to address the different tax treatment of debt and equity. Pratt assesses these proposals in terms of the distortions they would and would not address. She prefers a cost of capital allowance approach along the lines suggested by a US tax practitioner⁶ and the UK Institute of Fiscal Studies.⁷

T.E.

**Ian Roxan, “The Nature of VAT Supplies of Services in the Twenty-First Century”** [2000], no. 6 *British Tax Review* 603-23

This interesting article considers the concept of taxable supplies of services under VAT regimes as considered by UK courts and the European Court of Justice. In reviewing the relevant judicial decisions and the concept of taxable services set out in the Sixth Directive of the European Economic Community (the EEC), the author arrives at a definition of the term that he believes is consistent with the theoretical underpinnings of VAT systems. The essence of this definition is the requirement that a transaction must “give a benefit to an identifiable recipient that leads to consumption.”⁸ Roxan tests this definition by returning to first principles that should guide the derivation of the VAT base and by applying those first principles in characterizing particularly troublesome supplies of services, such as financial intermediation. The analysis of the relevant case law is subtle and an excellent example of classic legal analysis applied in the context of a broad policy framework.

T.E.


In exercising their statutory investigative powers, tax administrators are often confronted with a claim of legal professional privilege in respect of particular documents in the control of taxpayers or their advisers. Such a claim is often contentious, particularly in the context of an audit of a tax-avoidance transaction. The author of this article reviews the relevant jurisprudence in Australia considering the scope of the doctrine of legal professional privilege as a limitation on the statutory power of the Australian Taxation Office (ATO) to access information. Devos concludes that recent case law has arguably expanded the scope of the privilege by extending it from a “sole purpose” to a “dominant purpose” test. More particularly, recent case law suggests that the privilege extends to documents and communications effected with a dominant purpose of providing legal advice or contesting existing or anticipated litigation.

Devos argues that the ATO may have to change its stated position regarding the circumstances in which it will respect a claim of privilege in response to a request for information. Because of the similar parameters of the privilege and
the investigative powers of tax authorities in commonwealth countries, Canadian tax practitioners may want to review the summary and analysis in this article of the relevant Australian jurisprudence.

T.E.


The author of this article argues that payments made under “reverse convertible bonds” should not be considered interest payments for the purpose of article 11 of the OECD model tax treaty governing the application of non-resident withholding tax to such payments. The author describes a “reverse convertible bond” as a bond with an above-market rate of interest and a redemption amount on maturity equal to the lesser of the face amount of the bond and the spot price of referenced shares of a corporation other than the issuer. The article begins with a description of the analysis of the Dutch and German tax authorities supporting their characterization of the payments under a reverse convertible bond as interest payments. Rotondaro observes that this characterization is based, in part, on an expansive concept of interest under both the Dutch and German income tax legislation. The tax authorities in these two countries apparently preferred this expansive concept as the basis for characterizing the whole of the periodic payments under the relevant bonds. They clearly rejected the application of a bifurcation approach, which would involve breaking down the bonds into a combination of a fixed-rate debt obligation and a put option on the referenced shares written by the holders of the bonds. Under this approach, periodic payments associated with the former would be treated as interest; payments associated with the latter would be treated as payments on the grant and exercise or non-exercise of a put option.

Rotondaro contrasts this interpretative position with the characterization of the same payments under the OECD model treaty. The author argues that the text of the treaty and the related commentary suggests that the contingent nature of the principal payment under a reverse convertible bond means that these instruments cannot be considered “debt claims” that give rise to interest payments. This position is further contrasted with payments on participating debt obligations, which are specifically contemplated as interest for the purpose of article 11 of the model treaty. Rotondaro suggests that the “better view” is that periodic payments under reverse convertible bonds are neither dividend payments nor interest payments, but should be characterized as capital gains subject to article 13 of the model treaty. In particular, the “overall profit result,” defined as the value of the referenced shares plus interest coupon payments less the invested principal, should be considered gain from the alienation of the embedded put option in a reverse convertible bond. The result is a characterization of the whole
of a reverse convertible bond as a put option for the purposes of the OECD model treaty.

T.E.


Because of the significance of Japan’s economy in the context of international commerce, the Japanese international tax rules are among the most important in the world. There is some excellent literature in English describing the framework and details of these rules. This article, by a tax law professor at The University of Tokyo, is important for its description of the broad historical context within which the Japanese international tax rules have been developed.

The article describes the chronological development of the Japanese international tax system. Significant changes are discussed within the framework of five separate periods: (1) the early years (1899-1940); (2) the war period (1940-1945); (3) the postwar reforms (1945-1962); (4) the establishment of the core system (1962-1973); and (5) the addition of countermeasures (1973-present). In general, the framework of the current Japanese international tax system was constructed in the period immediately following World War II and the tax mission led by US economist Carl Shoup. Many of the details of the system were developed from 1962 onward. As Masui emphasizes, the dominant theme underlying these developments is the “Americanization” of the Japanese international tax system. Indeed, despite the presence of some elements reflecting a European influence and a uniquely Japanese perspective, the core set of international tax rules remains clearly patterned on the US model.

T.E.


This article provides a useful tour through the general tax policy developments in selected European countries over the period 1955 to 2000. The author, who is a former head of the OECD’s Fiscal Affairs Division, divides his tour into seven sections:

1) four northern countries (Denmark, the Netherlands, Norway, and Sweden);
2) four southern European countries (Greece, Italy, Portugal, and Spain);
3) two central European countries (Austria and Germany);
4) two western European countries (Ireland and the United Kingdom);
5) three eastern European countries (the Czech Republic, Hungary, and Poland);
6) a pioneer and laggard (France); and
7) rule by subcentral government (Switzerland).
Although Messere points out many of the obvious similarities of the European fiscal landscape, he prefers to emphasize important differences, which he attributes to historical factors, as well as to different economic and political constraints.

T.E.


In this short article, Jack Mintz, president and chief executive officer of the C.D. Howe Institute, examines an issue that has not received much attention in Canadian tax literature, the desirability of withholding taxes between Canada and the United States. In Canada, dividend and interest income account for most of the income subject to withholdings. An estimated $1.8 billion in tax revenues is raised annually through these taxes. Exemptions provided make this amount relatively small. Although the Canadian Income Tax Act imposes a 25 percent withholding tax, the Canada-US tax treaty significantly lowers this rate.

Mintz makes a strong case for bilateral elimination of these withholding taxes. He argues that removing them should increase efficiency of capital markets, encourage US investment in Canada, and increase the competitiveness of Canadian-based multinationals. He calculates that, if withholding taxes were eliminated, the increase in capital invested in Canada would exceed $28 billion, producing an income gain of over $7.5 billion to Canadians (over four times the estimated revenue lost). These estimates appear reasonable. According to Mintz, removal of the taxes would have little, if any, effect on government revenue.

G.F.


This book is a compilation of articles by some of Canada’s leading policy experts on the current state of fiscal federalism in Canada. Taken as a whole, these articles provide a balanced view of fiscal federation. I will briefly highlight the major points made by the various authors.

The first four chapters relate primarily to the theory of fiscal federalism. Chapter 1, “In Search of a New Mission Statement for Canadian Fiscal Federalism,” was written by Harvey Lazar, director of the Institute of Intergovernmental Relations at Queen’s University and editor of the book. Lazar makes three main interrelated points: first, there is significant uncertainty surrounding the direction of fiscal federalism; second, there is no overriding purpose or mission...
driving fiscal federalism; and third, the actions of government with respect to fiscal federalism are hard to predict. For me, the most interesting material in this chapter is Lazar’s discussion of the need for a new mission statement. Lazar does not attempt to set out the specific content of such a statement, but rather identifies some general rules or elements that should be included. These are

- that the federal and provincial governments should reduce the number of surprises sprung on the other level of government;
- that the federal government should not deal with big structural issues in the context of its annual budget cycle, since this approach excludes the provinces from being partners in change;
- that both orders of government should strive for mutual respect in the process; and
- that the importance of both equity and efficiency goals should be recognized.

Chapter 2, “Recent Developments in the Economics of Federalism,” was written by Robin Boadway, an economics professor at Queen’s University. Much of his article focuses on reviewing economic perspectives of federalism. I found this review interesting, particularly the last section titled “Canadian Fiscal Federalism Issues.” Here Boadway argues that reduced federal transfers and increased provincial occupancy of tax bases can seriously impede the ability of the federal government to achieve national equity and efficiency goals. He asserts that the federal government is less able to achieve these important goals if its spending power is diminished. The primary implication is that a sufficient fiscal gap must remain to allow the federal government to pursue its legitimate role.

Chapter 3, “On Re-Balancing Canadian Fiscal Federalism,” was written by Kenneth Norrie and L.S. Wilson, both professors of economics at the University of Alberta. Their discussion follows naturally from Boadway’s article and is consistent with his assertions. The authors first address the concern voiced by the provinces that a fiscal gap exists which makes it more difficult for the provinces to raise sufficient revenue. They note that, although the federal government and the provinces have access to the same tax bases, they may be at a disadvantage in using them, because tax bases are more mobile interprovincially than internationally. That is, it is socially more costly for the provinces to raise revenue. An argument may be made that the federal government should therefore impose tax and transfer these revenues to the provinces. However, like Boadway, Norrie and Wilson stress that transferring too much tax room could negatively affect the federal government’s ability to pursue its role.

In chapter 4, Lazar discusses the impact of the social union framework agreement (SUFA) on fiscal federalism. He argues that although SUFA does not significantly affect the content of fiscal federalism, the underlying principles it establishes are very important.

Chapters 5 through 8 examine the federal-provincial transfer system. In chapter 5, Edith Boucher and Arndt Vermaeten, both of the Department of Finance,
describe the transfers to the provincial governments, including the health and
social transfer, and equalization. This article provides a very good summary of
the various programs and discusses some recent changes. Unfortunately, changes
for 2000 are not included in the analysis. In chapter 6, Paul A.R. Hobson and
France St-Hilaire examine the history of federal-provincial fiscal arrangements.
In chapter 7, François Vaillancourt, an economist, examines federal-provincial
transfers to certain smaller programs—basically, all programs excluding equa-
lization and the Canadian health and social transfer. I found the analysis espe-
cially interesting in that little research has been done on these smaller transfer
programs. The tables provided by Vaillancourt are particularly illuminating (for
example, the province-by-province tables that include descriptions of the transfers,
the department responsible, and the amount). Vaillancourt finds that the combined
transfer amount under this myriad of smaller programs is large—they accounted
for about 15 percent of federal transfers to the provinces from 1993 to 1998.

In chapter 8, Lars Osberg asserts that for the Canadian social union to have
meaning, it should be appropriately reflected in poverty outcomes. Osberg there-
fore examines the trends in Canadian poverty. He finds that the tax and transfer
system appears to have lowered the level of poverty intensity in Canada from 1971
to 1994. However, he argues that since 1994, poverty outcomes have increased,
as has divergence across provinces, causing concern for our social union.

Federal-provincial taxation issues are examined in chapters 9 and 10. In
chapter 9, Geoffrey E. Hale, a political scientist at the University of Lethbridge,
discusses the implications of the movement of provinces to the use of a “tax-on-
income” personal income tax system. The chapter is well written and, in placing
the tax-on-income concept into a broader policy context, provides interesting
insights.

Chapter 10 is perhaps the most interesting in the book. Written by Richard M.
Bird and Jack M. Mintz, both of the University of Toronto, its subject is “Tax
Assignment in Canada: A Modest Proposal.” It is often interesting when senior
academics make significant proposals for change. The authors start by claiming
the existence of two primary tax assignment problems: first, there is an imbal-
ance between expenditures and revenues for all levels of government; and sec-
ond, the current system results in significant costs, largely associated with a
distorted allocation of resources. The authors’ proposal deals primarily with the
latter problem. Bird and Mintz propose that provincial corporate income and
capital taxes be replaced by a new business value tax—a benefit tax on business
by provincial and local government at a “low and uniform rate.” This chapter is
thought provoking, and its conclusions challenge some basic beliefs held by
many, if not most, public economists.

Chapters 11 and 12 focus on other orders of government. Chapter 11, by
Harry Kitchen, looks at the funding of municipalities, schools, universities, and
hospitals. Chapter 12, by Michael J. Prince and Frances Abele, examines the
funding of aboriginal self-government. The final chapter, written by Ronald L.
Watts of Queen’s University, provides a comparative perspective by discussing
fiscal federalism in other countries. His discussion is valuable in locating the Canadian situation in a far broader context. It has also dispelled some beliefs I previously held, such as the relative size of federal revenues to total revenues; the Canadian ratio is actually low relative to that of other countries studied. I wish I had read this chapter first, and I recommend that other readers do so, since it places the discussion in the other chapters in context.

While the separate contributions in this book are diverse, generally all are accessible. Having read the book, I have a greater understanding of the issues of Canadian fiscal federalism, including the inherent tradeoffs.

G.F.


Jonathan Kesselman, a professor of economics at the University of British Columbia, and Finn Poschmann, senior policy analyst with the C.D. Howe Institute, propose a major change to Canada’s registered retirement savings system—the introduction of tax-prepaid savings plans similar to the Roth individual retirement accounts in the United States.

The authors argue that a falling Canadian savings rate may have significant negative effects on our country. For example, a lower amount of savings can reduce the level of capital investment, thus negatively affecting growth. In addition, where individuals do not save for their own retirement, a greater cost may ultimately be imposed on society. To partially address these concerns, Kesselman and Poschmann propose that a new savings vehicle be created—a tax-prepaid savings plan (TPSP). Under a TPSP, the individual would contribute after-tax dollars to the plan, but there would be no further tax on the amount (that is, it could be withdrawn tax-free on retirement). Where an individual’s current marginal tax rate is less than the expected rate on retirement, it makes sense to contribute to such a plan rather than to an RRSP. As there is income testing of public retirement benefits (in the form of benefit reductions and clawbacks), marginal tax rates may be expected to be higher today than on retirement for a large proportion of Canadians. A TPSP would therefore increase the incentive for low- and moderate-income Canadians to save for retirement, thus improving tax fairness. From the government’s perspective, the introduction of a TPSP has an additional benefit; since the government collects the taxes up front, there is a positive effect on the current budget relative to investments in RRSPs and RPPs.

Kesselman and Poschmann discuss both the theory and the nuts and bolts of how a TPSP could work in Canada, including limits on contributions (which could be integrated with existing plans), mandatory termination at age 69, and transfers between TPSPs and other instruments (such as an RRSP).
This well-written article should raise the level of debate about Canada’s system for individual retirement savings. The article is very accessible and sets out cogent arguments for the introduction of a TPSP in Canada.

G.F.


This article examines the US income tax treatment of a plaintiff’s recovery in cases of employment discrimination. In civil rights cases, US federal statutes include “fee-shifting” provisions that permit a prevailing plaintiff to recover legal fees from the defendant. Under the Internal Revenue Code (“the Code”), a prevailing plaintiff in an employment discrimination case must report the entire amount recovered as income and, unless there is an offsetting deduction, the plaintiff must pay tax on the entire amount recovered. As Sager and Cohen explain, the associated legal fees in these cases in fact are not deductible for US income tax purposes, including the alternative minimum tax (AMT). They argue that this treatment of recovered amounts is incorrect, because the cost of producing the income amount (legal fees) should be deductible. Sager and Cohen further argue that the combination of an income inclusion for recovered legal fees and the non-deductibility of those fees undermines national policy with respect to civil rights litigation. In fact, the fee-shifting provisions were designed to encourage the pursuit of meritorious civil rights claims; yet the tax treatment of the associated legal fees as non-deductible expenses serves to discourage such claims.

Sager and Cohen begin by reviewing whether current US income tax law could permit a plaintiff to exclude from taxable income a portion of the recovery of legal fees, thereby precluding the need for an offsetting deduction. They note that an exclusion is available only where a state attorney lien law governs the attorney-client relationship and the damages sought are not for lost earnings. In all other cases, a plaintiff is required to report the entire amount. Consequently, the authors conclude that the availability of an offsetting income deduction is the only way a plaintiff can avoid being taxed on a portion of the recovery of legal fees.

In examining the deductibility of legal fees, Sager and Cohen discuss the categorization of expenses generally under the Code. They point out that recent changes to the Code have resulted in a distinction between reimbursed employment expenses that are fully deductible under both the regular tax and the AMT, and unreimbursed expenses that are only partially deductible under the regular tax and non-deductible under the AMT. The US Congress enacted these changes in the mid-1980s in an effort to restrict the deductibility of unreimbursed employment expenses, on the premise that these expenses commonly represented taxable personal consumption.
As the authors observe, the distinction between reimbursed and unreimbursed employment expenses is important for the tax treatment of recovered legal fees in employment discrimination cases, since a categorization of the fees as unreimbursed employment expenses means they are not fully deductible. To ascertain whether an employment expense qualifies as reimbursed, Congress added a substantiation requirement for the purposes of the regular tax under the Code. In order to satisfy this requirement, the expense must be paid under an arrangement that requires the employee to substantiate to the employer the expenses covered by the arrangement.

To explain the effect of these changes to the Code, Sager and Cohen review two cases that categorized legal fees as unreimbursed employment expenses. They argue that the result in both cases is inconsistent with sound tax policy. In particular, the policy underlying the substantiation requirement is intended to ensure that an expense is a bona fide income-earning expense. In effect, evidence of an arrangement between an employer and an employee for the reimbursement of an employment expense is accepted as sufficient assurance of the income-earning nature of the expense. Sager and Cohen point out that the kind of arrangement specified under the substantiation requirement would obviously not be in place when an employee is suing an employer for unlawful discrimination, since the employment relationship is disrupted at this point. Moreover, they emphasize that legal fees in employment discrimination cases are not personal consumption expenses.

Sager and Cohen then examine how a characterization of legal fees as unreimbursed employment expenses can affect plaintiffs in civil rights discrimination cases in the areas of education, housing and public accommodations, and violations of constitutional rights. As with employment discrimination cases, legal fees in these other kinds of discrimination cases are treated as miscellaneous itemized deductions (unreimbursed expenses) and are subject to the same deductibility problems discussed above with respect to amounts recovered in employment discrimination cases. The authors point to the fact that such treatment frustrates the intent of the fee-shifting provisions in civil rights litigation.

Sager and Cohen suggest two possible solutions. The first solution involves the “careful drafting” of a settlement agreement, with specific reference to the recovered amount as an employer reimbursement of an employment expense. The authors argue that this approach would satisfy the substantiation requirement and would qualify the legal fees as reimbursed employment expenses eligible for a full deduction. Their second solution involves the amendment of the Code to provide a full deduction for legal fees in employment discrimination cases (and other civil rights litigation) and to permit a plaintiff to exclude from income an amount recovered in respect of such fees.

Niki Vokas
Notes
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 At 1.
3 Ibid.
8 At 623.
9 Alexander v. IRS, 72 F.3d 940 (1st Cir. 1995); and Frederickson, Jr. v. Com., 99-1 USTC 50,167 (9th Cir. 1998).