Current Tax Reading

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Office of the Provincial Auditor of Ontario, *2002 Annual Report*
(Toronto: Office of the Provincial Auditor of Ontario, December 2002), chapter 3.02, "Corporations Tax," 62-86. Available on the Web at http://www.gov.on.ca/opa/.

While reports from the auditor general of Canada are frequently mentioned in this feature, reports by the provincial auditors are seldom as notable. This report is definitely the exception. Ontario Provincial Auditor Erik Peters presents an account of lax procedures within the Corporations Tax Branch of the Ontario Ministry of Finance that makes the problems discovered by the auditor general at the Canada Customs and Revenue Agency (CCRA) seem minor by comparison.

At the time of the provincial auditor's last report on corporate tax administration in 1996, the low rate of audits seemed to be the key issue.[1] This issue seems to have been resolved because field audits have more than doubled and desk audits have also increased.[2] However, concerns about audit coverage have been replaced with concerns about audit selection.

The selection procedure for field audits (which are conducted at the taxpayer's premises) is that each senior auditor is assigned a portion of the tax roll, from which 20 to 50 corporations are randomly selected. After a cursory review, the auditor chooses 10 to 20 corporations to audit. The hands-on selection of the subset is apparently thought to be reasonable, although it is reported that some managers, in order to reduce travel costs, limit their selection of corporations whose head offices

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1 Office of the Provincial Auditor of Ontario, *1996 Annual Report* (Toronto: Office of the Provincial Auditor of Ontario, 1996), chapter 3.10, at 2.

2 2002 report, at 75.

are located a great distance from the ministry's regional offices in North York, Mississauga, London, and Ottawa.[3]

The initial selection of the 20 to 50 corporations is random and not based on the risk of non-compliance. Senior audit managers acknowledged that corporations with a high risk of non-compliance were not necessarily identified and many low-risk corporations were audited. Almost one-half of all audits completed during 2000-1 resulted in nil or minimal reassessments of taxes owed.[4] Thus, the problems with the ministry apparently are not solely limited to a lack of resources.

The single statistic that best summarizes the Ontario report is that for the 2001 taxation year 355,000 corporations, or 47 percent of all corporations in Ontario, were in default of filing requirements. This default involves 930,000 corporation-years, or an average of 2.6 years per defaulting corporation.[5] By comparison, only 29 percent of corporations failed to file a federal corporate tax return on time.[6]

Some of the corporations that failed to meet provincial requirements might only be in default due to a technicality—it is possible that they were not required to submit an Ontario tax return because they qualified for exempt-from-filing (EFF) status, but the necessary EFF form had not been submitted. The requirements for EFF status include providing the ministry with the corporation's CCRA business number, being a Canadian-controlled private corporation, having filed a federal return, and having no Ontario-based taxable income or Ontario corporations tax payable in the year. The number of corporations in this situation is, of course, unknown.

Regardless of the doubt about the degree of default, how can this amazing 47 percent filing default rate be explained? The ministry points to the number of corporations on the tax roll, which grew at an average rate of over 10 percent from 1996 to 2001. The provincial auditor explains the high default rate by suggesting that efforts were reduced in following up on overdue returns: default notification letters requesting that outstanding returns be filed have not been regularly sent out since 1995; the threat of cancelling a non-filing corporation's charter and seizing its assets has not been used since 1997; and the addresses of 20 percent of those corporations in default are currently being traced so that notices requesting the required returns can be issued. Perhaps the most telling statistic is that there are at present only 15 provincial employees charged with the task of eliminating the backlog of 355,000 defaulting corporations.[7] Clearly, rapid progress cannot be expected.

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3 2002 report, at. 76-77.

4 2002 report, at 76-77.

5 2002 report, at 69. The similar percentage in 1996 was 20 percent, but since the requirement for EFF corporations to submit a form (see text below) began only in January 2000, observations on the time trend of non-filing compliance are not very meaningful.

6 Canada Customs and Revenue Agency, *Performance Report*, for the period ending March 31, 2002 (Ottawa: Public Works and Government Services, November 2002), 26.

7 2002 report, at 69-71.

The fact that Ontario is part of the tax-collection agreement for personal tax returns but not corporate tax returns creates an interesting dilemma. The ministry believes that field audits of such corporations are best done at the same time as audits of the personal income tax returns of the corporations' principals, but under the tax-collection agreements only the CCRA has access to these returns.[8] Hence, the ministry has decided not to audit corporations with annual gross revenue of less than $500,000 unless specific issues are identified with respect to a particular corporation, and instead relies on information stemming from CCRA assessments and reassessments.[9] However, because the CCRA does not audit on areas of difference between Ontario and federal tax legislation, it appears that given the limited number of such issues, smaller corporations are simply not audited at all.

The implicit question raised by this report is why Ontario does not join the tax-collection agreement for corporate income tax. Joining the agreement could save $45 million of the ministry's corporate tax administration budget,[10] less any CCRA charge for administering the Ontario corporate tax credit programs. There is also an unknown amount of revenue currently being lost because of the ministry's computer problems in processing the Ontario implications of CCRA reassessments.[11] The obvious cost of joining the agreement is the loss of control over the definition of Ontario taxable income, but differences between federal and Ontario rules are minor and could be eliminated.

A.M.

Edward J. McCaffery, *Fair Not Flat: How To Make the Tax System Better and Simpler* (Chicago: University of Chicago Press, 2002), 178 pages

For several years now, Edward McCaffery has been writing a number of scholarly articles advocating the repeal of the US gift and estate tax and the introduction of a progressive consumption tax in place of the current income tax.[12] In this short book, McCaffery presents a popular version of these arguments, proposing a "fair not flat" tax as an alternative both to the current US tax system and to other proposals for radical tax reform.

In addition to a brief introduction in which McCaffery denounces the current income tax and outlines the basic features of his proposal, the book comprises six chapters, a brief conclusion, and an appendix recapping his arguments in a question-and-answer format. The first chapter presents the "basics" of the US tax system,

8 1996 report, chapter 3.10, at 7.

9 2002 report, at 79.

10 2002 report, at 63.

11 2002 report, at 81.

12 See, for example, Edward J. McCaffery, "Tax Policy Under a Hybrid Income-Consumption Tax" (1992) vol. 70, no. 5 *Texas Law Review* 1145-1218; "The Political Liberal Case Against the Estate Tax" (1994) vol. 23, no. 4 *Philosophy & Public Affairs* 281-312; and "The Uneasy Case for Wealth Transfer Taxation" (1994) vol. 104, no. 2 *Yale Law Journal* 283-365.

reviewing the history of the modern income tax from its introduction in 1913, emphasizing the substantial role played by federal payroll taxes, and explaining the distinction between income and consumption as potential tax bases. Chapter 2 develops McCaffery's case against the income tax, which he regards as complex, inefficient, and unfair—complex because of the realization requirement and the US rule permitting a step-up of basis on death; inefficient because it distorts choices between saving and spending; and unfair because it allows the most affluent Americans to avoid income tax altogether by investing in appreciating assets, borrowing against this appreciation, and obtaining a stepped-up tax basis on death.

Chapters 3, 4, and 5 contain McCaffery's arguments in favour of a spending tax and progressivity and against the taxation of wealth transfers. In chapter 3, McCaffery reviews a number of prominent consumption tax proposals (Hall and Rabushka's "flat tax" proposal, proposals for a national retail sales tax or value-added tax (VAT), and the "USA" or "unlimited savings allowance" tax proposed by senators Sam Nunn and Pete Domenici), using these as building blocks in the development of his own proposal for a progressive consumption tax. Chapter 4 criticizes the US estate tax as ineffective, inefficient, and unfair—tainted with "legal loopholes,"[13] unable to prevent the increasing concentration of wealth in the United States, a penalty against frugality, and consistently unpopular to boot. Chapter 5 makes the case for progressivity in the imposition of a personal consumption tax, extending the principle of a personal exemption or zero-rated bracket to exempt spending on life's necessities by proposing a higher rate on high-end spenders in order to impose a heavier tax burden on the consumption of luxury goods.

Chapter 6 and the last part of chapter 5 bring together the elements of McCaffery's argument in his proposal for a "fair not flat" tax, which would repeal US income and estate taxes; introduce a 10 percent sales tax or VAT; provide a 10 percent refundable sales tax credit on consumption up to $20,000 (thereby exempting taxpayers with annual consumption of less than $20,000); and impose an additional tax of 10 percent on annual consumption between $80,000 and $160,000, 20 percent on annual consumption between $160,000 and $500,000, 30 percent on annual consumption between $500,000 and $1 million, and 40 percent on annual consumption exceeding $1 million. For McCaffery, this approach promises a simpler, fairer, and more efficient tax system that better corresponds to prevailing values than the income and estate taxes that it would replace.

For advocates of personal consumption taxation, McCaffery's book provides an accessible and concrete alternative both to the current tax system and to other proposals for radical reform, though one might prefer a more precise concept of taxable consumption[14] and a more sophisticated analysis of the ability of McCaffery's

13 At 64.

14 For example, without any explanation or justification, McCaffery's proposal excludes home mortgage interest, charitable contributions, and payments for medical expenses and education from the consumption tax base that he imagines. Ibid., at 89.

proposal to produce revenues comparable to the current income and wealth transfer taxes.[15] Advocates of income and wealth transfer taxes, however, are likely to remain unconvinced by McCaffery's normative arguments and by his unsupported assertions regarding the behavioural effects of different tax policies. While these readers might agree with some of McCaffery's criticisms of current income and wealth transfer taxes, their preferred solution is likely to be reform rather than replacement.

D.D.

Canada Customs and Revenue Agency, *Performance Report*, for the period ending March 31, 2002 (Ottawa: Public Works and Government Services, November 2002), 149 pages. Available on the Web at http://www.tbs-sct.gc.ca/rma/dpr/01-02/0102dpr-rmr_e.asp.

In this, its second annual report,[16] the CCRA reduces the amount of fluff and increases the amount of useful information. The fact that the report contains an auditor general's assessment of its content appears to be having some effect. However, the CCRA has not succeeded in making it easy to find this report—at the time of writing, a search of the entire CCRA Web site for "performance report" turns up only a page that lists prior years' reports.

Here are a few of the report's more interesting points:

- "[T]he CCRA's reputation for sound financial management was severely damaged by the discovery of an error in the allocation of the capital gains refunds earned by mutual fund trusts (the T3 issue). This error resulted in overpayments to a number of provinces totalling about $3.4 billion for the 1993 to 1999 tax years."[17] Although the CCRA admits that this error has "[r]educed credibility with the provinces," it also claims that it has "since put in place corrective measures that have had a positive effect on stakeholders' confidence."[18]
- The percentage of business accounts with a substantive risk of non-compliance has increased from 19 percent to 22 percent for self-employed individuals and from 29 percent to 31 percent for corporations. The CCRA optimistically describes the situation as "relatively unchanged."[19]

15 McCaffery himself admits that his numbers are "a guess at revenue-neutral rates." Ibid., at 91. Sadly, there is no empirical analysis to support this "guess," and McCaffery does little more than offer a variety of reasons why revenue-neutral consumption tax rates need not be as high as generally assumed—the current income tax is not a consistent income tax, his proposal would tax debt-financed consumption, there is no need for a capital gains preference under his proposal, and the rates would increase for the highest spenders. Ibid., at 92-93.

16 For a review of the first report, see this feature (2002) vol. 50, no. 3 *Canadian Tax Journal* 1230-38, at 1231-32.

17 At 99.

18 At 18.

19 At 51.

- "Enforcement efforts under our Contract Payment Reporting Initiative were redirected in response to lower than anticipated revenue."[20] No elaboration is provided.
- "At the end of March 2002 the level of accounts receivable was about $16 billion compared to $13.9 billion the year before." Taking the most benign view, the CCRA spins this outcome as "[c]ontinued slow progress in our ability to prevent further deterioration of the level of accounts receivable as a percentage of gross revenues."[21]
- "In the corporate returns area, we experienced unanticipated problems with the introduction of our new corporate processing system. As a result, we faced a considerable challenge this year in addressing a substantial backlog of unassessed T2 returns from 2000-2001."[22] The percentage of returns processed in 90 days fell from 89 percent in 2000-1 to 79 percent in 2001-2.[23]
- The percentage of returns that were filed electronically increased from 35.6 percent for the 2000 tax year to 39 percent for the 2001 tax year. The 2002 target is 50 percent, and the CCRA plans to be capable of processing 75 percent of returns electronically in the next few years.[24]

A.M.

Canada Customs and Revenue Agency, *Lists of Canadian Registered Charities*. Available on the Web at http://www.ccra-adrc.gc.ca/charitylists/.

In late 2002, the CCRA added to its Web site the T3010 returns of all registered charities and charitable foundations. The CCRA suggests that citizens use this information to answer the following questions about any organization to which they are thinking of donating: "Is it a registered charity? How much of its funds are spent on charitable works? What kinds of charitable works does it perform?"[25]

A.M.

Canada Customs and Revenue Agency, Compliance Strategy Division, "Impact of E-Commerce on the Canadian Tax Base: Report for Discussion," draft no. 3 (internal memorandum, n.d.)

This CCRA report on e-business, released through the Access to Information Act, shows that the CCRA does not believe in doomsday scenarios about the impact of e-business on tax revenues. The general conclusion is that "the risk is not as great as

20 At 53.

21 At 48 and 18.

22 At 46.

23 At 47.

24 At 46-47.

25 Canada Customs and Revenue Agency, "CCRA Revokes Registered-Charity Status of Canadian Association of the Blind," *News Release*, December 21, 2002.

expected." The product or service must be digitized in order to be affected, and much of what is currently produced in a variety of industrial sectors cannot be digitized. The key industry to watch is said to be the music industry.

A.M.

Julie Roin, "Truth in Government: Beyond the Tax Expenditure Budget," ***Hastings Law Journal*** (forthcoming). Available on the Web at http://ssrn.com/abstract_id=350981.

The publication of regular tax expenditure budgets is generally viewed as a valuable method of promoting transparency and accountability in government decision making. Among critics, however, disagreements over both the normative baseline for determining tax expenditures and the computation of forgone revenues render the use of the concept suspect. In the United States, for example, where legislation mandating the inclusion of a tax expenditure budget in the annual federal budget report was enacted in 1974,[26] the Bush administration has questioned the value of the tax expenditure budget in its last two budgets.[27]

In this article, Professor Roin of the University of Chicago Law School defends the publication of an annual tax expenditure budget, arguing that its deficiencies are matched by those of the regular budget, and advocating, in addition to these two kinds of budgetary information, the introduction of a regular "regulatory budget" that estimates the costs and benefits of regulatory alternatives to traditional expenditure programs and tax expenditures.

The article begins by emphasizing the value of information in a democratic society, not only to control the kinds of rent-seeking behaviour predicted by public choice theories of government, but also to facilitate informed decision making by voters and government officials. It then provides a brief history of the tax expenditure concept and the tax expenditure budget in the United States, and reviews common criticisms of the concept relating to the selection of a baseline and the computation of forgone revenue.

In the third part of the article, Roin considers the regular federal budget, contending that it also suffers from the same baseline ambiguities and computational challenges that characterize the tax expenditure budget. Assuming a zero baseline for federal expenditures, for example, ignores the likelihood that many federal expenditures would be duplicated by private expenditures in the absence of government programs. Nor can the elimination of a specific spending program (for example, housing subsidies) be certain to reduce government expenditures by the amount currently spent on the program, since those who currently benefit from

26 Congressional Budget and Impoundment Control Act of 1974, Pub. L. no. 93-344, enacted on July 12, 1974.

27 United States, Office of the President, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2002* (Washington, DC: US Government Printing Office, 2001), 61; and *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2003* (Washington, DC: US Government Printing Office, 2002), 95.

the program may migrate toward other programs (for example, health care) in its absence. The point of this discussion, Roin emphasizes, "is not to bemoan the existence of imperfections in our democratic system" but "to put the flaw inherent in the tax expenditure budget in context."[28]

The remainder of the article makes the case for the introduction of a regular "regulatory budget" in addition to the conventional budget and the tax expenditure budget. Observing that regulatory measures can redistribute resources and substitute for conventional spending programs as well as tax expenditures, Roin argues that such a measure is necessary to ensure "informational parity" and to prevent inefficient and inequitable substitution of regulatory measures for more explicit expenditure programs or tax expenditures.

D.D.

Canada, Department of Justice, *The Harmonization of Federal Legislation with Quebec Civil Law and Canadian Bijuralism: Collection of Studies in Tax Law* (Ottawa and Montreal: Department of Justice and Association de planification fiscale et financière, 2002), 538 pages

In 1995, the Department of Justice adopted a policy on legislative bijuralism, intended to ensure that federal legislation that incorporates or refers to private law concepts employs both civil law and common law terminology. In implementing this policy, the federal government has amended various federal statutes and enacted new sections 8.1 and 8.2 of the federal Interpretation Act requiring federal legislation to be interpreted in a manner consistent with Canada's bijural character.[29] Further legislation has been proposed,[30] and the Department of Justice continues to review federal legislation including federal tax legislation.

This collection reflects part of the department's review, and consists of several studies about the implications of Canadian bijuralism for Canadian tax law. As well as an interesting introduction by the Honourable Alban Garon, chief judge of the Tax Court of Canada, the collection contains studies on "The Retroactive Effect of Conditional Obligations in Tax Law,"[31] the concepts of employee and self-employed worker, and the concepts of a business, residence, partnership, an interest, and licence. The book is a valuable resource not only for anyone interested in the implications of Canadian bijuralism for federal tax legislation, but also for anyone interested in the legal character of the particular concepts examined.

D.D.

28 At 17.

29 Federal Law-Civil Law Harmonization Act, No. 1, SC 2001, c. 4.

30 See Canada, Department of Justice, *Program for the Harmonization of Federal Legislation with the Civil Law of the Province of Quebec: Second Series of Proposals To Harmonize Federal Law with the Civil Law of the Province of Quebec* (Ottawa: Department of Justice, 2003).

31 This article was originally published as Marie-Pierre Allard, "The Retroactive Effect of Conditional Obligations in Tax Law" (2001) vol. 49, no. 6 *Canadian Tax Journal* 1726-1839.

Peter Dobell and Martin Ulrich, "Parliament's Performance in the Budget Process: A Case Study" (2002) vol. 3, no. 5 *Policy Matters* 1-24 pages. Available on the Web at http://www.irpp.org/.

This is a report card from a political science perspective on the performance of the House of Commons with regard to the annual budgetary process. Most of the paper offers subjective impressions of Parliament's involvement in this process through pre-budget consultation by the Finance Committee and other House of Commons committees, parliamentary action related to approving the aggregate budget, and parliamentary scrutiny of government expenditures. The authors recommend improving the expenditure-approval process, strengthening committee studies, and involving citizens more in the budget process.

A.M.

Kevin Milligan, *Tax Preferences for Education Saving: Are RESPs Effective?* C.D. Howe Institute Commentary no. 174 (Toronto: C.D. Howe Institute, November 2002), 17 pages. Available on the Web at http://www.cdhowe.org/.

This study nicely fills a gap in the literature by providing a policy evaluation of the registered education savings plan (RESP) program. Using the theoretical framework of life-cycle saving and data on the different types of savers, the author concludes that specific tax-preferred accounts for any one type of saving (education, home ownership, health, etc.) serve no purpose given the tax-preferred savings room available through registered retirement savings plans (RRSPs). It would make more sense either to fold the RESP into the existing RRSP system or to launch a general tax-prepaid savings plan. The author also recommends that the Canada education savings grant program (whereby the federal government makes a matching grant for RESP contributions) be discontinued.

A.M.

Jack M. Mintz and Thomas A. Wilson, *Saving the Future: Restoring Fairness to the Taxation of Savings*, C.D. Howe Institute Commentary no. 176 (Toronto: C.D. Howe Institute, November 2002), 12 pages. Available on the Web at http://www.cdhowe.org/.

Despite its general title, this paper is about the Canadian retirement savings system. Although little new information is presented, the paper is a handy summary of current issues in this area, written from the perspective of consumption tax advocates who seek an increase in contribution limits.

A.M.

Kevin Milligan, "How Do Contribution Limits Affect Contributions to Tax-Preferred Savings Accounts?" (2003) vol. 87, no. 2 *Journal of Public Economics* 253-81

In this article, the author builds a simple three-period model in which a taxpayer saves for retirement through two assets, an RRSP and a non-sheltered asset. Using this model, the author shows that allowing unused contribution room to be carried forward can cause the "use it or lose it" motivation for contributing to the RRSP to disappear. This model is supported empirically by Canadian tax return data, in which an inverse relationship is found between future contribution limits and current contributions.

A.M.

William G. Gale, James R. Hines Jr., and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Washington, DC: Brookings Institution Press, 2001), 515 pages

In the spring of 2000, the Brookings Institution and the Office of Tax Policy Research at the University of Michigan Business School convened a conference to examine various features of the US estate and gift tax. Although the US Congress subsequently voted to eliminate these taxes by the year 2010, the nature of this legislation (which reverts to the pre-2001 statute absent further legislation) guarantees that wealth transfer taxes will remain a subject of debate in the United States over the next several years. As a foundation for this debate, there is probably no better collection of studies than this book.

The book contains 10 papers and commentaries, plus an excellent introductory overview by William Gale and Joel Slemrod. The papers examine the structure of the federal gift and estate tax; methods of avoiding these taxes; the role of wealth transfer taxes within an optimal tax framework; the impact of gift and estate taxes on saving, inequality, wealth accumulation, and charitable giving; the extent of non-compliance with the federal estate tax; the distributional burden of taxing estates and unrealized capital gains at death; and the relationship between health and asset management among the elderly.

D.D.

Maureen B. Cavanaugh, "Democracy, Equality and Taxes" (2002) vol. 54, no. 1 *Alabama Law Review* 415-81

For some critics of progressive taxation, the principle of political equality in a democratic society requires a corresponding principle of equality in the imposition of tax burdens—an equality that might be achieved through poll taxes or through flat-rate income taxes. In this article, Maureen Cavanaugh sets out to disprove this link by examining the institutions of Athenian democracy from the late 6th to 4th centuries BCE. Observing that the rise of Athenian democracy during this period corresponded with a shift in taxation from flat-rate taxes on agricultural production to property taxes and liturgical obligations imposed solely on the most affluent Athenians, Cavanaugh contends that the imposition of "the greatest tax burden on the wealthy is ultimately a necessary correlate of the political decision for democracy."[32]

Although Cavanaugh's review of taxation in Athenian democracy is certainly interesting, the conclusion is not well established. Aside from concerns regarding the relevance of ancient experience to taxation in a modern market economy, the mere correlation of progressive taxation with Athenian democracy cannot be relied upon to establish a necessary connection. While progressive taxation is clearly compatible with a democratic society, it is not clear that progressive taxation is necessary to democracy. Advocates of progressive taxation would do better to look to other justifications.

D.D.

Marina Karasseva, *Tax Law in Russia* (The Hague: Kluwer Law International, 2001), 152 pages

With the disintegration of the Soviet Union, formerly socialist states were confronted with the challenge of devising tax systems to raise revenues from newly established private sectors in order to provide revenues for newly constituted public sectors. The most prominent of these former states, the Russian Federation, enacted its first tax system at the end of 1991. On January 1, 1999, this initial system was displaced by the enactment of a new Tax Code of the Russian Federation.

This book provides a comprehensive overview of the tax law in Russia, containing chapters on tax administration and practice (part I, chapter 1); procedure (part I, chapter 2); taxes on income, profits, and capital gains (part II, chapter 1); social security contributions (part II, chapter 2); other payroll taxes (part II, chapter 3); taxes on property including wealth and wealth transfers (part II, chapter 4); taxes on goods and services (part II, chapter 5); taxes on international trade and transactions (part II, chapter 6); miscellaneous other taxes (part II, chapter 7); and rules and treaties governing international taxation (part III, chapters 1 to 4). The book should provide a useful introduction and reference for anyone seeking a basic understanding of taxation in the Russian Federation.

D.D.

David K. Hoffman, "State Income Taxation of Nonresident Professional Athletes" (2002) vol. 97, no. 8 *Tax Notes* 1083-91

Supporters of Alberta's new tax on National Hockey League players have often cited the fact that many American states have taxes on non-resident athletes, so it is interesting to read this evaluation of American "jock taxes." The author criticizes such taxes on four grounds: the public is often misled into thinking that such taxes apply only to millionaire superstars, when in fact they apply to team support staff

32 At 80.

as well; jock taxes are arbitrary because they target a specific occupational category; those affected by the jock taxes suffer increased compliance costs; and the incidence of the jock taxes is not aligned with the location of the associated economic activity, which creates economic inefficiencies.

A.M.

Francine J. Lipman, "Incentive Stock Options and the Alternative Minimum Tax: The Worst of Times" (2002) vol. 39, no. 2 *Harvard Journal on Legislation* 337-73

With the stock market reaching historic highs in the 1990s, employee stock options were used extensively in compensation packages. This article focuses on the tax consequences of incentive stock options (ISOs) under the Internal Revenue Code.[33] In particular, the article reviews the alternative minimum tax (AMT) consequences for option holders. The author examines various proposals for AMT reform and suggests three changes that are consistent with tax policy principles and the rationale for the AMT. She contends that her proposed changes would simplify the system and properly limit the application of the AMT to high-income taxpayers.

The author begins by describing some perceived horror stories of taxpayers who were faced with AMT liability on their ISOs. To explain how this can happen, she provides the reader with a fairly detailed account of the interactions between ISOs and the AMT in the Code. She argues that the AMT is flawed in that it is extremely complex and lacks transparency. Yet Congress, despite acknowledging the AMT's shortcomings, has not acted. To spur congressional action, a grassroots campaign is currently being waged on the Internet at http://www.reformamt.org/. The campaign is led by Jeffery Chou, whose own harrowing experience with the AMT is reviewed in the article. The campaign is intended to pressure Congress to provide retroactive relief to employees affected by the AMT on their stock option plans, as well as to inform the public generally about potential AMT liability.

During the 1990s, employees often preferred to receive equity interests in their corporate employers in lieu of cash compensation. The demand was attributable in part to the Code's preferential tax treatment of ISOs. First, tax on the value of the option is deferred until the option is exercised, because the Code does not regard an ISO grant to be a transfer of property between an employer and an employee. When the ISO is exercised, tax is applied on the "bargain purchase price," which is the difference between the option's exercise price and the fair market value of the shares. The second tax advantage to an ISO is that bargain purchase income is subject to the long-term capital gains rate, which is lower than the rate for regular income.

The AMT is a separate tax that operates parallel to the regular income tax under the Code. The AMT is intended to ensure that taxpayers are subject to a minimum

33 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

income tax liability. Like Canada's AMT, introduced in 1985, the AMT under the Code is meant to apply to high-income individuals who, through various exclusions and deductions, would otherwise pay little or no regular income tax. The AMT system expands the tax base by adding various income items to regular taxable income and deleting various deductions. This modified tax base is referred to as "alternative minimum taxable income" (AMTI). Bargain purchase income must be included in AMTI in the year that an ISO is exercised. Lipman provides the reader with a description of the different treatments of bargain purchase income under the Code. These treatments depend on particular circumstances, such as whether the disposition of the ISO stock is a qualifying or a non-qualifying distribution and whether the disposition and exercise of the stock were made in the same year. She also provides helpful numerical examples to guide the reader through the complex Code provisions.

Lipman then argues that the bargain purchase income under an ISO is properly subject to AMT treatment. In this respect, she notes that Congress intended to provide tax benefits to taxpayers who exercise ISOs. However, to limit the benefits, bargain purchase income was made subject to an AMT adjustment and a number of other limitations under the Code. For example, where an ISO grant is exercised for the first time, an employee's benefit is limited to $100,000 of stock in any taxation year. Also, an ISO may not be granted to an employee who controls 10 percent or more of the corporate voting power.

Lipman believes, however, that the AMT provisions are so complicated that taxpayers are often unknowingly subject to significant tax liability. Her criticisms of the AMT go beyond the treatment of ISOs and are more general in nature. While proper tax planning can minimize any potential AMT liability, most taxpayers either do not think they need a tax planner or obtain the services of a tax planner too late to avoid AMT consequences. Lipman uses the example of the Chou family, who unwittingly became liable for AMT on $7 million of bargain purchase income. Lipman, and the many politicians she cites, believes that situations like the Chous' are unacceptable and that the AMT must be reformed. She argues, however, that AMT reform will not be easy. Simply repealing the tax would not only make little policy sense, but result in the loss of approximately $600 billion in revenue through 2011.[34] It is also estimated that, by 2010, 33 percent of all individual taxpayers will be subject to the AMT.[35] Nevertheless, given the bipartisan support of Congress, there is momentum to amend the AMT, and Lipman suggests three changes to best achieve the defensible policy objective of taxing bargain purchase income on ISOs under the AMT.

First, Lipman recommends indexing the AMT system for inflation because the regular tax system, which the AMT is supposed to parallel, is largely indexed. Specifically, she argues that the AMT exemptions, phase-out thresholds, and tax rate

34 At 359.

35 At 363.

brackets should be indexed. Without these reforms, taxpayers may become subject to AMT solely as a result of "bracket creep" rather than a change in circumstances, and this happens merely because their regular and minimum tax liabilities are calculated differently. Lipman suggests that this kind of "stealth tax policy" is intolerable to taxpayers and undermines their confidence in the tax system. She believes the benefits of a fairer tax liability and transparency outweigh the substantial cost to the government of indexation (an estimated $370 billion in lost tax revenue from 2002 to 2011).

Second, Lipman suggests that AMT adjustments for state and local tax deductions be eliminated. This proposal would permit the deduction of state and local taxes for AMT purposes. She notes that this proposal would have a significant impact on the AMT system because 54 percent of all AMT adjustments are for this category. She argues, however, that this change is necessary to ensure that individuals are not penalized for satisfying their legal obligation to pay local taxes. She also emphasizes that the non-deductibility of state and local taxes for AMT purposes affects taxpayers differently depending on where they live; a taxpayer in a high-tax jurisdiction is in a worse AMT position than a taxpayer in a low-tax jurisdiction. Accordingly, the adjustments are unfair, and a deduction for state and local taxes ought to be permitted.

Third, Lipman argues that AMT adjustments for personal and dependency deductions should be eliminated. These deductions exist under the regular income tax system to reduce the income tax liability of middle- and low-income taxpayers. Because the deductions are phased out as income increases, high-income taxpayers do not benefit from them. Accordingly, the personal and dependency deductions should be permitted for AMT purposes on a phased-out basis in the same manner as they are for regular income tax purposes. Such a result is consistent with the author's view that the impact of the AMT should be focused on high-income taxpayers.

Although the AMT treatment of employee stock option plans in Canada[36] is similar to that in the United States, the only one of Lipman's recommendations for reform that is relevant to Canadians is her suggestion for indexation. In Canada, the current basic exemption for an individual is $40,000, unchanged since the AMT's introduction in 1986.[37] As such, Canadian taxpayers are subject to the same inconsistent treatment as US taxpayers, with an indexed regular income tax on one hand and an unindexed AMT on the other.

Mike Gemmiti

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36 For an analysis of the Canadian income tax consequences of employee stock option plans, see Michael J. Fremes, Perry Phillips, and Harvey Wortsman, "Employee Share Ownership Plans," in *R & D: Credits Today, Innovation Tomorrow*, 1999 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1999), 15:1-77, and Daniel Sandler, "The Tax Treatment of Employee Stock Options: Generous to a Fault" (2001) vol. 49, no. 2 *Canadian Tax Journal* 259-319.

37 For a discussion of how the AMT operates in Canada, see the Department of Finance Web site at http://www.fin.gc.ca/taxexp/2000/taxexp00_4e.html.

Robert H. Scarborough, "How Derivatives Use Affects Double Taxation of Corporate Income" (2002) vol. 55, no. 4 *Tax Law Review* 465-532

Under the US classical corporate income tax, income is taxed at the corporate level and then again at the shareholder level on distribution as a dividend. Although there has been some recent public discussion of the merits of a dividend tax credit, there is still no integration of the corporate and personal income taxes. In this article, Scarborough argues that "self-help integration" can be realized, nonetheless, through the use of derivatives as a partial substitute for equity.

Scarborough begins by reviewing certain corporate finance principles described in the literature. He relies on the general insight that all financial instruments provide returns that are attributable to a "time-value" and a "bet" element. This insight is illustrated using the put-call parity theorem, which holds that a purchase of shares is equivalent to (1) the purchase of a zero-coupon bond, (2) the purchase of a call option on the shares with a strike price equal to the amount payable on maturity of the bond, and (3) the issue of a put option on the shares with the same strike price. Scarborough notes that, from the issuer's perspective, issuing shares is the equivalent of issuing a bond and entering into a short forward contract with these same put and call terms. Differences in the income tax treatment of debt and equity fail to recognize, however, these kinds of basic financial equivalences. In particular, the time-value return on shares is subject to the corporate-level tax, but the same return on a bond is generally deductible by the corporation as interest expense.

Scarborough suggests that decisions about the corporate capital structure can be seen as decisions about how to "package" the time-value and bet elements in financial instruments. In effect, the corporate-level tax can be minimized to the extent that it is possible to package the time-value element as debt. However, this tax incentive is constrained by certain non-tax factors, particularly the problems associated with increased corporate leverage and the risk of financial distress. In this respect, the author notes that financial theory, which posits that the tax savings from the use of debt must be balanced against expected bankruptcy risk, ignores the use of derivatives in the corporate capital structure. For example, a corporation that issues a debt instrument whose principal is adjusted downward if earnings decline may enjoy the tax benefits of issuing corporate debt and the non-tax benefit of decreased financial risk, because the corporation's obligation to repay the principal declines if the corporation experiences financial distress.

Scarborough illustrates his general argument about packaging through a series of examples that consider four general financing alternatives available to US corporations: (1) an all-equity capital structure, (2) an all-debt structure, (3) the issue of debt with a derivative linked to the issuer's shares, and (4) the issue of debt with a derivative linked to specified factors external to the issuer. A capital structure composed entirely of equity offers no tax advantage, because all income is subject to both corporate- and shareholder-level taxes. In effect, this type of structure combines the time-value and bet elements in a single equity instrument. However, Scarborough notes that the disadvantage attributable to the two levels of tax is partially offset by the fact that dividends are taxed in investors' hands on a cash basis, whereas interest is taxed on an accrual basis. To the extent that the shareholder-level tax rate is higher than the corporate-level tax rate, shares can be issued in an effort to defer dividend taxation. But this advantage is lost where the corporate-level rate exceeds the maximum shareholder-level rate, as is presently the case in the United States. Under these conditions, the tax advantages of debt always outweigh any shareholder advantages of equity.

A capital structure composed entirely of debt increases the ratio of debt to equity and thereby increases the risk of financial distress. In addition, Scarborough indicates that both the US courts, through their inherent jurisdiction, and the Code restrict a corporation's ability to replace equity with debt to minimize the double taxation of corporate income. Judicial recharacterization of debt as equity for income tax purposes will occur if repayment is too uncertain, resulting in a denial of the corporate interest deduction. In addition, section 163(e)(5) of the Code impedes the ability to replace equity with debt where the instrument has a yield exceeding the federal rate by 5 percent, where the instrument has a term of more than 5 years, and where more than one year of original issue discount is deferred. The effect of section 163(e)(5) is to deny or defer a deduction for original issue discount on the impugned debt instruments. Furthermore, both judicial and statutory recharacterization would not benefit the investor because the security would continue to be considered a debt security owned by the investor.

A capital structure composed of the issue of debt with a derivative linked to shares of the issuer can hedge against bankruptcy risk and promote "self-help integration." In effect, this type of structure packages a time-value element in corporate debt and a bet element in the related derivative. Scarborough notes that this capital structure can be realized either by embedding the derivative in the debt instrument itself or by issuing it as a legally distinct instrument. While concluding that the latter structure is generally more effective, the author indicates that debt that is payable either at the issuer's option or on a mandatory basis is likely to be recharacterized as equity by US courts. In addition, section 163(l) of the Code constrains a corporation's ability to embed explicit equity derivatives in debt. This provision applies if the debt instrument is "part of an arrangement" that is reasonably expected to have the same result as debt that is payable at the issuer's option in its stock. In the case of an option exercised by the holder, recharacterization is not likely unless there is a substantial certainty that the holder will exercise the option.

A capital structure composed of the issue of debt with a derivative linked to factors that are external to the issuer can also hedge against bankruptcy risk and promote "self-help integration." As with the issue of debt with a derivative linked to the issuer's shares, this type of structure packages a time-value element in corporate debt and a bet element in a related derivative. Scarborough notes, again, that this capital structure can be accomplished either by embedding the derivative in the debt instrument or by issuing it in a separate instrument. Debt that is secured by a specific asset of the corporation gives the corporation the right to put the asset to the investor and, therefore, the corporation need not incur the costs of bankruptcy. However, as with other embedded derivatives, he notes that the instrument may not be respected for US income tax purposes, unless the instrument provides for an amount of non-contingent principal that is substantial in relation to the issue price. There is no statutory rule, however, similar to section 163(l) of the Code that is applicable to this particular structure.

Scarborough then considers the income tax consequences of holding debt and a derivative together from the perspective of an investor. Keeping in mind that the investor must hold sufficient capital to effectively shift risk from the issuer and allow the issue of more debt without increasing bankruptcy risk, the investor can reconstitute the time-value and bet elements of shares to create a "synthetic equity." He discusses the impact of holding "synthetic equity" on three different investors: (1) foreign and tax-exempt investors, (2) individual taxable US investors, and (3) US corporate investors. Foreign and tax-exempt investors are not taxable on either dividends or capital gains. However, to the extent that dividends are subject to withholding tax in the United States, the foreign investor is better off holding synthetic equity. In this respect, Scarborough discusses the treatment of interest and dividends. Generally, no US tax is payable on portfolio interest under the Code. Conversely, with dividend withholding tax, the "notional principal contract" concept determines whether dividends are subject to tax. A swap agreement referencing factors external to the issuer that correlate closely to either party's earnings or to general market risk will generally qualify as a notional principal contract; however, a swap referencing the issuer's share price or earnings will not. If the derivative is determined to be a notional principal contract, neither a tax-exempt investor nor a foreign investor who is not engaged in business in the United States is subject to tax on that income.

Individuals who hold synthetic equity are usually taxed on interest income on an accrual basis. In contrast, dividends on non-synthetic equity are taxed as received, which means that an investor can benefit from the deferral of dividend payments. However, as Scarborough notes, the corporate tax advantage of the interest deduction will always outweigh any individual investor advantage of holding non-synthetic equity, where the corporate-level tax rate exceeds the maximum shareholder-level tax rate, as is presently the case in the United States.

A US corporation that enters into a derivative (such as a forward contract for share purchase) with an issuer may hedge against possible losses arising from the derivative by purchasing debt instruments of another corporation that are due to mature when the derivative settles. The issuer could simultaneously issue debt to another corporation to fulfill its current need for capital. The interest income earned by the US corporation on the debt instruments is taxed on an accrual basis, which exactly offsets the interest expense deduction for the issuer, assuming that (1) the coupon on the debt issued by the issuer is equivalent to that of the debt held by the investor, and (2) the tax rates for both corporations are equivalent. Replacing non-synthetic equity with synthetic equity provides an overall tax advantage, because the portion of the investor corporation's return equal to the interest rate on debt that it holds is subject to only one level of corporate tax, not two levels, as would be the case if it held non-synthetic equity. In the latter case, the dividends-received deduction may partially offset one of the levels of tax; however, synthetic equity is able to discharge the other level of tax entirely.

Scarborough acknowledges that some corporations, particularly ones with loss carryovers, do not benefit from the deduction of interest expense. For these corporations, it is advantageous to split common stock into a combination of preferred stock and derivatives in order to access the intercorporate dividends-received deduction for corporate holders. He notes, however, that the deduction is less than 100 percent for dividends received from corporations other than wholly owned subsidiaries, and therefore interest expense deductions on debt will create a better after-tax position. In effect, substituting preferred stock for debt converts the time-value return on debt into a form that is eligible for the dividends-received deduction. Looking at the practicality of shifting the time-value portion of debt into a form that is eligible for the dividends-received deduction, Scarborough analyzes both the corporate shareholder that wants the economic exposure of owning common stock, and the corporate shareholder that does not. For the former category of investors, an issuer corporation can enter into a forward contract to sell common shares and issue dividend-paying preferred shares. The author suggests that the issuer is not obligated to distribute earnings to all shareholders, and the particular corporate shareholder can receive the dividends at a reduced rate of tax. Furthermore, this structure provides the corporate shareholder with a lower capital gain on the future disposition of the common shares, assuming the purchase of the common shares at a higher market price in the future. As Scarborough notes in an example, the shareholder who purchases only common stock receives the same profit before tax, but the use of the derivative increases the shareholder's after-tax return. As well, the corporate issuer is in the same economic position in either case, and its tax position is unaffected, because it recognizes no gain or loss on the issuance of its common shares in settlement of the forward contract.

For a corporate shareholder that does not want the exposure associated with common stock, a tax-advantageous structure involves purchasing common shares and entering into a total return equity swap with another party that wants this exposure without the capital investment. In effect, this structure leaves the time-value element with the corporate shareholder and shifts the bet element to the other party. The corporate shareholder will be taxed currently on payments received from the other party to the equity swap because these payments are not eligible for the dividends-received deduction. In this structure, the corporate issuer's economic and tax positions are both unaffected. Alternatively, the issuing corporation could enter into a total return equity swap, referencing its own common stock with another party that wants the economic exposure of a common shareholder. The corporate shareholder could acquire preferred shares from the issuing corporation, paying a dividend rate equal to the return in the equity swap in the former situation. However, in this situation the corporate shareholder will be eligible for the dividends-received deduction, yet the economic position of the issuing corporation is approximately the same in either case. The issuing corporation could use payments from the other party under the equity swap to fund payments of the dividend to the corporate shareholder, if the equity swap requires such payments. On the other hand, if the derivative is a forward contract that does not require such payments, the issuer will be required to finance the dividend stream until settlement of the forward. Whether the issuing corporation's tax position is affected depends on whether the Code applies to prevent the issuing corporation from recognizing gains or losses on the swap. Since either a gain or a loss may result from the swap, it is not clear whether the corporation is better or worse off upon application of the Code. It is clear, however, that if the Code applies to prevent recognition of gains or losses on the swap, the corporation's tax position is the same as if it had issued common stock.

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