Current Tax Reading

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Richard Bird, *Taxing Electronic Commerce: A Revolution in the Making*, C.D. Howe Institute Commentary no. 187 (Toronto: C.D. Howe Institute, September 2003), 25 pages, ISSN 0824-8001

Richard Bird discusses three issues regarding international electronic commerce: problems arising under retail sales taxes; problems arising under value-added taxes (VATs); and problems with respect to the attribution and characterization of income from international operations.

Bird concludes that publicity arising from the United States' problems in imposing taxes on electronic commerce has created an incorrect impression that there is an equally large problem in Canada. Not true, says Bird, at least with respect to within-country sales. The United States relies exclusively on retail sales taxes imposed by states, while in Canada we also have VATs (the GST/HST). Because the GST/HST is imposed by the federal government, it is readily collected nationally. Also, Canadian courts have been kinder to tax collectors with respect to mail-order sales. Although the current practice in the United States is that out-of-state vendors are not generally required to collect destination sales taxes (whether or not the sale is over the Internet), most major electronic retailers based in Canada appear to be levying all applicable domestic taxes (GST/HST and retail sales taxes) on sales.

Even cross-border sales are not always a problem, at least regarding VAT. For imports of business-to-business (B2B) services, no tax is imposed but the buyer is taxed indirectly through the denial of an input tax credit. This "reverse-charge" mechanism largely solves the problem for VATs.

Cross-border business-to-consumer (B2C) sales are an issue, however. The seller cannot easily be required to register for VAT, let alone collect and pay the tax to the authorities. Even if sellers agreed to charge the tax, there would be a large compliance burden for sellers who ship to many countries, because they would have to apply a

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different tax regime for buyers in each country. The European Union has attempted to address this problem by taxing sales from within on an origin basis—that is, by the country of the seller. Thus Portugal, which has the lowest rate within the European Union (13 percent in the case of one region within the country), may receive a horde of non-EU vendors seeking to establish an EU subsidiary or branch.

In Canada, a partial solution to the B2C problem is that the Canada Customs and Revenue Agency attempts to collect GST/HST at the border, along with provincial sales taxes for all provinces but Prince Edward Island and Saskatchewan. Obviously, this would not be effective for digitized goods, such as downloads of music and software. Requiring credit card companies to collect the tax for services charged on cards is one solution, but Bird regards this as an unreasonable imposition on such companies.

Bird's optimism with regard to consumption taxes does not extend to income taxes: "Unfortunately, with respect to income taxes, everyone seems to be in the same leaky boat."[1] Enforcement is the main problem. Bird suggests that governments require all transactions to be geographically coded to be legally valid. Thus, the erosion of privacy may be the cost of protecting the tax base.

A.M.

Kim Brooks, "Learning To Live with an Imperfect Tax: A Defence of the Corporate Tax" (2003) vol. 36, no. 3 *University of British Columbia Law Review* (forthcoming)

When President Bush proposed to eliminate the personal income tax on dividends earlier this year, a number of Canadian commentators voiced their approval and urged the Canadian government to follow the US lead.[2] In this article, Professor Brooks of the Queen's University Faculty of Law takes an opposing view, defending a "classical" corporate tax in which corporate-level tax is generally ignored at the shareholder level.

After an introduction summarizing some of the debate surrounding the Bush proposal, the article consists of three parts: (1) arguments in favour of a separate corporate tax, (2) arguments commonly made against the corporate tax, and (3) specific recommendations and comments on the future of the corporate tax.

The author's arguments in favour of a separate corporate tax are as follows: (1) the corporate tax increases the comprehensiveness, progressivity, and fairness of the tax system by ensuring that income from capital bears at least some tax; (2) to the extent that it applies to pure economic profits or economic rents, the corporate tax raises revenue efficiently; (3) the corporate tax prevents the unlimited opportunity for tax

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1 At 12.

2 See, for example, Jack Mintz, "We Need Relief, Too," *National Post*, January 7, 2003; and Vern Krishna, "Let Fairness, Balance in Tax System Be a Basic Priority," *Globe and Mail*, January 27, 2003.

deferral under a realization-based personal income tax; (4) the corporate tax is a defensible and widely accepted method of taxing non-residents; (5) the corporate tax ensures that corporate entities pay for the general benefits that they receive from governments in the form of incorporation and publicly provided goods and services; (6) the corporate tax raises significant revenue in an administratively efficient and politically acceptable manner; and (7) the corporate tax is a well-established feature of the tax system and major changes to it would entail substantial transitional costs. With respect to the integration of corporate- and personal-level taxes, Professor Brooks argues that they involve enormous complexity and create as many distortions as they appear to remove—particularly at the international level, where biases cannot be eliminated without complete harmonization.[3]

With respect to arguments against a separate corporate tax, Professor Brooks discusses the following: (1) the combination of corporate tax and separate tax dividends involves inequitable double taxation; (2) the corporate tax inefficiently distorts corporate financial decisions by creating biases in favour of retained earnings and debt finance, and it distorts investment decisions by creating a bias in favour of non-corporate investments; and (3) the corporate tax complicates the tax system by requiring arbitrary and difficult distinctions to be drawn by tax administrators. Regarding the first of these arguments, she questions the characterization of "double taxation" whenever two kinds of taxes are imposed on similar amounts (as is the case with income and payroll taxes on labour income); observes that the frequency of this outcome is exaggerated given low effective rates of corporate tax, tax-exempt shareholders, and the existence of retained earnings; and contends that any inequity could be eliminated by a reduction in the price of shares.[4] Turning to arguments about the distortionary effects of the corporate tax, Professor Brooks argues that they are not as serious as often alleged; that a bias in favour of retained earnings makes little sense if marginal investors are tax-exempt and/or the marginal source of equity is retained earnings in any event; that a bias in favour of debt over equity is lessened by retained earnings likely offset by additional risk and transactions costs associated with debt; and that a bias in favour of unincorporated enterprises is limited for large firms for which incorporation is driven by non-tax considerations and offset for small firms by the small business tax credit. Finally, she argues, although the legal distinctions that the corporate tax requires to be drawn between debt and equity and between dividends and return of capital are difficult, they are no more difficult than the distinctions drawn in several areas of law and might be supplemented by bright-line rules based on the economic substance of the taxpayer's enterprise.

As a result, Brooks concludes, Canada should not go down the path of the Bush proposal to eliminate all personal tax on dividends and should repeal the dividend

3 For this reason, the author notes, countries such as Germany, Japan, and the United Kingdom have recently reduced the amount of corporate tax that they refund to shareholders.

4 See, for example, Boris I. Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?" (1979) vol. 16, no. 4 *San Diego Law Review* 735-48.

tax credit, use the increased tax revenue to reduce the corporate tax rates, and allow small corporations to elect to be taxed as partnerships. Despite reports of its imminent demise, the corporate tax is as justifiable today as it has been throughout its history.

D.D.

Pierre Lefebvre and Philip Merrigan, "Assessing Family Policy in Canada: A New Deal for Families and Children" (2003) vol. 9, no. 5 *Choices* (Institute for Research on Public Policy) 1-100

This study uses Statistics Canada's Social Policy Simulation Database and Model (SPSD/M) to examine alternative family policies for the federal and provincial governments. The authors conclude that the present Canada child tax benefit (and related provincial programs) should be replaced because its income-testing features create work incentive problems and, by denying child benefits to higher-income parents, do not provide horizontal equity between higher-income people with and without children. The authors recommend that the Canada child tax benefit and related provincial programs be replaced by a program that provides child benefits to all families regardless of income. Unlike the old family allowance program, the new program would involve non-taxable payments and would be graduated with age so that the highest payments go to parents with young children.

Other tax recommendations are as follows: a family tax credit delivered to low-income earners who work 17 hours or more per week, which would promote entry into and long-term attachment to the labour force; converting the child-care expense deduction into an income-tested refundable credit, in order to provide more benefit to families without tax liability; and reducing the tax support provided to post-secondary education, where most of the benefits provided by such education go to the students themselves rather than to society at large.

A.M.

Amin Mawani, "Cancellation of Executive Stock Options: Tax and Accounting Income Considerations" (2003) vol. 20, no. 3 *Contemporary Accounting Research* 495-518

The frequent use of executive stock options as a method of executive compensation in Canada is somewhat puzzling to people who believe that taxes are important in business decision making. Even if (and this has recently been questioned) granting options to executives is justified by incentive reasons, why should the company allow employees to later exercise these options and acquire shares that they often immediately sell? Instead, when employees decide to exercise the options, the company could offer them a cash payment that would produce the same or better after-tax income. The reason the company can afford to make a sufficiently large payment is that the latter ("cancellation") strategy produces a tax deduction for the company while the former ("exercise") strategy does not.

Mawani uses Ontario Securities Commission insider-trading data for the period 1993-1997 to show that only about 30 percent of companies follow the more tax-effective cancellation strategy. Mawani's explanation, based on a statistical analysis of which companies follow both of the strategies, is that in this time period the cancellation strategy produced lower book income than the exercise strategy, and companies that needed book income followed the exercise strategy despite the fact that it hurt cash flows.

The question for the future is, will the cancellation strategy become more popular now that accounting rules are being changed to recognize an expense arising from stock options? A followup study is needed to resolve this issue.

A.M.

Chris Evans, "Studying the Studies: An Overview of Recent Research into Taxation Operating Costs" (2003) vol. 1, no. 1 *eJournal of Tax Research* 64-92

The *eJournal of Tax Research* is a new electronic tax journal published by the Australian Tax Studies Program (Atax) at the University of New South Wales in Sydney and available online at http://www.atax.unsw.edu.au/ejtr/. In addition to other articles (on political party affiliation and tax preferences, tax harmonization and tax competition in the European Union, and the politics of gender in Australia's tax-transfer system), the inaugural issue of the journal contains an excellent survey of recent research into tax operating costs by the director of Atax, Chris Evans.

The purpose of the survey, according to Evans, is "to make available in a single source an overview of recent research into tax operating costs."[5] By taxation "operating costs," he refers both to the administrative costs borne by governments and to compliance costs incurred by taxpayers and practitioners. By "recent," he means all studies performed since 1980—over 60 studies, as it turns out, which are carefully summarized in a detailed appendix.

After a brief introduction, the survey contains five sections: (1) providing a historical context to recent research on taxation operating costs, (2) surveying the scope of taxes and taxpayers that have been subjects of operating cost studies, (3) discussing the methodologies of these studies, (4) summarizing the outcomes of this research, and (5) considering the future of operating cost research and the implications of this research for tax design.

With respect to historical context, Evans observes a "flourishing" of worldwide research in the 1980s after initial beginnings in North America in the 1930s and Europe (primarily the United Kingdom) in the 1960s and 1970s. This flourishing is attributable both to the improved technological ability of computers to carry out such research and to the increased interest in operating costs (particularly compliance costs) attributable to the introduction of VAT regimes, increased governmental

5 At 65.

attention to the role of small business, and efforts to reduce administrative costs that may have increased compliance costs.

With respect to the studies themselves, they have considered almost every kind of tax, but have focused primarily on business taxpayers, particularly employers. For the most part, these studies have been quantitative in orientation and survey-based. Although most consider only one jurisdiction, a few recent studies have adopted a comparative perspective.

With respect to the results of this research, studies suggest that compliance costs are significant for most of the major taxes on which developed countries rely (personal income taxes, corporate income taxes, and value-added or goods and services taxes), ranging from 2 to 10 percent of revenue collected, averaging about 2.5 percent of gross domestic product in aggregate, and exceeding government administrative costs by two to six times. As a general rule, moreover, these compliance costs are regressively distributed—particularly in the case of VATs or GSTs, which impose a much heavier compliance burden on small businesses than large incorporated enterprises.

In conclusion, Evans suggests that future research into taxation operating costs is likely to be both deeper and broader—investigating particular problem areas while drawing on other methodologies and disciplines and adopting a more comparative orientation. Finally, he suggests, "[t]he greatest contribution that research into operating costs can make in the future is to ensure that those who formulate and implement legislative change are properly informed as to the operating cost implications of their actions."[6] Though these implications need not be decisive, he emphasizes that they should not be ignored as they have been so often in the past.

D.D.

Aradhna Krishna and Joel Slemrod, "Behavioral Public Finance: Tax Design as Price Presentation" (2003) vol. 10, no. 2 *International Tax and Public Finance* 189-203

This rather innovative article uses evidence from marketing research about behavioural biases in processing information to explore whether tax laws—consciously or unconsciously—present the tax system in a way that minimizes people's awareness of the true size of the tax burden and defuses their objections to the effects produced by the tax laws. For example, the tax system calculates taxable income and then applies a series of credits for medical expenses, charitable contributions, disability, and so forth. It would be possible to create a nearly equivalent income tax system that features a lower baseline tax liability plus tax surcharges for those who are

6 At 74.

uncharitable, who have low medical expenses, who are not disabled, and so forth. The former approach can be thought of in marketing terms as a way to suggest that the taxpayer eligible for these credits is getting a special "discount" on their taxes, just as insurance policies feature non-smoker or good-driver discounts instead of smoker or bad-driver surcharges.

Another example is the underestimation of the cost of future effort. Consumers often buy a product with an attached rebate coupon with the idea that the rebate is equivalent to a price reduction. However, consumers often fail to apply for these rebates, and this cost reduction is a factor in a firm's choice to employ these rebates. Similarly, targeted tax credits and deductions are often greeted with more public favour than seems warranted, and the possible reason is that taxpayers fail to realize the effort involved in documenting the tax-favoured activities.

The information presented in the article may be viewed as a scheming politician's guide to raising taxes, but it could be used by taxpayer advocates as a guide to government strategies that should be protested.

A.M.

Martin J. McMahon Jr., "Beyond a GAAR: Retrofitting the Code To Rein in 21st Century Tax Shelters" (2003) vol. 98, no. 12 *Tax Notes* 1721-48

In recent years, a proliferation of tax shelter transactions in the United States, coupled with a few key judicial decisions in which taxpayers have prevailed, has led several commentators to ask whether the United States should codify one or more of the judicial anti-avoidance doctrines that their courts have employed for several years, or adopt a general anti-abuse or anti-avoidance rule.[7] Indeed, proposed legislation would codify the US "economic substance doctrine" by specifying that "tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose," and stipulating that

> a transaction has economic substance only if—
> (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> (ii) the taxpayer has a substantial non-tax purpose for entering into such a transaction and the transaction is a reasonable means of accomplishing such purpose.[8]

In this article, McMahon, a professor of law at the University of Florida, reviews this proposed legislation and defends it and other statutory amendments as a response to tax shelter transactions.

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7 See, for example, Ellen P. Aprill, "Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines" (2001) vol. 54, no. 1 *SMU Law Review* 9-35.

8 Section 101 of introduced but unenacted American Competitiveness and Corporate Accountability Act of 2002, HR 5095, 107th Cong., 2d sess., adding section 7701(m) to the Internal Revenue Code of 1986, as amended.

Part I of the article reviews both the draft legislation and the criticisms advanced by the American Bar Association Tax Section; the New York State Bar Association Tax Section; and David Hariton, a tax practitioner at Sullivan and Cromwell in New York. As a general rule, critics argue that codification would rob the economic substance doctrine of its flexibility and that the provision itself is too broad.

Parts II to IV respond to these criticisms, tracing the origins of the proposed test to US judicial decisions (part II), defending the values underlying the economic substance doctrine and other anti-avoidance rules (part III), and emphasizing the need for a statutory anti-avoidance rule to resolve the conflicting views of different circuit courts, to ensure the survival of these anti-avoidance doctrines from potential reversal by the Supreme Court, and to "provide a more salient warning to practitioners and taxpayers that a literal interpretation of the code and regulations that produces a result that is 'too good to be true' is exactly that" (part IV).[9] Part V presents a number of alternative statutory reforms to address the problem of tax shelter transactions. Part VI returns to the codification of the economic substance doctrine, concluding that this approach is likely to be "far less complex and less far reaching"[10] than the numerous specific amendments proposed in part V.

D.D.

Daniel Shaviro, "Money on the Table? Responding to Cross-Border Tax Arbitrage" (2002) vol. 3, no. 2 *Chicago Journal of International Law* 317-31

Cross-border tax arbitrage has been defined as taking advantage of inconsistencies between different countries' tax rules in order to achieve a more favourable result than that which would have resulted from investing in a single jurisdiction.[11] Common examples include (1) the deduction of corporate losses in two countries through the use of a dual-residence company that is a member of a resident group of companies in each country among which income and losses are consolidated or losses can be transferred, and (2) "double-dip leases" in which depreciation deductions are claimed by the legal owner of depreciable property in a civil law jurisdiction and the beneficial owner in a common law jurisdiction.

In this article, New York University School of Law professor Dan Shaviro examines the national and global welfare considerations that may be relevant to a country's decision whether or not to permit tax benefits that are duplicated in other countries, drawing implications from this analysis for international tax cooperation. For this purpose, he first considers US behaviour in isolation, assuming that US responses to cross-border tax arbitrage have no impact on other countries' decisions, before

9 At 1735.

10 At 1748.

11 See, for example, Philip R. West, "Foreign Law in U.S. International Taxation: The Search for Standards" (1996) vol. 13, no. 12 *Tax Notes International* 987-1008, at 1000; and H. David Rosenbloom, "International Tax Arbitrage and the 'International Tax System'" (2000) vol. 53, no. 2 *Tax Law Review* 137-66, at 142.

considering the more realistic scenario in which US action may provoke a response by the other country concerned.

Beginning with the isolationist perspective, Professor Shaviro concludes that the unilateral denial of deductions may or may not be welfare enhancing. To the extent that double deductions create a worldwide tax preference for these transactions that distorts economic decisions, this response may enhance domestic and global welfare, both by eliminating the preference and raising domestic revenues that can be used to reduce economically distorting taxes on something else. To the extent that the double deduction offsets other distortions such as domestic double taxation of corporate income, however, it is possible that this response would diminish overall welfare.

Turning to the more realistic scenario where US action can provoke a response by the other country concerned, Professor Shaviro at first questions why other countries should be concerned if the United States denies a tax benefit that was not deliberately intended by the other country and results solely from the interaction of the tax rules of both countries. Although speculating that the other country could be grateful to the United States for stepping in (because US action could induce the other country's residents to make better investments and spend less money on tax planning), he concludes ("a lot more reasonably") that the other country might object to the United States capturing the entire fiscal benefit. Not surprisingly, the other country might respond by disallowing the benefit—as the United Kingdom did with dual-residence companies after the United States eliminated loss consolidation—resulting in double non-deductibility. Because other countries may be slow to act, and taxpayer self-help through tax planning and political pressure can minimize "bilateral overkill," Shaviro concludes that "opportunities to free-ride on other countries' willingness to offer deductions . . . may often be worth exploiting."[12]

In the final section of the article, Professor Shaviro considers the implications of this analysis for international tax cooperation. Noting that the elimination of cross-border tax arbitrages resembles tax base harmonization, but without requiring different countries to adopt the same rules, he concludes that challenges to effective bilateral coordination in this area might favour multilateral arrangements.

D.D.

Robert P. Dellavalle, Lisa M. Schilling, Alan K. Chen, and Eric J. Hester, "Teenagers in the UV Tanning Booth? Tax the Tan" (2003) vol. 157, no. 9 *Archives of Pediatrics & Adolescent Medicine* 845-46

Taxing tans? It sounds like a joke, but the authors have some reasonable arguments for proposing a US$20 tax per commercial tanning session for those younger than 18 years old. Consider these points: skin cancer is the most commonly diagnosed cancer; youth represents an especially critical period during which ultraviolet radiation increases skin cancer risk; more than 25 percent of US white female adolescents

12 At 329.

have used tanning booths three or more times in their lives;[13] and, on the basis of evidence from tobacco taxation, tax-induced price increases are very effective in reducing young people's exposure to carcinogens. Taxing tans from tanning booths may be even more effective than tobacco taxes, because many youths obtain cigarettes from friends or parents, but tans are, to quote the authors, "not a commodity easily shared after purchase."[14]

A.M.

Richard W. Tresch, *Public Finance: A Normative Theory*, 2d ed.
(London: Academic Press, 2002), 950 pages, ISBN 0-12-699051-4

This well-known PhD-level text in public economics was first published more than 20 years ago, in 1981. It retains the same five-part structure of the original: an introduction, first-best theory, second-best theory, cost-benefit analysis, and fiscal federalism. One difference of particular interest between this book and competing texts is that it provides a thorough discussion of some of the more applied issues in the economics of taxation: the Haig-Simons definition of income (at 338-44), tax capitalization and its implications for tax reform (at 363-70), accrual-equivalent methods of taxing capital gains on realization (at 373-78), economy-wide empirical studies of tax incidence (at 585-621), and income testing of transfer payments (at 634-46).

A.M.

Alan J. Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 4 (Amsterdam: North-Holland, 2002), 643 pages, ISBN 0-444-82315-8

The fourth volume of this highly reputed series presents nine new surveys of different parts of the public economics literature: "Tax Incidence" by Don Fullerton and Gilbert E. Metcalf, "Generational Policy" by Laurence J. Kotlikoff, "International Taxation" by Roger H. Gordon and James R. Hines Jr., "Local Public Goods and Clubs" by Suzanne Scotchmer, "Publicly Provided Education" by Eric A. Hanushek, "Health Care and the Public Sector" by David M. Cutler, "Social Security" by Martin Feldstein and Jeffrey Liebman, "Labor Supply Effects of Social Insurance" by Alan B. Krueger and Bruce D. Meyer, and "Welfare Programs and Labor Supply" by Robert A. Moffitt.

A.M.

13 Catherine A. Demko, Elaine A. Borawski, Sara M. Debanne, Kevin D. Cooper, and Kurt C. Stange, "Use of Indoor Tanning Facilities by White Adolescents in the United States" (2003) vol. 157, no. 9 *Archives of Pediatrics & Adolescent Medicine* 854-60.

14 At 845.

Herbert G. Grubel, ed., *Tax Reform in Canada: Our Path to Greater Prosperity* (Vancouver: Fraser Institute, 2003), 262 pages, ISBN 0-88975-199-4

A few of the papers in this volume are of interest. Finn Poschmann and William Robson survey whether tax competition is good or bad for the country. Thomas A. Wilson reviews developments in business taxation since the Technical Committee on Business Taxation reported in 1997. Kenneth J. McKenzie compares recent tax policy in Alberta and Ontario and produces some interesting observations. In particular, he notes that the tax-induced brain drain to the United States is relatively small, and fiscally induced migration among provinces is much more likely; hence, progressive rate structures are best imposed by the federal government rather than the provinces. He also argues that corporate rate cuts in Ontario create a disincentive to invest in Alberta through a novel channel: the corporate income tax allocation formula, through the weight it gives to salaries, effectively creates a tax on hiring new workers in Alberta.

A.M.

Jason Clemens, Joel Emes, and Rodger Scott, *The Corporate Capital Tax: Canada's Most Damaging Tax*, Public Policy Sources no. 56 (Vancouver: Fraser Institute, 2002), 62 pages

This study provides useful information on Canada's vanishing capital taxes, including detail on the relative reliance of different provinces on this revenue source.

A.M.

Australian Taxation Office, *Large Business and Tax Compliance* (Canberra: Australian Taxation Office, 2003), 30 pages

Ken Kies, "CEO Tax Return Signing—Worst Idea of the Decade?" (2003) vol. 99, no. 13 *Tax Notes* 1974-76

Enron and other recent financial scandals seem to have had an impact on the public's views of aggressive tax avoidance by large corporations. So far not much has happened in Canada; even Enron's Slapshot deal to avoid Canadian taxes seemed to have more impact in the United States. Still, the issue has assumed a high profile.

Kies's article notes that a Senate-passed economic growth bill would require that corporate tax returns follow the pattern of the Sarbanes-Oxley legislation for financial statements and would have to be certified by a company's chief executive officer as being true, correct, and complete. Could this "worst idea of this decade"[15] come to Canada?

15 At 1974.

Also in that vein, the report by the Australian Tax Office adopts the most confrontational approach to business tax compliance that we have seen in some time. A single quotation conveys the spirit of the document:

> Where large businesses consistently seek to avoid their tax obligations—whether through tax planning designed to avoid the policy reflected in the law, or through careless or reckless approaches to tax compliance—we will maintain our audit activity until we can be confident that a more constructive approach has developed.[16]

The report goes on to document the specific types of transactions that are of concern and presents a checklist for a chief executive officer of indications that his or her company may be involved in non-compliance behaviours.

A.M.

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16 At 6.