Current Tax Reading

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The Canadian Tax Foundation is pleased to welcome Amin Mawani of the Schulich School of Business at York University, Toronto, as co-editor of the Current Tax Reading feature. Professor Mawani, who is a frequent contributor of articles to this journal, earned his PhD in taxation from the University of Waterloo, his LLM from Osgoode Hall Law School at York University, and his MA in Economics from the University of Toronto. He is also a certified management accountant and a certified financial planner. With his research and teaching interests in the tax aspects of accounting, finance, and public economics, Professor Mawani promises to bring to the feature a variety of interesting and useful reviews of the current tax literature.

Alan J. Auerbach and Kevin A. Hassett, eds., *Toward Fundamental Tax Reform* (Washington, DC: American Enterprise Institute Press, 2005), 171 pages, ISBN 0844742341

The tax reform drums seem to beat constantly in the United States. Only the volume of the beat seems to vary. The unravelling of the 1986 tax reform has apparently turned up the volume, with President Bush now promising tax reform (and not just tax cuts) as a centrepiece of his second term.

A sure sign that the tax reform drums in a country are beating ever more loudly is the migration of tax academics and tax policy analysts to seminars, conferences, and symposia (choose your favourite label) to weigh in on the composition of the tax reform agenda. This collection of essays is evidence of such a stirring of interest in US tax reform. It consists of the following papers by nine leading US tax policy analysts on the question of "fundamental tax reform," as that term is used (uniquely perhaps) in US political and policy circles:

- David F. Bradford, "A Tax System for the Twenty-First Century"
- William G. Gale, "Tax Reform Options in the Real World"

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- Michael J. Graetz, "A Fair and Balanced Tax System for the Twenty-First Century"
- Robert E. Hall, "Guidelines for Tax Reform: The Simple, Progressive Value-Added Consumption Tax"
- R. Glenn Hubbard, "Would a Consumption Tax Favor the Rich?"
- Casey B. Mulligan, "Politics and Economic Perspectives on Taxes' Excess Burdens"
- Ronald A. Pearlman, "A Tax Reform Caveat: In the Real World, There Is No Perfect Tax System"
- Edward C. Prescott, "The Elasticity of Labor Supply and the Consequences for Tax Policy"
- Joel Slemrod, "My Beautiful Tax Reform."

The editors provide a valuable introduction and conclusion. The former sets the stage, more or less, for the essays; the latter draws them together thematically.

In general, the essays reflect certain unique aspects (some might say pathologies) of the US tax reform debate. For example, both of the editors, as well as seven of the contributors, are economists, mirroring the dominance of economists in the academic discussion of tax reform in the United States. Although this dominance is not surprising, given the necessary economic content of any serious debate on tax reform, it has arguably been a significant factor in focusing the US debate on a single issue: the replacement of the income tax with some form of consumption tax. This single-mindedness may be attributable, in part, to the emphasis that economists place on market-exchange efficiency and, in particular, the alleged distortion of the savings/consumption decision, which is presumed to be a property of an income tax, with its double taxation of savings.

It is not surprising, therefore, that one of the principal themes of this volume is the need for a greater role for consumption taxes in the US tax mix. In this respect, Bradford describes yet again his ideal of a progressive consumption tax, which he has labelled "the X tax." Hall also reprises his version of a subtraction-method value-added tax (VAT), which would have a similar element of progressivity that is uncharacteristic of invoice/credit VATs used in most countries. The essay by Bradford is especially notable because of his untimely death from injuries suffered in a house fire earlier this year. It is probably the last written work that we will see from this public finance giant.

Hubbard tackles straight on the principal argument against consumption taxes—that they have undesirable distributional consequences. Mulligan argues that consumption taxes should be combined with greater reliance on payroll taxes in order to minimize tax-induced distortions. Prescott, however, argues that the elasticity of labour supply has been underestimated in the literature, and tax policy makers should be cautious about increasing personal income taxes or payroll taxes. He believes that the benefits of increasing reliance on consumption taxes have been underestimated because of a failure to appreciate the elasticity of labour supply over the medium to long term.

Each of the essays by Gale, Graetz, Pearlman, and Slemrod describes a tax reform agenda that includes a mix of income tax reforms, rather than the prescription of consumption taxes as the panacea for all the ills that are perceived to afflict the US economy. These essays are notable for their more realistic perspective on tax reform. In particular, the authors recognize that replacement of the income tax with some form of consumption tax is exceedingly risky, given the uncertainty of the potential efficiency gains. Moreover, the intractable transitional issues associated with such a reform are seen to seal its fate, leaving it as nothing more than the plaything of academics. It is interesting though that Graetz, one of the two tax lawyers in this volume, advocates what is probably the most radical of the realistic tax reform agendas, largely because of the reduced role he envisages for the personal income tax. In fact, however, Graetz's proposal would move the United States closer in many respects to the rest of the world in its tax mix at the federal government level. By way of contrast, Pearlman's essay reflects the realism (some might say cynicism) of a tax lawyer who has spent a large portion of his career in government in the tax reform trenches. His experience makes him pessimistic about any reform that would alter the US tax mix in any substantial manner. He would prefer, therefore, to reprise the 1986 tax reform, which resulted in a substantial broadening of the income tax base. This position is echoed to a large extent by Gale, who rightly notes that the Graetz proposal is not sufficiently detailed to disclose many of its important properties, including its revenue effects.

Non-economists will find this volume especially refreshing for its lack of the mathematical modelling that is grist for the economics profession. The contributions by the tax economists are all accessible to readers who do not have the technical tools of the trade. Indeed, they are well-written and easy-to-read expositions of much of the current state of play in tax policy analysis from an economics perspective.

T.E.

Robert Attard, *An Introduction to Income Tax Theory* (Luqa, Malta: Agenda, 2005), 412 pages, ISBN 9993267279

The title of this book is incomplete, given that the subject is, in fact, the income tax system of Malta. A better title might well be something along the lines of "An Introduction to Income Tax Theory and Practice in Malta," so as not to suggest a book that is squarely within the mainstream of the tax literature. Yet, because the author packages his subject within a broad conceptual framework that applies across country tax systems, his title is defensible, at least in part. Moreover, it may pique the curiosity of readers who would otherwise ignore a book on the Maltese income tax system. There is much in this book that should be of general interest to a broad range of readers, including those who just want to know something about the income tax in Malta.

The book is especially worthwhile for the access it provides to a body of case law that would otherwise be inaccessible to English-speaking readers. This case law should be of particular interest to tax practitioners in Commonwealth countries because of the shared influence of UK judicial authority. The book provides a deep and nuanced discussion of Maltese tax decisions across the range of usual income tax issues, including jurisdictional rules, tax base and unit definitions, and procedural rules. The four core chapters of the book (chapters 3 to 6) are devoted to a description and analysis of the concept of chargeable income (chapter 3), jurisdiction to tax (chapter 4), the definition of taxable persons (chapter 5), and the enforcement powers of the Commissioner of Inland Revenue (chapter 6). In each chapter, the author illustrates how UK concepts have been translated into Maltese legislation and how those concepts have been massaged in the indigenous tax jurisprudence.

The book also begins with an interesting review of the history of the income tax in Malta (chapter 1). This historical review is followed by a discussion of fundamental human rights and the income tax, which is especially noteworthy in light of the now incessant and often annoying forays of the European Court of Justice into tax law. The final chapter (chapter 7) reviews the concepts of tax evasion and avoidance as developed in Maltese income tax law.

T.E.

Richard Eccleston, *The Thirty Year Problem: The Politics of Australian Tax Reform*, Research Study no. 42 (Sydney: Australian Tax Research Foundation, 2004), 206 pages, ISBN 0949482811

This book adds to a burgeoning literature on the politics of taxation. In many respects, the book is the Australian counterpart to Geoffrey Hale's earlier book on the politics of taxation in Canada.[1] Both books cover much the same period (the mid-1970s to the present) and the authors use a similar methodology, essentially describing the relevant events chronologically and critiquing them through the lens of institutional politics. Readers unfamiliar with the history of tax reform in Australia during this period should find Eccleston's account of events informative; it is also, notably, quite comprehensive. The discussion is less compelling, however, when Eccleston moves from the particular to the general in an effort to identify the institutional factors that he believes have shaped the politics of tax reform in Australia. Part of the problem may be that the more generalized analysis is not especially accessible to readers who are untrained in the jargon and associated concepts that are, presumably, the tools of political scientists.

T.E.

1 Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press, 2001), reviewed in this feature (2002) vol. 50, no. 1 *Canadian Tax Journal* 410-27, at 410-11, and the subject of commentary in the Policy Forum feature (2002) vol. 50, no. 6 *Canadian Tax Journal* 2025-58.

Yoram Keinan, "Book Tax Conformity for Financial Instruments"
(2004) vol. 6, no. 7 *Florida Tax Review* 676-753

Linda M. Beale, "Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor" (2004) vol. 24, no. 2 *Virginia Tax Review* 301-474

The tax literature is replete with critiques and condemnations of income tax regimes for financial instruments that tax policy makers have developed independently of financial accounting standards and practices. With the possible exception of the New Zealand accruals regime, no independent tax accounting regime appears to escape unscathed. The strongest criticism seems to be directed against the United States, where tax policy makers have arguably been the most active in developing detailed legislative responses to the products of financial innovation. This chorus of criticism contrasts sharply with the predominantly positive characterization of the recent developments in financial accounting for financial instruments.

The very different attitudes in the literature to the tax and financial accounting regimes for financial instruments have predictably led to a call from some tax commentators for closer alignment of these regimes, following the model used in the United Kingdom and many continental European countries.[2] A parallel is found in the general calls for alignment of tax and financial accounting in the measurement of business income for tax purposes. In particular, compliance and administrative imperatives are seen to support reliance on financial accounting, at least in the first instance, in the measurement exercise. The two articles reviewed here address the issue of book-tax conformity in the US context, focusing specifically on the application of mark-to-market recognition or valuation for income tax purposes to certain financial instruments (Keinan) and swap transactions (Beale).

Keinan examines the current relationship between tax and financial accounting for financial instruments in the United States. Following a cursory review of the pros and cons of book-tax conformity, he compares the recent developments in financial accounting with the US tax accounting regime in terms of the classification of financial instruments, the rules governing the timing of the recognition of gain or loss, and the valuation of financial instruments. The article concludes with a proposal that borrows heavily from financial accounting practice for timing rules governing the recognition of gain or loss on debt instruments, shares, and derivative financial instruments. More particularly, Keinan would apply mark-to-market recognition for derivatives and a broad range of debt instruments and shares, including shares that are the subject of a fair value hedge.

2 See, for example, John J. Ensminger, "Concerto for Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?" (2001) vol. 16 *Akron Tax Journal* 23-98; and Steven M. Rosenthal and Mark H. Price, "Tax and Accounting for Derivatives: Time for Reconciliation" (1999) vol. 84, no. 6 *Tax Notes* 895-908.

Beale's article critically reviews the book-tax conformity debate within the specific context of corporate tax shelters in the United States. The article begins with a historical account of book-tax conformity in the measurement of business income for US tax purposes. This is followed by a first-rate discussion of normative and pragmatic criteria for the evaluation of conformity proposals. Beale argues that any such proposal should be assessed in terms of its "structural coherence" and "self-assessment" properties. In particular, Beale believes that pragmatic concerns of compliance costs and administrative simplicity can support a proposal for book-tax conformity only where the proposal conforms to the overall structure of the income tax and minimizes the ability of taxpayers to manipulate their tax liabilities.

Beale then analyzes the proposed mark-to-market safe harbour rule for the swap book of securities broker-dealers, to demonstrate the application of her evaluative criteria. Under the proposed safe harbour, this category of taxpayers would be permitted to value their swap book for income tax purposes consistent with the relevant financial accounting methodology. Beale's exhaustive analysis of the proposed safe harbour leads her to conclude that it fails to satisfy her second evaluative criterion: that is, valuation methodologies for swap dealers leave wide scope for discretion, which could be used to manipulate tax liabilities. Moreover, because this discretion could permit deferral of the recognition of the dealer spread that was intended to be accelerated under the mark-to-market accounting regime, Beale also concludes that the proposed safe harbour fails to satisfy her first evaluative criterion of structural coherence. Beale suggests a number of provisions that would have to be adopted for income tax purposes to ensure that swap books are appropriately marked to market.

T.E.

Michael Kobetsky, "Attribution of Profits to Branches of International Banks: The OECD Discussion Drafts" (June 2005) vol. 20 *Banking & Finance Law Review* 319-60

Michael Kobetsky, "Intra-Bank Loans: Determining a Branch's Business Profits Under Article 7 of the OECD Model" (2005) vol. 59, no. 2 *Bulletin for International Fiscal Documentation* 48-62

The project of the Organisation for Economic Co-operation and Development (OECD) on the attribution of profits to a permanent establishment under article 7 of the model treaty appears to be rolling to a conclusion, although the precise details of the final outcome remain in some doubt. The general aim of the project is to import the arm's-length principle, developed in the context of associated enterprises, to the head office/branch context.

The first of these two articles provides a useful overview of the genesis of the OECD project, its apparent rationale, and the initial iteration of "the working hypothesis," which purported to explore the extent to which the arm's-length principle could, in fact, be imported into the head office/branch context. However, Kobetsky's focus is limited to part II of the OECD discussion draft, which explores the working hypothesis in the context of international branch banking.[3] Kobetsky argues that the highly integrated nature of an international bank organized in branch form makes application of the arm's-length principle inappropriate. In particular, the absence of transactions between a head office and its branches would introduce significant compliance and administrative costs that are difficult to justify. Moreover, the discussion draft itself recognizes the conceptual inappropriateness of the application of the arm's-length principle to branch banking by creating exceptions to its application in many areas. Most important perhaps, the various approaches to the allocation of bank capital are difficult to rationalize in terms that have any basis in economic logic. In the absence of any such basis, Kobetsky argues that OECD member countries should attempt to reach a consensus on a minimum amount of equity capital allocable to a branch. The goal could be realized by denying a fixed portion of a branch's interest expense deduction.

In the second article, Kobetsky develops in more detail his argument regarding the allocation of debt and equity capital of a bank operating internationally in branch form. He reviews in detail the portion of the commentary on article 7 that sanctions the recognition of intrabank loans in a branch context. He believes that such recognition was conceptually ill founded, and the resultant problems would only be compounded by the extension of the arm's-length principle to the determination of branch profits. Kobetsky apparently favours some form of formulary apportionment of bank interest expense as the only allocation method that suitably recognizes the highly integrated nature of head office/branch operations in international banking.

T.E.

Jim O'Donnell, "Quarantining Interest Deductions for Negatively Geared Rental Property Investments"
(2005) vol. 3, no. 1 *eJournal of Tax Research* 63-113

The appropriate role of the reasonable expectation of profit (REOP) standard as a precondition for the recognition of losses under Canada's Income Tax Act[4] has arguably moved the issue of restrictions on the deduction of interest expense closer

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3 Organisation for Economic Co-operation and Development, *Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part II (Banks)* (Paris: OECD, March 2003). The application of the arm's-length principle to branches of non-financial businesses is explored in *Discussion Draft on the Attribution of Profits to Permanent Establishments—Part I (General Considerations)* (Paris: OECD, August 2004). Part III explores the application of the principle to securities trading: *Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs): Part III (Enterprises Carrying on Global Trading of Financial Instruments)* (Paris: OECD, March 2003). Part IV, dealing with insurance, was released in 2005: *Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment: Part IV (Insurance)* (Paris: OECD, June 2005).

4 RSC 1985, c. 1 (5th Supp.), as amended.

to the front of the tax-policy burner. The fate of the Department of Finance's proposal to legislatively resurrect the REOP standard[5] (and enhance it) in the wake of the Supreme Court's decisions in *Stewart*[6] and *Walls*[7] remains uncertain, however. A similar, though not necessarily judicially motivated, debate over interest deductibility restrictions has waxed and waned in Australia. To some extent, the debate has heated up following a recent report of the Australian Productivity Commission suggesting that the unrestricted deduction of interest expense on borrowings used to acquire rental property has fuelled a real estate bubble.[8]

The author of this article argues that the interest deductibility debate in Australia has been framed incorrectly. In particular, O'Donnell argues that the interest deductibility issue should be assessed in terms of the consequential attributes of an unrestricted versus a restricted deduction. That is, different deductibility rules should be assessed in terms of their effects on the allocation of resources in the economy and the distribution of the tax burden. In this respect, the first part of the article reviews the evidence for two quite different claims regarding the effect of an unrestricted interest expense deduction in Australia. One claim is that the lack of any deductibility restrictions has increased housing prices. The other claim is that an unrestricted deduction has increased the level of housing stock. After reviewing the empirical evidence, O'Donnell concludes that neither claim is supportable and, in the absence of any positive consequential attributes of an unrestricted deduction, some form of restriction should be adopted.

The second part of the article reviews various legislative options to restrict the deduction of interest expense. O'Donnell argues that the preferable form of restriction for Australia is one that extends beyond rental real estate to apply to investment assets generally; it would also apply on an asset-by-asset basis. The latter feature would mean that interest expense linked with a particular asset would be capitalized to the extent that it exceeded taxable revenue from the asset in any year. There would be no ability to offset excess interest expense associated with one asset against revenue from another asset. This form of interest deductibility restriction is tighter than the US passive loss rules and resembles the deductibility restrictions originally proposed by Michael McIntyre, a US tax academic.[9]

T.E.

5 Canada, Department of Finance, *News Release* 2003-055, October 31, 2003.

6 *Stewart v. The Queen*, 2002 DTC 6969; [2002] 3 CTC 439 (SCC).

7 *The Queen v. Walls et al.*, 2002 DTC 6960; [2002] 3 CTC 421 (SCC).

8 Australia, Productivity Commission, *First Home Ownership*, Report no. 28 (Melbourne: Productivity Commission, June 2004), 75-121, reviewed in this feature (2004) vol. 52, no. 4 *Canadian Tax Journal* 1285-1303, at 1296.

9 See, for example, Michael J. McIntyre, "Tracing Rules and the Deduction for Interest Payments: A Justification for Tracing and a Critique of Recent U.S. Tracing Rules" (1992) vol. 39, no. 1 *Wayne Law Review* 67-120.

Martin J. McMahon Jr. and Ira B. Shepard, "Privilege and the Work Product Doctrine in Tax Cases"
(2005) vol. 58, no. 2 *The Tax Lawyer* 405-34

This article provides a succinct overview of the circumstances in which, under US tax law, taxpayers can deny access to tax advisers' communications and related documents in litigation proceedings. The scope of such protection in the United States extends beyond the conventional solicitor-client privilege in other countries. Nonetheless, the article should be of interest to non-US tax practitioners for some analogous judicial reasoning. As the authors note, the corporate tax shelter firestorm has magnified the significance of the privilege claim in the United States. They also point out that a careful review of the relevant US authorities suggests that the scope of the privilege is not as broad as some practitioners believe.

T.E.

Bolivia S.W. Cheung and Alice P.L. Chui, "A Comparison of the International Monetary Fund and the People's Republic of China VAT Policies" (2004) vol. 30, no. 2 *International Tax Journal* 10-16

This brief article compares the broad design features of the VAT in the People's Republic of China with the design features of the VAT endorsed by the International Monetary Fund (IMF). The authors conclude that the VAT in the PRC conforms to the IMF model in many respects. The principal deviation is the treatment of VAT on capital inputs in the production process. Under the VAT in the PRC, input credits are unavailable for businesses in respect of their purchases of capital goods, resulting in tax cascading. The authors review the rationale for this treatment and the need for reform, but suggest that reform is unlikely in the near term because of the associated revenue loss.

T.E.

Simon James, Kristina Murphy, and Monika Reinhart, "Taxpayer Beliefs and Views: Two New Surveys"
(2005) vol. 20, no. 2 *Australian Tax Forum* 157-88

This article presents the results of two large Australian surveys on taxpayer attitudes. The survey evidence is consistent with the school of thought in behavioural economics that posits that taxpayer compliance behaviour is influenced by a wide range of social and psychological factors. A contrary school of thought maintained by neoclassical economists argues that taxpayer compliance behaviour is the outcome of a rational calculation of financial costs and benefits. Yet the proposition that compliance behaviour is a function of a variety of social and psychological factors is so intuitively obvious that it is a testament to the intellectual hegemony of neoclassical economics that its impoverished view of human nature still holds any currency in the literature on taxpayer compliance behaviour.

Given the predictability of the survey results, this article is more interesting for its discussion of the general conceptual backgrounds associated with the two schools of thought on taxpayer compliance behaviour. One of the authors' more important observations is the recognition that the tax authorities' goal of tax compliance entails much more than prevention of tax evasion and, in particular, extends to a broad range of enforcement mechanisms that are not focused on tax evasion per se. The authors also provide some useful suggestions regarding possible compliance strategies based on a broader view of the motivations underlying taxpayer compliance behaviour. Some of these strategies have been the subject of a compliance project undertaken by the Australian Taxation Office.

T.E.

United States, Government Accountability Office, *Tax Expenditures Represent a Substantial Federal Commitment and Need To Be Reexamined*, GAO-05-690 (Washington, DC: Government Accountability Office, September 2005), 130 pages, available on the Web at http://www.gao.gov/cgi-bin/getrpt?GAO-05-690

The title of this US GAO report should be a rallying point for all tax reformers. The report essentially updates an earlier GAO report on tax expenditures released in 1994.[10] It criticizes the US executive branch for failing to take steps to (1) improve the transparency of tax expenditure reporting, (2) integrate tax expenditures with spending programs in the budgetary process, and (3) conduct periodic reviews of the goals and effectiveness of specific tax expenditure programs. The report also presents data on the growth of US tax expenditures over the past 30 years, following the institution of the tax expenditure account.

One of the appendixes to the report reproduces the comments of the Office of Management and Budget (OMB). Under the current Bush administration, the OMB has been especially critical of the tax expenditure concept. The comments here reflect many of the standard criticisms, including a litany of methodological problems encountered in any attempt to measure the magnitude of the revenue loss from tax expenditures. The OMB insists that a focus on tax expenditures would lead to undesirable tax increases, given the US federal budgetary circumstances. One cannot help but suspect that the OMB's position reflects that of business interests and a broad range of politicians, who incessantly extol the virtues of the market and call for government to limit its regulatory role; at the same time, many of these same individuals support tax expenditure programs for various market activities. Taking the tax expenditure concept seriously would no doubt expose the hypocrisy of many

10 United States, Government Accounting Office, *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO-94-122 (Washington, DC: Government Accounting Office, June 1994).

of those who insist on a limited regulatory and redistributive role for government in the so-called global economy.[11]

T.E.

Miranda Stewart, "Venture Capital Tax Reform in Australia and New Zealand" (2005) vol. 11, no. 2 *New Zealand Journal of Taxation Law and Policy* 216-49

Given the pervasiveness of tax and non-tax subsidies for venture capital, it is surprising that so little has been written on the subject. Daniel Sandler's recent study for the Canadian Tax Foundation is the only comprehensive examination of tax subsidies for venture capital that we are aware of.[12] This article by an Australian tax academic at the University of Melbourne law school is therefore a welcome addition to a slender literature.

Stewart reviews in detail some recent legislative initiatives in both Australia and New Zealand that provide a range of tax preferences intended to attract foreign venture capital, as well as foster a domestic venture capital industry. These tax preferences are combined with the development of a legal entity that would provide limited liability for investors and flowthrough treatment for income tax purposes. Stewart argues that these Australian and New Zealand initiatives are modelled on the US approach to fostering venture capital, which focuses on the later stages of the venture capital cycle—that is, the expansion and buyout stages. She notes, however, that a largely hidden subsidy in the US tax system is the valuation approach to employee stock options, which, when combined with the issuance of convertible preferred shares to venture capital funds, provides more of a front-loaded tax subsidy for the entrepreneurs who are responsible for the early development of high-growth start-up firms. In effect, this particular subsidy kicks in at the earlier stages of intellectual property commercialization. Moreover, the US legal system provides for a range of legal entities that combine limited liability and flowthrough tax treatment at the level of the operating business and not just the venture capital investment fund. As a result, start-up losses are available to entrepreneurs for tax use. Neither the Australian nor the New Zealand reform initiatives (nor the Canadian tax and legal systems, for that matter) incorporate these features of the US tax and

11 See, in this respect, Joseph E. Stiglitz, *The Roaring Nineties* (New York: Norton, 2003), 106-12 (criticizing corporate welfare and corporate hypocrisy). See also Joel Slemrod, "My Beautiful Tax Reform," in Alan J. Auerbach and Kevin A. Hassett, eds., *Toward Fundamental Tax Reform* (Washington, DC: American Enterprise Institute Press, 2005), 135-48, at 139 (reviewed above): "This is the issue that separates the tax-reform men from the tax-reform boys concerning the most fundamental of all questions—the extent of government involvement in the economy. Many conservatives who pay lip service to limited government get cold feet when it comes to sweeping away the interventions that occur via the tax system."

12 Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Canadian Tax Paper no. 108 (Toronto: Canadian Tax Foundation, 2004).

legal systems. The absence of these features means that the recent reforms may end up benefiting investors and fund managers, rather than the entrepreneurs who are responsible for the development of the intellectual property that is the driving force behind the venture capital sector.

T.E.

Canada, Department of Finance, *Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)* (Ottawa: Department of Finance, September 2005), 39 pages, available on the Web at http://www.fin.gc.ca/toce/2005/toirplf_e.html

Paul Halpern, *Is the Trust in Trusts Misplaced? A Study of Business Income Trusts and Their Role in Canadian Capital Markets* (Toronto: University of Toronto, Capital Markets Institute, November 2004), 51 pages, available on the Web at http://www.rotman.utoronto.ca/cmi/IncomeTrust.pdf

(Editor's note: Shortly before this issue of the journal went to press, on November 23, 2005, the Minister of Finance announced that he would table a notice of ways and means motion enhancing the dividend tax credit for eligible dividends paid generally by public corporations. The proposed measure, which is to take effect starting in 2006, is intended to level the playing field between income trusts and public corporations by lowering the personal income tax rate on dividends paid by the latter.)

The recent release of the Department of Finance's consultative document may or may not signal the beginning of a merciful end to the income trust saga in Canada. We hope that it does, since it is tiresome to have to listen to investment bankers whine, cajole, threaten, and otherwise establish lobbying positions through their mouthpieces in the popular business press. In combination with a moratorium on advance income tax rulings on income trust structures,[13] the Finance document may indicate the government's commitment to do something about this sector. It is just not clear yet what that something might be.

The consultative document is quite brief. It surveys the growth of the income trust sector, the tax policy implications of that growth, possible legislative responses, and the treatment of flowthrough entities in Australia, the United States, and the United Kingdom. There is also an estimate of the associated revenue loss. Presumably because the document is intended to be the basis for consultations with private sector representatives, the Department of Finance offers nothing in the way of definitive policy analysis. In fact, the document strains mightily to present both sides of the policy debate over the rise of the income trust sector. There is no indication whatsoever as to which way, if any, the government may be leaning in a choice of

13 Canada, Department of Finance, *News Release* 2005-059, September 19, 2005.

legislative response. The most interesting element of the consultative document is probably the estimate of the revenue loss at the federal government level attributable to the use of the income trust and other flowthrough structures rather than a conventional corporate structure. The Department of Finance pegs this loss for 2004 at approximately $300 million, which is relatively modest.

Halpern's paper provides a thorough review of the role of income trusts in Canadian capital markets. Halpern concludes that the income trust structure is most appropriate for mature corporations with certain characteristics, including (1) a low ratio of fixed to variable costs, (2) little competition, (3) little or no technological change, (4) limited capital expenditures, (5) products with strong consumer loyalty, and (6) non-cyclical cash flows. Halpern also suggests that shareholder gains from conversion to an income trust structure are not attributable solely to the elimination of the corporate-level income tax. Most importantly, he emphasizes the argument that the cash distribution requirements suitably discipline corporate management. He thus characterizes the income trust structure as a legitimate form of financial instrument that has a role to play for retail and institutional investors.

Halpern acknowledges that the income trust structure creates a type of equity security. However, consistent with much of the existing literature on income trusts, he fails to recognize the redundant nature of that security. In fact, the cash flow pattern provided by the income trust structure replicates the cash flow pattern associated with an existing set of securities, namely, preferred shares. The income trust structure thus provides nothing more than a type of tax-deductible preferred share. This redundancy in cash flow pattern means that the development of the income trust structure is, in fact, entirely tax-driven; it does not constitute genuine financial innovation in the sense of providing investors with a risk-and-return profile that is not otherwise available.

This redundancy lies at the heart of the tax policy analysis. The Department of Finance must face squarely the need to restore an element of consistency in the tax treatment of preferred shares and high-yield junk debt (the defining feature of the income trust structure). There is a range of legislative responses that can realize this desirable consistency of treatment. The choice of any single response depends ultimately on one's view of the role of the corporate income tax, which also has implications for the tax treatment of limited partnerships and other flowthrough entities that can be used to replicate many of the tax-effective results of an income trust structure.

T.E.

David A. Weisbach, "The (Non) Taxation of Risk"
(2004) vol. 58, no. 1 *Tax Law Review* 1-57

There is an extensive theoretical literature that concludes that portfolio adjustments by taxpayers can offset the effects of an income tax on the return to risk bearing. Given certain idealized assumptions, the significant policy lesson of this literature is that only the time-value return to capital can be reached by an income tax—even in its idealized Haig-Simons form. Because inflation-adjusted, time-value returns are low, the debate over an income or consumption tax may be incorrectly framed in much of the mainstream literature. Briefly, given that the principal difference between the two bases is the taxation of time-value returns, the important consequential attributes of income and consumption taxes may be their administrative and compliance costs, not their efficiency and distributional effects.

In this article, Weisbach reviews the intuition that underlies much of the modelling in the literature that suggests that portfolio adjustments can negate the taxation of risk under an income tax. He then considers why this literature has been largely ignored in the broader debate over the relative strengths and weaknesses of income and consumption taxes. In particular, he explores the argument that the models have limited explanatory power primarily because they posit an unrealistic world governed by an ideal income tax. He also explores the argument that the models unrealistically assume full portfolio adjustments by taxpayers and the government. Weisbach explains in detail why these arguments should be discounted and why the debate over an income versus a consumption tax should be reframed to take into account the non-taxation of risk under an income tax. In this respect, he suggests that the income tax may be saved, not because of its more desirable distributional effects, but rather because of the transitional issues that make movement to a consumption tax impractical. Since the principal lesson of the literature modelling the effect of portfolio adjustments is that the differences between an ideal income tax and an ideal consumption tax are not that significant, tax reformers can defensibly push forward with an agenda that would bring the current income tax closer to the ideal as a means of approximating a consumption tax, but without the need to resolve the difficult transitional issues associated with a move to the latter.

T.E.

Dan S. Dhaliwal, Kaye J. Newberry, and Connie D. Weaver, "Corporate Taxes and Financing Methods for Taxable Acquisitions" (2005) vol. 22, no. 1 *Contemporary Accounting Research* 1-30

Firms subject to high tax rates have incentives to use debt financing for corporate acquisitions to generate tax deductions. In the United States, these incentives are mitigated to the extent that such firms have excess foreign tax credits (FTCs), since FTCs reduce the marginal tax benefit of each additional dollar of interest deduction. The authors of this article show empirically that the likelihood that US acquirors will use debt to finance their acquisitions declines significantly as FTC limitations reduce the marginal tax benefits of borrowing. By specifying the FTC amount as a continuous measure between 0 and 1, the authors find that the FTC limit is significantly lower for acquirors using primarily debt to finance their acquisitions (0.05) compared with acquirors using primarily internal funds (0.20). The lower FTC limit for acquirors using debt financing limits their loss of interest deductions on a present value basis to 3 percent of the deal value, compared with a loss of 14 percent of the deal value in present value terms for acquirors using internal funds (estimated for an arbitrary 10-year loan at 10 percent for the average value of acquisition). The authors conclude that such evidence shows how US foreign tax credit provisions materially affect firms' cost of capital, potentially putting them at a competitive disadvantage.

Amin M.

Li Jin, "Capital Gain Tax Overhang and Price Pressure,"
Journal of Finance (forthcoming)

This empirical study relies on a database of large US institutions' stock holdings that includes institutions' client profiles. The author shows that taxable clients are more reluctant to sell their holdings relative to tax-exempt clients, and that the reluctance among taxable clients is based on cumulative capital gains. Both the likelihood and the magnitude of selling by tax-sensitive clients are negatively related to cumulative capital gains.

In general, investors often change their beliefs about a stock around the time of a surprising earnings announcement, and therefore trade. However, taxable clients facing cumulative capital gains are unwilling to vote with their feet in response to large earnings surprises in either direction. Tax-sensitive investors sell their holdings with cumulative capital gains less aggressively, contributing to a less negative (in the case of an unfavourable earnings surprise) or more positive (in the case of a favourable earnings surprise) price reaction for such stocks. Jin hypothesizes that a significant clientele with capital gains tax overhang may create an order imbalance because sellers and potential buyers are affected asymmetrically. More specifically, taxable sellers sell less or sell slowly, whereas potential buyers are not affected. The study results show that stocks held by a large number of shareholders who are tax-sensitive (taxable with cumulative capital gains) have higher abnormal returns associated with larger capital gains, while stocks held predominantly by tax-exempt shareholders do not exhibit such higher abnormal returns (associated with larger capital gains).

Amin M.

Douglas J. Cumming and Jeffrey G. Macintosh,
"Crowding Out Private Equity: Canadian Evidence,"
Journal of Business Venturing (forthcoming)

The authors compare labour-sponsored venture capital corporations (LSVCCs) with private venture capital funds and find evidence consistent with their hypotheses that LSVCCs have higher agency costs and lower profitability. The more interesting question that the authors examine is whether the tax incentives offered through LSVCCs meet the government's objective of increasing the overall supply of venture capital funds available to Canadians, or whether, instead, they merely result in the substitution of LSVCCs for private venture capital funds. All tax-assisted programs should be subject to this research question. (An example in another context is whether tax incentives for registered retirement savings plans [RRSPs] increase overall savings of Canadians, or simply result in the substitution of RRSPs for non-registered savings.) The authors provide empirical evidence that LSVCCs end up crowding out private venture capital funds and reduce the aggregate supply of venture capital, thereby thwarting the government's objective. The authors also confirm that supply and demand for venture capital funds is affected by macroeconomic factors such as real interest rates, real gross domestic product, and stock market performance. Finally, the authors find that entrepreneurs seeking venture capital prefer to incorporate their businesses federally rather than provincially.

Amin M.

Francine J. Lipman, "Anatomy of a Disaster Under the Internal Revenue Code" (2005) vol. 6, no. 10 *Florida Tax Review* 953-1023

Disasters such as hurricanes, floods, ice storms, and forest fires are often followed by some form of disaster relief from governments and insurance companies. This article serves as a systematic primer of the tax consequences facing disaster victims receiving relief payments and going through the reinvestment process in the US context. Taxes affect reimbursement of immediate food, clothing, shelter, and medical treatment costs, as well as longer-term decisions to replace homes and businesses. The article follows a fictitious family experiencing the 2003 Southern California wildfires, and relies on comprehensive government data, newspaper accounts, and interviews with insurance agents, non-profit relief workers, victims, and federal government representatives. While the tax issues analyzed apply to US disasters, they are clearly relevant to the fiscal treatment of disaster relief in other jurisdictions as well.

Amin M.

Wolfgang Schön, "The Odd Couple: A Common Future for Financial and Tax Accounting?" (2005) vol. 58, no. 2 *Tax Law Review* 111-48

This 2004 David R. Tillinghast Lecture examines the issue of book-tax conformity in the context of changing tax and accounting rules and principles, and in a global context through a comparative analysis of the United States, the United Kingdom, and Germany. The broad range of perspectives includes arguments from both economics and law, with detailed coverage of political considerations and technical issues. The article addresses criteria for the assessment of tax policy, such as ability to pay, efficiency, and certainty. It also discusses strategic management incentives under book-tax conformity.

Financial reporting is designed to provide timely and relevant information to shareholders, creditors, management, and other stakeholders in a manner that is consistent and mitigates misleading disclosure. The income tax system is designed to collect equitable revenues in a manner that protects the public fisc. While the different objectives of the tax and financial reporting systems make it difficult to determine taxable income from financial accounting income, some degree of book-tax conformity remains a benchmark for most tax systems around the world.

Accounting rules (such as the one requiring employee stock options to be expensed) are converging around the globe, with international accounting standards increasingly becoming the lingua franca. Recent US fraud cases such as Enron and WorldCom have brought US accounting standards into disrepute, and a greater following for the International Accounting Standards Board. Canada has stated its intention to follow international accounting standards, a shift from its traditional close ties to US accounting standards. Schön argues that global convergence of internationally accepted accounting rules could potentially be harnessed to align computation of global taxable profits and to apportion such profits across tax jurisdictions in order to address global transfer-pricing issues. Obviously, tax legislators will find it difficult to give up any sovereignty to an international and private standard setter in determining the foundation of the domestic tax base, and such issues are fully explored.

Amin M.

Kyle D. Logue, "The Problem of Tax Law Uncertainty and the Role of Tax Insurance" (2005) vol. 25, no. 2 *Virginia Tax Review* (forthcoming)

This article examines the role of private and public insurance in resolving regulatory and legal (including tax law) uncertainty. More specifically, the article describes a new type of tax risk insurance policy (tax indemnity insurance) that provides coverage against the risk that the tax authorities disagree with (and disallow) a taxpayer-insured's treatment of a specific tax transaction. Logue considers whether such insurance increases aggressive tax-filing behaviour (moral hazard) or offers certainty to taxpayers that the tax authority is not able to provide (as in the recent case of conversions to income trusts by corporations). Should such insurance be encouraged or prohibited, and should it be offered by private companies or by the government (in the form of either private rulings or some type of tax indemnity insurance policy)? Logue concludes that tax indemnity insurance should be privately available; however, taxpayers acquiring such policies should be compelled to disclose the fact to the tax authorities, to mitigate the possibility that the insurance might be considered to have been acquired solely for the purpose of covering detection risk.

Amin M.

Kenneth J. McKenzie, "Tax Subsidies for R&D in Canadian Provinces" (2005) vol. 31, no. 1 *Canadian Public Policy* 29-44

Bev Dahlby, "A Framework for Evaluating Provincial R&D Tax Subsidies" (2005) vol. 31, no. 1 *Canadian Public Policy* 45-58

In these complementary articles, McKenzie documents that effective provincial subsidy rates for research and development (R & D) in Canada range from approximately 40 percent in Alberta to over 200 percent in Quebec, while Dahlby suggests that such substantial tax incentives for R & D may not be warranted. Dahlby presents a framework in which the tax treatment of R & D expenditures depends in part on the multiplier for these expenditures, the marginal cost of public funds, and the combined federal and provincial marginal tax rates on income generated by R & D expenditures. He concludes that provincial tax subsidies for R & D expenditures may be justified only if a dollar of tax incentives generates almost $2 of additional R & D expenditures.

Amin M.

Maureen Donnelly and Allister Young, "Aspects of Constructing a Rational Framework for Loss Relief: A Sample of How Four Countries Compete" [2005] no. 4 *British Tax Review* 432-47

In an extension of their earlier study published in this journal,[14] Donnelly and Young discuss the tax loss utilization regime in the United Kingdom, comparing it with the loss utilization rules in Australia, Canada, and the United States.[15] The framework they use continues to focus on when the losses can be offset (in the same year or other years) and by whom (by the same business, the same corporation, or the same shareholders).

Amin M.

Margaret Lamb, Andrew Lymer, Judith Freedman, and Simon James, eds., *Taxation: An Interdisciplinary Approach to Research* (Oxford, UK: Oxford University Press, 2005), 316 pages, ISBN 0199242933

This edited collection of essays examines how discipline-based approaches to tax research have developed in law, economics, accounting, political science, and social policy, leading to a call for more interdisciplinary and multidisciplinary research. Multidisciplinary research within the tax context is often jokingly described as research that looks at both sections X and Y of the Income Tax Act given the tendency of researchers to be mile-deep and micron-wide. However, a countervailing force that keeps many researchers broad in their focus is the explosion of research abstracts and full-text papers readily available on researchers' desktops via push-button technology.

The book is organized in four parts. Part I introduces the multifaceted nature of taxation and the issues arising from researching tax in general. Part II contains five chapters exploring single-discipline traditions of researching tax issues in law, economics, accounting, political science, and social policy. Part III contains nine

14 Maureen Donnelly and Allister Young, "Policy Options for Tax Loss Treatment: How Does Canada Compare?" (2002) vol. 50, no. 2 *Canadian Tax Journal* 429-88.

15 See also M. Donnelly and A. Young, "Relaxing the SBT: A Recommendation from the Canadian and American Experience" (2004) vol. 19, no. 1 *Australian Tax Forum* 45-79, reviewed in this feature (2004) vol. 52, no. 4 *Canadian Tax Journal* 1285-1303, at 1289.

chapters, each introducing a survey of a specific topical area of research along with examples of research questions and a rich bibliography. Specific chapters include

- "Taxation and Ethics,"
- "Behavioural Studies of Tax Practice,"
- "Taxation and Business Strategy,"
- "Microeconomic Approaches to Tax Research,"
- "International Transfer Pricing,"
- "Tax Compliance Costs,"
- "European Law of Taxation,"
- "Taxation and Capital Markets," and
- "Taxation in an Electronic World."

Authors in this section survey and characterize the types of research questions that can be addressed by the literature selected, and suggest directions for future research within the field. Part IV contains a concluding chapter discussing tax research from the editors' perspective.

Amin M.