Current Tax Reading

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South African Revenue Service, *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1961)*
(Pretoria, SA: South African Revenue Service, November 2005),
76 pages, available on the Web at http://www.sars.gov.za/

One apparent consequence of the globalization of investment banking, as well as accounting and legal practices, is the "franchising" of tax-avoidance schemes. A scheme is developed in a particular jurisdiction and then exported to other jurisdictions with similarly vulnerable tax systems. This globalization of tax planning makes comparative work on statutory general anti-avoidance rules (GAARs) and judicially developed anti-avoidance doctrines all the more interesting and of considerable importance. This particular discussion paper is worthwhile both for its account of the common elements of tax-avoidance transactions and for its review of the development of anti-avoidance law in South Africa, primarily in the context of the South African statutory GAAR. The paper is intended to provide the basis for submissions regarding proposed changes to the South African GAAR that attempt to strengthen it as a tool to control abusive tax avoidance. Many of the transactions presented as examples of tax-avoidance transactions will be familiar to readers in Canada and other jurisdictions.

After a brief introduction, there is a discussion of some of the terminology used in the paper. The most significant distinction is that between impermissible tax avoidance and acceptable tax planning. The former category appears to consist of transactions that have no non-tax purpose and exploit a statutory loophole or anomaly. The latter category appears to consist of transactions that have a non-tax purpose and have been structured to substitute a lower-taxed for a higher-taxed transactional form. Such substitution is considered acceptable only if it is contemplated by the relevant legislation.

The discussion of terminology is followed by a brief description of the kinds of factors that have allowed tax-planning structures to spread rapidly across jurisdictions.

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The paper then presents an overview of the "harms" caused by impermissible tax avoidance. These include short-term revenue loss, disrespect for the tax system, increasing complexity associated with legislative responses, deadweight losses to the economy, unfair shifting of the tax burden, and weakening of the ability of the government to set and implement economic policy.

The most significant substantive discussion is found in sections 5 and 6, which describe the common structural features of impermissible tax avoidance at both a conceptual and a practical level. Conceptually, the paper reviews the features of tax systems that make them vulnerable to tax-avoidance transactions. Practically, it reviews the common features of tax-avoidance transactions, such as a lack of economic substance, the use of tax-indifferent accommodation parties or special-purpose vehicles, unnecessary steps and complexity, inconsistent treatment for tax and financial accounting purposes, high transaction costs, and contingent fee arrangements.

Section 7 of the paper provides a perfunctory review of anti-avoidance rules and judicial doctrines in selected jurisdictions. The countries chosen as points of comparison are Australia, Canada, New Zealand, Spain, the United Kingdom, and the United States (all except Spain being the usual suspects among English-speaking countries). The international comparison is followed by a review of the legislative history of the South African GAAR, including a discussion of some changes to the provision that were proposed in the past but rejected for various reasons. Section 10 concludes with a summary of the current series of proposed changes, which aim to strengthen the GAAR in four areas:

1. Because application of the GAAR depends on a finding that the relevant transaction or transactions evidence a required level of "abnormality," the paper proposes that a non-exclusive set of factors be set out to create a rebuttable presumption of abnormality where these factors exist.
2. The paper also proposes that the GAAR be amended to ensure that the purpose test is determined objectively with reference to the relevant facts and circumstances.
3. Another proposed amendment would provide that the GAAR can be applied to steps within a larger scheme, and that a general business purpose for a larger scheme is insufficient to shield each step in that scheme.
4. Finally, the paper introduces new penalties for scheme promoters and taxpayers who substantially underreport their income.

The third of these proposed amendments should resonate with Canadian readers. In *The Queen v. Canada Trustco Mortgage Co.*[1] and *Mathew v. The Queen*,[2] the Supreme Court of Canada appears to have interpreted the definition of "avoidance

1 2005 DTC 5523; [2005] 5 CTC 215 (SCC).

2 2005 DTC 5538; [2005] 5 CTC 244 (SCC).

transaction" in subsection 245(3) of the Income Tax Act[3] in the context of a series of transactions in a manner that is consistent with the amendment of the South African GAAR proposed in the discussion paper. However, in the subsequent decision of the Tax Court in *Evans v. The Queen*,[4] Bowman CJ interpreted the definition of an avoidance transaction in a manner that is inconsistent with the interpretation of the Supreme Court. It may be that a statutory amendment like that proposed in the discussion paper is ultimately needed to ensure that the non-tax purpose of a larger series of transactions is not imputed to the steps in the series that are inserted for tax purposes.[5] It may also be the case that the adoption of the kinds of penalties proposed in the discussion paper is an idea whose time has come in Canada.

The discussion paper includes six appendixes. Four of them reproduce the statutory GAARs in Australia, Canada, New Zealand, and Spain, respectively; one reproduces a draft of the South African GAAR incorporating the amendments proposed in the discussion paper; and the last describes a cross-border film scheme as an example of impermissible tax avoidance.

T.E.

United States, Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons* (Washington, DC: Congressional Budget Office, November 2005), 46 pages, available on the Web at http://www.cbo.gov/

This study provides an overview of recent trends in corporate income tax rates internationally. For this purpose, the study distinguishes importantly between statutory rates and effective marginal rates. Consistent with the usage in the literature, the latter term is defined as "the percentage of the income from a marginal investment that must be paid as corporate income taxes."[6] An investment is considered marginal "when it pays just enough income to make the investment worthwhile."[7] The most obvious and probably most important trend is the combination of a reduction of statutory rates and a broadening of the corporate income base. This trend is especially prominent in Europe,[8] where the gap between statutory and effective marginal tax rates is closed by eliminating tax incentives, such as accelerated depreciation and tax credits, for targeted investments. The base-broadening strategy partially funds reductions of the statutory rate and mutes tax-induced movement

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Section 245 is Canada's GAAR.

4 2005 DTC 1762 (TCC).

5 Before the Supreme Court of Canada decisions in *Mathew* and *Canada Trustco*, such an amendment to section 245 of the Act was proposed in Brian J. Arnold, "The Long, Slow, Steady Demise of the General Anti-Avoidance Rule" (2004) vol. 52, no. 2 *Canadian Tax Journal* 488-511.

6 At x, footnote 4.

7 Ibid.

8 European Commission, *Structures of the Taxation Systems in the European Union* (Luxembourg: Office for Official Publications of the European Communities, 2005), table II-5.1.

of corporate investment internationally.[9] Reductions of the statutory rate mute the incentive of multinational firms to shift income out of a source country through transfer-pricing practices and debt financing.[10]

The second part of the study presents data focused on a comparison of US corporate income tax rates and the rates in certain other countries—specifically, members of the Organisation for Economic Co-operation and Development (OECD) and members of the Group of Seven (G7). The study concludes that, although US statutory rates are among the highest compared with those of OECD countries, they are within the range of statutory rates in other G7 countries. The study also concludes that US effective marginal income tax rates depend on the type of corporate investment and the type of financing. For equity-financed investment, the US effective marginal tax rates are close to the average of other G7 countries for both investment in machinery and investment in industrial structures. By comparison with the average of OECD countries, the US rates are higher in both cases, although the gap is not as great for investment in machinery. For debt-financed investment, US effective marginal tax rates are low for investment in machinery compared with the rates in other G7 and OECD countries. The second part of the study also makes the somewhat obvious point that the history of corporate tax rates between 1982 and 2003 suggests that countries do not change their corporate tax rates independently of one another.

The first part of the study sets the stage for the second part by reviewing the standard domestic distortions caused by differences in effective marginal tax rates. The study notes some of the economic literature supporting the notion that the dimension of these distortions is significant relative to the revenue raised by the corporate income tax. The first part of the study also reviews the evidence on the responsiveness of corporate investment to differences in effective corporate income tax rates internationally. As noted above, the significance of differences in statutory rates lies in the inducement they provide for tax planning intended to shift income from high-tax to low-tax jurisdictions. These differences are not relevant to the decision to locate corporate investment.

T.E.

Organisation for Economic Co-operation and Development,
***The Taxation of Employee Stock Options*, Tax Policy Studies no. 11**
(Paris: OECD, January 2006), 171 pages, ISBN 9264012486

The grant of stock options is a form of non-cash remuneration that is commonly treated inconsistently with cash remuneration under income tax systems.[11] Instead

9 See Martin Sullivan, "A New Era in Corporate Taxation" (2006) vol. 41, no. 5 *Tax Notes International* 415-18.

10 Ibid.

11 See, for example, the discussion in Daniel Sandler, "The Benchmark Income Tax Treatment of Employee Stock Options: A Basis for Comparison" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1204-29.

of a full deduction/inclusion approach, the employer granting the stock option may be denied any deduction for its value, while the employee receiving the option may not be taxed until the option is exercised or otherwise disposed of. The taxing point for the employee may even be deferred until the shares that are acquired on exercise are disposed of. Moreover, the value of the option may be subject to partial inclusion for the employee and thereby taxed at rates that are less than those applicable to cash remuneration. This preferential income tax treatment is conventionally justified on the basis that stock options help to align the incentives of corporate management and shareholders and assist startup firms in reducing cash outflows. However, the inconsistency in income tax treatment of employee stock options and cash remuneration creates some difficult cross-border issues. These issues are the principal focus of this study.

The first chapter of the study reviews the domestic policy issues associated with the income tax treatment of employee stock options. The focus of this review is the derivation of the conditions under which employee stock options and cash remuneration are taxed consistently. The principal conclusion is the unsurprising proposition that a deduction/inclusion approach maintains consistency of taxation, whether the taxing point is on grant or on exercise of the option. Following this overview of the domestic treatment of employee stock options, chapter two presents a review of OECD country practices, including computations of effective tax rates for employee stock options as compared with such rates for cash remuneration. The survey of country practices and the computation of effective tax rates are based on the relevant legislation in force in 2002.

The remainder of the study is devoted to the cross-border issues raised by employee stock options. The first set of issues, discussed in chapter three, relates to sourcing rules that determine jurisdiction to tax the value of compensation taken in the form of stock options. The discussion is framed in terms of the OECD model treaty[12] and includes recommendations for major revisions to the commentary on the relevant treaty articles.

The second set of issues, discussed in chapter four, concerns transfer pricing.[13] The discussion is divided into three discrete parts. The first part focuses on those circumstances in which a corporation grants stock options to employees of an associated corporation resident in another jurisdiction. The transfer-pricing issue raised in these circumstances is whether the arm's-length principle requires recognition of a charge for the provision of the options. The second part focuses on those circumstances in which the transfer-pricing method to be applied under the arm's-length principle to particular transactions is sensitive to employee remuneration. The third part focuses on the impact of employee stock option plans on cost contribution ar-

12 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003) (herein referred to as "the OECD model treaty").

13 For a detailed discussion on this topic, see Amin Mawani and Marsha L. Reid, "Transfer Pricing and Employee Stock Options" (2005) vol. 53, no. 3 *Canadian Tax Journal* 607-39.

rangements. In both the second and third parts, the transfer-pricing issue is whether the provision of stock option plans should be accounted for in evaluating other intragroup transactions.

T.E.

Dick Molenaar, *Taxation of International Performing Artistes*, Doctoral Series vol. 10 (Amsterdam: IBFD Publications, 2005), 416 pages, ISBN 9076078874

Article 17(1) of the OECD model treaty provides for source-country taxation of the business or employment income of artists and athletes. In contrast to articles 15 and 16, the only requirement for the assertion of source jurisdiction is that the artist or athlete derives income from the exercise of personal activities in the source country. Countries commonly implement this source jurisdiction to tax by applying withholding taxes at source to the gross amount of any payments made to non-resident artists or athletes performing in the country.

This book is a doctoral thesis, the 10th in a series of selected doctoral theses published by the International Bureau of Fiscal Documentation. The author is a Dutch tax lawyer who represents a number of artists and athletes. He recommends that article 17 of the OECD model treaty should be repealed and, subject to certain conditions, replaced with an article shifting the jurisdictional balance from source to residence taxation.

Molenaar bases his recommendation on two principal arguments. First, the application of withholding taxes to the gross amount of payments at source results in overtaxation of the relevant income. The overtaxation takes the form of an excess foreign tax credit position in the country of residence of the artist or athlete. This credit position results from the imposition of source-country taxation on the gross amount of the relevant payments, even though recognition of such taxes in the residence country is limited to residence-country tax on the income net of associated expenses. The second argument in support of repeal of article 17 is based on recognition of the fact that the original rationale for the imposition of source-country taxation on a gross withholding basis is no longer compelling. In particular, Molenaar argues that a broad range of artists and athletes are not, in fact, resident in tax haven countries. For these taxpayers, residence-country tax may be a real liability, the enforcement of which may be buttressed by the application of exchange-of-information articles in bilateral tax treaties.

Molenaar's preferred reform option is to replace article 17 with a new article providing for source-country taxation only where there is a presence in the jurisdiction consistent with that required for either non-resident employees or independent contractors under article 15(2) or article 7, respectively. Withholding at source would still be applied, however, as a mechanism to enforce source jurisdiction as a backstop to residence-based taxation. This backstop role would be implemented through the adoption of a procedure to waive withholding where treaty relief is otherwise available.

As an alternative to the preferred option, Molenaar proposes a series of changes to article 17, including (1) application of source taxation net of associated expenses; (2) exemption of a de minimis level of remuneration from source taxation; and (3) use of an exemption, rather than a foreign tax credit, system by the residence country as the means of recognizing source taxation. He also recommends modifying article 17(2), which extends source taxation to any payments made to any person in respect of personal activities exercised by an artist or athlete. Molenaar would amend this provision to limit the application of source taxation to those circumstances in which income accrues to an artist or athlete but is paid to a related person. He would also codify the exception from source taxation for performances that are subsidized by either or both of the source and residence countries. The exception is currently incorporated in the commentary on article 17.

T.E.

J. Clifton Fleming Jr. and Robert J. Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial System) Tax System"
(2005) vol. 109, no. 12 *Tax Notes* 1557-77

The authors of this article are US legal academics who have written extensively on the income tax treatment of outbound direct investment. This particular topic remains the subject of some debate in the United States, resulting in a number of proposals to shift from a foreign tax credit to an exemption system. Two such proposals have been made most recently by the President's Advisory Panel on Federal Tax Reform[14] and the Staff of the Joint Committee on Taxation.[15] Fleming and Peroni have been relentless critics of an exemption system; they favour, instead, a tightening of the US treatment of income from foreign direct investment to eliminate deferral of US tax on all such income. Consistent with their earlier work, in this article Fleming and Peroni criticize both of the recent proposals to move to an exemption system. They argue, in particular, that the proposals would not achieve a substantial simplification of the US system for the taxation of income from outbound direct investment. More importantly perhaps, they also argue that a new rationale for an exemption system, which is articulated in several articles by Desai and Hines[16] and is labelled

14 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: President's Advisory Panel on Federal Tax Reform, November 2005), 102-5, reviewed in this feature (2006) vol. 54, no. 1 *Canadian Tax Journal* 345-58, at 354-55.

15 United States, Staff of the Joint Committee on Taxation, *Options To Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Washington, DC: Joint Committee on Taxation, January 2005).

16 Mihir A. Desai and James R. Hines Jr., "Reply to Grubert" (2005) vol. 58, no. 2 *National Tax Journal* 275-78; Mihir A. Desai and James R. Hines Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting" (2004) vol. 57, no. 4 *National Tax Journal* 937-60; Mihir A. Desai, "New Foundations for Taxing Multinational Corporations" (2004) vol. 82, no. 3 *Taxes: The Tax*

"ownership neutrality," amounts to nothing more than a repackaging of the tired arguments associated with capital-import neutrality. Fleming and Peroni reiterate their position that fundamental reform of the US taxation of income from outbound foreign direct investment should be directed toward elimination of the deferral of such income until repatriation to US shareholders.

T.E.

Andrew J. Maples, "The Fixed and Circulating Capital Test: Down and Out in New Zealand?" (2005) vol. 11, no. 3 *New Zealand Journal of Taxation Law and Policy* 315-41

The distinction between current and capital expenses is fundamental to an income tax. Canadian courts have articulated a variety of tests to draw this distinction. Because many of these tests are derived from UK tax jurisprudence, it is perhaps unsurprising that they are found in the tax jurisprudence of most Commonwealth countries. This article considers the status of the fixed and circulating capital test in New Zealand. After an extensive review of the NZ courts' consideration and criticism of this test, Maples argues that the principal difficulty with the test is its imprecision. He attributes this feature to a focus on the source of funds rather than their use by a taxpayer in the acquisition of an identifiable asset. Although the test appears to have fallen out of favour with Canadian courts, it does re-emerge occasionally. This article should therefore prove useful as a point of comparison for Canadian tax practitioners and academics.

T.E.

Margaret McKerchar, "The Impact of Income Tax Complexity on Practitioners in Australia" (2005) vol. 20, no. 4 *Australian Tax Forum* 529-54

This article presents the findings of an electronic survey of Australian tax return preparers regarding the complexity of the Australian income tax. The author draws a number of conclusions. First, the volume of technical material that must be absorbed, including Australian Taxation Office rulings and technical interpretations, is overwhelming and is the principal source of complexity. Second, a secondary cause of complexity is the rapid pace of change in the law. Third, tax return preparers are trying to cope by undertaking technical training and using technical experts, but do not always pass on the cost to clients. Fourth, tax return preparers are frustrated with the tax legislative and administrative processes and would like more input into those processes. The principal weakness of the survey is an apparently low response rate, which calls into question the representativeness of the respondents.

T.E.

Magazine 39-46; and Mihir A. Desai and James R. Hines Jr., "Evaluating International Tax Reform" (2003) vol. 56, no. 3 *National Tax Journal* 487-502.

Johnny Rex Buckles, "The Community Income Theory of the Charitable Contributions Deduction" (2005) vol. 80, no. 4 *Indiana Law Journal* 947-86

This article develops what the author claims is a "new tax-base theory in support of the charitable contributions deduction,"[17] which he labels "the community income theory." He argues that this concept of income rests on two principal propositions. The first proposition concerns the definition of the proper tax base and holds that community income is more naturally attributed to the community than to its individual members. The second proposition concerns the definition of the proper taxpaying unit and holds that the community is an entity exempt from taxation. Because charities are agents of the community, they are properly exempt from taxation on the community income that they generate. Likewise, individuals who donate to charities may be viewed as acting on behalf of the community with respect to the portion of their income that is donated.

Buckles derives his concept of "community income" by analogy with the treatment of public goods and services. That is, for various reasons, the value associated with the consumption of public goods and services is not imputed to individuals and taxed as income. Buckles argues that because charitable goods and services have the same features as public goods and services, the provision of those goods and services should be similarly non-taxable. Realization of non-taxable status requires an income deduction for donors, exemption of charities from tax on their income, and the non-taxation of the consumption of goods and services provided by the charitable sector.

Although Buckles claims to have developed a new theory of income to explain the standard tax-preferred status of charitable contributions, it is not at all clear that his theory is entirely distinct from other tax-base theories in the literature.[18] Moreover, it is not at all clear that any such theories are helpful in thinking about the appropriate treatment of charitable contributions and the charitable sector. In deciding on such treatment, tax policy makers must ultimately determine the allocative and distributive consequences of the provision of tax recognition for charitable contributions and whether those consequences can be justified in terms of the role played by the charitable sector in a market economy.[19] Buckles's theory of income may, in fact, be more compelling for its explanatory power. In short, it may articulate a community norm that explains the resilience of the provision of tax relief for

17 At 986.

18 See, for example, William D. Andrews, "Personal Deductions in an Ideal Income Tax" (1972) vol. 86, no. 2 *Harvard Law Review* 309-85 (articulating a tax-base theory supporting an income deduction for charitable contributions).

19 See, in this respect, David G. Duff, "Charitable Contributions and the Personal Income Tax: Evaluating the Canadian Credit," in Jim Phillips, Bruce Chapman, and David Stevens, eds., *Between State and Market: Essays on Charities Law and Policy in Canada* (Montreal and Kingston, ON: McGill-Queen's University Press, 2001), 407-56.

charitable contributions despite considerable criticism of any such relief in some of the policy literature.[20]

T.E.

John A. Lynch, "Travel Expense Deductions Under I.R.C. §162(a)(2)—What Part of 'Home' Don't You Understand?"
(2005) vol. 57, no. 3 *Baylor Law Review* 705-84

Section 162(a)(2) of the US Internal Revenue Code[21] permits a taxpayer to deduct travelling expenses while away from home in the pursuit of a trade or business. The provision is similar in wording to the exception to the prohibition of the deduction of personal or living expenses in paragraph 18(1)(h) of Canada's Income Tax Act. Both provisions are apparently intended to refine the basic boundary in the tax law between non-deductible personal expenses and deductible income-earning expenses by characterizing what would otherwise be expenses in the former category as deductible income-earning expenses, presumably because of the occasion for the expenditure—that is, travel while carrying on business. Despite the similar rationale for, and wording of, the Canadian and US provisions, there is considerably more judicial and administrative commentary on the interpretation and application of IRC section 162(a)(2) than there is on the exception to non-deductibility in paragraph 18(1)(h) of the Act. Probably the most substantial aspect of the judicial and administrative gloss on the US provision is the requirement that a taxpayer have a "tax home" at his or her principal place of work. This requirement is apparently used as a proxy to screen for the existence of the duplication of living expenses, which is critical to the characterization of travel expenses as income earning. In effect, travel expenses are seen to be deductible income-earning expenses where they duplicate otherwise non-deductible personal expenses associated with the taxpayer's tax home.

This article criticizes the requirements of a tax home and the existence of duplication of expenses for deductibility status. After reviewing the relevant US case law and Internal Revenue Service (IRS) administrative positions, Lynch illustrates his critique with an application of the requirements to (1) taxpayers who have a principal place of business away from their residence, (2) taxpayers away from home who never really leave home, and (3) taxpayers who have no home. Lynch then proposes a set of amendments to IRC section 162(a)(2) that would permit the deduction of travelling expenses for taxpayers in each of his defined categories. In all of these fact patterns, Lynch believes that the travelling expenses are properly characterized as income-earning expenses, although they are not recognized as such because of the judicial and administrative gloss that has been placed on section 162(a)(2).

T.E.

20 See, for example, Neil Brooks, "The Tax Credit for Charitable Contributions: Giving Credit Where None Is Due," ibid., 457-81.

21 Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

Mark S. Hoose, "The Conservative Case for Progressive Taxation"
(2005) vol. 40, no. 1 *New England Law Review* 69-111

The author of this article argues that various proposals in the United States for fundamental tax reform are inconsistent with "classical conservatism." In general, these proposals involve two principal components: (1) shifting from an income to a consumption tax base; and (2) replacing a progressive rate structure with a flat rate structure. Although these proposals have been developed and championed by politicians and interest groups calling themselves "conservative," Hoose puts forward the proposition that their versions of conservatism diverge in many respects from what he refers to as "classical conservatism." He characterizes this school of conservative thought as consisting of six canons:[22]

1. belief in a transcendent order or body of natural law that rules society;
2. opposition to uniformity or egalitarianism;
3. conviction that civilized society requires orders and classes;
4. belief that freedom and property are closely linked;
5. distrust of intellectuals who would reconstruct society on the basis of abstract designs; and
6. recognition that change may not be salutary.

After reviewing the principal proposals for radical tax reform in the United States, Hoose shows that many features of these proposals are inconsistent with this conception of classical conservatism and that, conversely, continued reliance on the progressive income tax is in many ways consistent with it. He argues that classical conservatism favours "prudent changes to lessen the impact" of the negative aspects of the progressive income tax in order to ensure that it survives as "a workable institution."[23]

T.E.

"Capital Gains Tax—40 Years On" [2005] no. 6 *British Tax Review* 584-665

The 40-year anniversary of the adoption of a capital gains tax in the United Kingdom is the occasion for the dedication of this issue of the *British Tax Review* to the subject of capital gains taxation. The issue includes the following articles:

- David Stopforth, "The Birth of Capital Gains Tax—The Official View"
- Ben Staveley, "The Quest for the Allowable Loss: Reflections on Lord Hoffmann's Approach to *Ramsey*"

22 These canons are derived from the US political philosopher Russell Kirk, *The Conservative Mind: From Burke to Eliot*, 7th ed. (Chicago: Regnery Books, 1986).

23 At 111.

- Wolfgang Schön, "Capital Gains Taxation in Germany"
- Graeme MacDonald and David Martin, "Taxing Corporate Gains: Proposals for Reform"

The articles are not linked conceptually in any way other than the broad context of capital gains taxation. Indeed, they are all quite independent in their focus on various specific aspects of the subject. Stopforth provides a detailed review of the legislative background to the adoption of capital gains taxation in the United Kingdom. Staveley reviews the development of judicial anti-avoidance doctrines in the United Kingdom as applied to capital gains taxation. Schön describes the very different approach to capital gains taxation in Germany as a point of comparison with the United Kingdom. MacDonald and Martin review how closer alignment of financial and tax accounting for corporate income tax purposes can address some of the problems associated with corporate capital gains taxation.

T.E.

"Rethinking Redistribution: Tax Policy in an Era of Rising Inequality"
(2005) vol. 52, no. 6 *UCLA Law Review* 1627-1916

This symposium issue of the *UCLA Law Review* consists of five relatively lengthy articles exploring various aspects of the use of the tax system to redistribute income and wealth. The contributors are

- Eric Zolt of the School of Law, University of California at Los Angeles, and Richard Bird of the Rotman School of Management, University of Toronto;
- Marjorie Kornhauser of the School of Law, Tulane University;
- Edward McCaffery of the University of Southern California Law School and Jonathan Baron of the Psychology Department, University of Pennsylvania;
- Ajay Mehrotra of the School of Law, University of Indiana; and
- Lawrence Zelenak of the School of Law, Duke University.

In the first article, "Redistribution Via Taxation: The Limited Role of the Personal Income Tax in Developing Countries," Zolt and Bird make the case for the use of tax policy instruments other than the tax system to reduce income and wealth inequality. Kornhauser's article, "Choosing a Tax Rate Structure in the Face of Disagreement," frames the choice of a progressive rate structure in terms of an "integrity principle," which is loosely based on the work of legal scholar Ronald Dworkin. In "The Political Psychology of Redistribution," McCaffery and Baron review the results of experiments in psychology that suggest that, even though the tax system may be the preferable policy instrument (at least in theory) to effect redistribution, its use is clouded by various factors that result in tension between the public finance goals of equity and neutrality. Mehrotra's article, "Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax," describes the shift at the turn of the 19th century in the United

States from regressive tariffs to a progressive income tax as the principal revenue source for the federal government. Zelenak, in "Tax or Welfare? The Administration of the Earned Income Tax Credit," finds that enforcement by the IRS of the conditions of eligibility for the earned income tax credit, although more robust than enforcement of structural income tax provisions, is much looser than enforcement of comparable spending programs delivered outside the income tax system. Zelenak suggests a number of reasons for this difference.

T.E.

J.B. Chay, Dosoung Choi, and Jeffrey Pontiff, "Market Valuation of Tax-Timing Options: Evidence from Capital Gains Distributions"
(2006) vol. 61, no. 2 *The Journal of Finance* 837-65

Taxes on capital gains are triggered only when the underlying assets are disposed of or deemed to be disposed of. This policy provides asset owners with a valuable option for timing the realization of capital gains and losses so as to reduce the expected present value of tax liability and increase the present value of after-tax returns, in part by enjoying the compound returns on the taxes postponed. This tax-timing option is more valuable if capital losses are tax-deductible, or at least partially tax-deductible, against deferred or unrealized capital gains. The tax-timing option can be even more valuable in jurisdictions, such as the United States, where capital gains tax rates are lower for longer holding periods.

The presence of this tax-timing option is clearly implicit in the end-of-year triggering of tax losses documented by various authors in several countries. The strategy of selling stocks with capital losses early while postponing the sale of stocks with capital gains so as to yield arbitrage gains is well documented in most finance and tax planning textbooks. Compared with the statutory burden of capital gains taxes, the tax-timing option can significantly reduce the effective tax burden. Conversely, forced realization (or distributions) of capital gains can be expected to command compensation (in the form of higher returns) relative to unrealized gains in the same way that (tax-disfavoured) interest income commands compensation relative to (tax-favoured) dividends or capital gains.

While the tax-timing option is easy to understand, its equilibrium magnitude is difficult to determine. This question is clearly important now that many mutual funds and data providers (such as Morningstar) disclose after-tax performance assuming that unrealized gain either remains untaxed or is taxed at top marginal tax rates (since the effective tax rate on unrealized gains has not been estimated until this study by Chay et al.). In an earlier study of after-tax returns of Canadian equity mutual funds, Mawani, Milevsky, and Panyagometh document both pre-liquidation and post-liquidation after-tax returns assuming a 10-year holding period for all funds.[24] This highly sensitive

24 Amin Mawani, Moshe Milevsky, and Kamphol Panyagometh, "The Impact of Personal Income Taxes on Returns and Rankings of Canadian Equity Mutual Funds" (2003) vol. 51, no. 2 *Canadian Tax Journal* 863-901.

and unrealistic holding period assumption implicitly narrows down the value of the tax-timing option for all investors. Mawani et al. also use the highest personal combined (federal and provincial) marginal tax rate to compute the tax impact of mutual fund distributions, thereby providing a worst-case scenario of the tax wedge. This top rate may not be representative; as Mawani suggests in a subsequent study, the wealthiest individuals are more likely to own stock directly, rather than through mutual funds.[25]

The most appealing calculations of after-tax performance require an effective tax rate for unrealized capital gains, implicitly reflecting the value of the tax-timing option. In this study, Chay et al. empirically estimate the market value of such a tax-timing option in the US context by analyzing a unique type of capital gain that is distributed to shareholders in the form of a cash dividend. The only difference between this distributed capital gain and other realized capital gains is that recipient shareholders do not have the tax-timing option (of when to realize the capital gains). Unlike other distributions that are valued on the basis of variations in investors' comparative tax rates, capital gains distributions are subject to the same tax rate that applies to realized capital gains for all investors. The theoretical context for this study is an efficient capital market where stock prices drop on the ex-day by an amount equal to the distribution in the absence of taxes. If the marginal investor did not value the tax-timing option, then the ex-distribution-day price decline would be the same for this uniquely distributed capital gain and other realized capital gains. If the marginal investor valued the tax-timing option sufficiently that all future capital gains taxes would be eliminated by appropriate use of the timing option (that is, the effective capital gains tax rate would be zero), then the ex-distribution-day price decline would be the after-tax amount of the capital gains distribution.

Chay et al. formulate a drop-off ratio, or *DOR*, defined as $(P_{cum} - P_{ex})/CGDIV$ where P_{cum} is the security price before the distribution, P_{ex} is the security price after the distribution, and *CGDIV* is the amount of the distribution. A *DOR* value of 1 would imply that investors do not attach any value to the tax-timing option, whereas a *DOR* value of less than 1 would imply a positive valuation of the tax-timing option.

Chay et al. estimate the effective capital gains tax rate on unrealized gains by examining 1,375 capital gains distributions by 322 firms between January 1970 and December 2002, and comparing them with a matched sample. They find that shareholders receiving capital gains distributions are more likely to be fully taxed than shareholders in the matched sample, and the tax-timing option is statistically as well as economically significant. They compute the premium associated with a given capital gains distribution and find the *DOR* value to be 0.93, implying that the ability to tax-time a dollar of capital gains is worth about 7 cents in unrealized capital gains. In other words, investors are willing to pay taxes on an additional 7 cents of capital gains in order to decide the time at which they will trigger their capital gains or losses. Chay et al. further show that a *DOR* value of 0.93 implies

25 Amin Mawani, "To Disclose or Not To Disclose After-Tax Returns of Mutual Funds" (2003) vol. 51, no. 5 *Canadian Tax Journal* 1908-17.

that an investor with an effective tax rate of 28 percent on realized capital gains will have an effective tax rate of 22.6 percent (19.3 percent lower) on unrealized capital gains, while an investor with an effective tax rate of 15 percent on realized capital gains will have an effective rate of 8.6 percent (approximately 57 percent lower) on unrealized capital gains.

Amin M.

Dan Dhaliwal, Linda Krull, Oliver Zhen Li, and William Moser,
"Dividend Taxes and Implied Cost of Equity Capital" (2005)
vol. 43, no. 5 *Journal of Accounting Research* 675-708

This study examines the effect of investor-level taxes on equity values, or whether stock prices capitalize shareholder-level taxes on dividends distributed. The dividend tax capitalization hypothesis states that the higher tax rates on dividends relative to tax rates on capital gains increase required equity returns, and therefore the cost of equity capital. While some prior studies (such as Naranjo, Nimalendran, and Ryngaert[26] and Ayers, Cloyd, and Robinson[27]) have found that dividend taxes are capitalized in stock prices, others (such as Fama and French[28] and Shackelford and Shevlin[29]) suggest that the evidence on dividend capitalization is mixed and remains controversial. This study estimates the implied cost of equity capital independently based on recent developments in the accounting and finance literature, and then tests whether shareholder-level taxes on dividends are associated with the independently computed implied cost of equity capital.

While higher tax rates on distributed dividends (relative to undistributed capital gains) increase the required return on equity and the firm's cost of capital, dividends may also signal aspects of firm quality that can reduce its cost of capital and required return. For example, the signalling effect of sticky dividends (which are almost never reduced) reduces the information asymmetry between shareholders and management, while the discipline of distributing some free cash flows reduces agency costs. Reduction of information asymmetry and agency costs contributes to reducing the firm's cost of capital. To extract these positive information benefits of dividend payments, Dhaliwal et al. focus solely on the dividend tax penalty in the United States over the 1980-2001 period as proxied by the excess of the top dividend tax rate over the top capital gains tax rate, grossed up by the top capital gains tax rate. This dividend tax penalty, estimated by $(t_d - t_{cg})/(1 - t_{cg})$, ranges from a low of zero in the

26 Andy Naranjo, M. Nimalendran, and Mike Ryngaert, "Stock Returns, Dividend Yields, and Taxes" (1998) vol. 53, no. 6 *The Journal of Finance* 2029-57.

27 Benjamin Ayers, C. Brian Cloyd, and John Robinson, "The Effect of Shareholder-Level Dividend Taxes on Stock Prices: Evidence from the Revenue Reconciliation Act of 1993" (2002) vol. 77, no. 4 *The Accounting Review* 933-47.

28 Eugene F. Fama and Kenneth R. French, "Taxes, Financing Decisions, and Firm Value" (1998) vol. 53, no. 3 *The Journal of Finance* 819-43.

29 Douglas A. Shackelford and Terry Shevlin, "Empirical Tax Research in Accounting" (2001) vol. 31, nos. 1-3 *Journal of Accounting and Economics* 321-87.

1998-1990 period to a high of 0.6068 in 1981. This narrow focus on the variation in dividend tax penalty, which depends solely on the dividend and capital gains tax rates, allows the authors to infer that any relationship between firms' cost of capital and dividends is driven strictly by relative shareholder-level taxes on dividends and capital gains, having assumed that information and agency beneficial effects are constant over time.

Dhaliwal et al. further investigate whether the relation between the cost of equity capital and the dividend tax penalty (or dividend tax capitalization) decreases as the level of institutional ownership increases, since institutional investors do not generally face the dividend tax penalty. They find that the dividend tax penalty is indeed capitalized in equity returns, with the implied cost of equity capital increasing in the magnitude of the dividend tax penalty (hypothesis 1), and the magnitude of capitalization decreasing as aggregate level of institutional ownership increases (hypothesis 2). This study has obvious implications for cost-of-capital studies of Canadian income trusts, and whether institutional ownership of income trusts affects their cost of capital.

Amin M.

Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut" (2005) vol. 120, no. 3 *The Quarterly Journal of Economics* 791-833

This study documents a sharp and widespread surge in dividend payments following the large tax cut on individual dividend income enacted in the United States in 2003. Many firms started paying dividends after this tax cut, reversing a declining trend over the previous two decades. Many more firms increased their regular dividend payouts significantly, as well as declaring special dividends. Such increases were beyond those predicted by firm profits or other firm characteristics. The dividend increases were part of a total increase in payout, and not a substitute for share repurchases. Dividends increased more in firms with large taxable institutional investors or independent directors with large shareholdings, as well as in firms with large managerial ownership and low levels of executive stock options (since options are not dividend-protected). These findings illustrate the impact of corporate governance features and incentive mechanisms in explaining firms' response to tax changes. The 2006 dividend tax cut in Canada (from 31.3 percent to 20.5 percent for the top-rate British Columbian taxpayer) can be expected to produce similar results and variation.

Amin M.

Mihir A. Desai and Dhammika Dharmapala, "Corporate Tax Avoidance and High-Powered Incentives" (2006) vol. 79, no. 1 *Journal of Financial Economics* 145-79

This article continues the emerging paradigm that links corporate value derived from taxation and corporate governance. It develops a theoretical framework and presents empirical evidence on how incentive compensation affects tax sheltering or tax avoidance, and how this relationship can be mediated by corporate governance mechanisms. The common link is the manager who decides both the extent of tax avoidance and the extent of rent diversions or private consumption of corporate control. The tax avoidance in the title refers to the extent of tax sheltering by firms, and is quantified in a novel measure in this context by the gap between book income and taxable income (book-tax gap) not attributable to accounting accruals. To the extent that tax sheltering increases firm value, managers with high-powered incentives tend to be more aggressive about increasing firm value through tax avoidance. However, high-powered incentives also better align managers' interests with those of the shareholders, thereby reducing incentives to divert rents. Desai and Dharmapala demonstrate in their model that tax sheltering and rent diversion are complementary activities, consistent with legal and anecdotal evidence. Thus, stopping one activity (diversion of rents) usually leads to a decline in the other complementary activity (tax sheltering). Shareholders facing such tradeoffs may instruct their managers to undertake less tax sheltering even if it contributes to after-tax shareholder value, since allowing managers to undertake tax sheltering also allows them greater opportunities for diversion of rents. In this context, shareholders may find that the benefits of tax sheltering are exceeded by the costs of rent diversions, and therefore sound corporate governance should ideally discourage both.

Empirical analysis of 656 US firms over the period 1993-2001 shows that sound corporate governance—presumably in firms that had less diversion of rents—was associated with reduced tax-sheltering activity. Positive association between incentive compensation and tax-sheltering activity was found primarily in poorly governed firms, where governance quality was proxied by the index of anti-takeover provisions and the fraction of the corporation owned by institutional investors. This confirms the hypothesis that the link between incentive compensation and tax sheltering is mediated by the corporate governance characteristics of the firm. Desai and Dharmapala conclude that corporate tax avoidance is not simply a transfer of resources from the state to shareholders, in the context of agency problems characterizing shareholder-manager relations.

Amin M.

Randall Morck and Bernard Yeung, "Dividend Taxation and Corporate Governance" (2005) vol. 19, no. 3 *The Journal of Economic Perspectives* 163-80

The authors of this article support the reduction of shareholder-level tax on dividends (enacted in the United States in 2003) on the grounds that double taxation deters corporate investment by increasing cost of capital, favours debt over equity financing, and favours earnings retention over dividend payout, thereby potentially encouraging excessive and suboptimal investments. If high shareholder-level taxes allow managers to distribute inefficiently low dividends and retain excessive free cash flows or maximize payouts on employee stock options, then higher dividends (resulting from lower taxes on dividends) should enhance efficiency as well as improve corporate governance.

However, Morck and Yeung are against eliminating all shareholder-level taxes on dividends, for two reasons. First, some level of tax on intercorporate dividends discourages pyramid business groups with all their governance problems. Mork and Yeung attribute the absence of pyramid groups in the United States to the tax on intercorporate dividends—a plausible argument, given the strong presence of pyramid groups in Canada, where intercorporate dividends are mostly exempt. Second, some shareholder-level tax on dividends is beneficial since it preserves the relative advantage for tax-exempt institutional investors (compared with corporate or individual shareholders) to invest in widely held corporations on a sufficiently large scale to undertake a monitoring role in improving corporate governance (which small shareholders cannot rationally afford to do). Morck and Yeung also describe the historical dividend policy of the Hudson's Bay Company in sufficient detail to illustrate the interaction of dividends and corporate governance.

Amin M.

Felipe Aguerrevere, Federica Pazzaglia, and Rahul Ravi, "Income Trusts and the Great Conversion" (2005) vol. 18, no. 4 *Canadian Investment Review* 8-14

Aguerrevere et al. compare a sample of Canadian companies that announced their intention to convert into an income trust between January 1996 and January 2004, with a control sample of companies that operate in the same industries but have not announced or carried out such restructuring activities. Three hypotheses are developed.

First, corporations for which tax payments represent a higher fraction of corporate earnings are hypothesized to have a higher incentive to restructure as an income trust. The authors are surprised to find that the ratio of taxes paid to earnings before interest, taxes, depreciation, and amortization (EBITDA) is statistically equivalent for both the restructuring and control samples. It is not clear from the article what precise measure of tax burden they selected, since the amount of income taxes paid is not usually disclosed in annual reports, while income tax expense reflects the accounting convention of matching expenses to revenues earned and is not necessarily a measure of tax burden.

The second hypothesis is that profitable corporations wishing to signal their prospects for growth (via fixed distributions) are more likely to restructure or convert into an income trust. Aguerrevere et al. find that restructuring firms are more than 1.5 times smaller in their market capitalization than firms in the control sample. Furthermore, restructuring firms are found to have statistically significant higher levels of EBITDA and higher leverage, but lower median book-to-market value of equity (the authors' measure of the firm's prospects) compared with the (non-restructuring) firms in the control sample.

Signalling growth prospects via trust distributions may be difficult to justify, given their unstable nature. Signalling growth prospects also seems inconsistent with trusts claiming to be mature enterprises with stable cash flows. Standard & Poor's as well as Dominion Bond Rating Service have developed Web sites that track the stability ratings of income funds over time.[30] One in five business trusts has cut its distributions since 1999,[31] and many more have maintained their distributions with return of capital rather than return on capital.

The third hypothesis is that firms with higher free cash flows (reflecting higher agency costs) are more likely to restructure or convert, since distributions that reduce excess cash retained inside a company can have positive valuation consequences to the extent that they reduce over-investments in negative net present value projects. The results indicate that restructuring firms have negative free cash flows, and most do not pay dividends in the years prior to conversion. Aguerrevere et al. suggest that perhaps restructuring firms are financially constrained companies that need to reinvest all available cash flows to finance their operations. On the evidence that converting companies are smaller and more prone to liquidity constraints, they suggest that restructuring or converting may be a way for such firms to access the Canadian capital markets on a more competitive basis.

Amin M.

Mihir A. Desai, "The Degradation of Reported Corporate Profits"
(2005) vol. 19, no. 4 *The Journal of Economic Perspectives* 171-92

Corporations often face tradeoffs between reporting higher book income and paying lower taxes. A book-tax tradeoff is necessary when accounting methods have to be similar for both financial reporting and tax reporting purposes. For example, Erickson, Hanlon, and Maydew found that firms that restated their earnings as a result of allegations of accounting fraud paid $320 million in taxes on overstated earnings of about $3.36 billion, illustrating the stark tradeoff faced by firms wanting to report higher book income and pay lower taxes.[32] However, book-tax tradeoffs are avoided if the tax-planning strategy only affects a tax calculation that has no book income counterpart. For example, if financial statements are issued on a consolidated basis for a corporate group but tax returns are prepared for each company, the choice of transfer price can affect consolidated tax liability but not consolidated book profits (since higher reported profits in one legal entity cancel out the lower reported profits in another legal entity).

In this article, Desai traces the evolution of the dual reporting system that allows corporations to appear profitable to capital suppliers while appearing poor to the tax

30 Standard & Poor's (http://www2.standardandpoors.com/) offers stability ratings from SR-1 (most stable) to SR-7 (least stable), while Dominion Bond Rating Service (http://www.dbrs.com/) offers stability ratings for most income funds on a scale of STA-1 to STA-5.

31 McLean & Partners (Calgary), "Business Trust Red Flag Report," February 3, 2006.

32 Merle Erickson, Michelle Hanlon, and Edward L. Maydew, "How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings" (2004) vol. 79, no. 2 *The Accounting Review* 387-408.

authorities. Using case-based evidence, he suggests that corporations do exploit the differences between book and tax reporting opportunistically, and thereby reduce the quality of reported profits to both the tax authorities and the capital markets. Desai provides evidence suggesting that both book and tax reporting have become degraded in recent years, and he explores the underlying reasons. One solution he proposes is to make corporate tax returns publicly available, allowing capital market users to more accurately assess the book-tax tradeoffs made by the firm. Finally, he discusses the nature of the corporate tax as a withholding tax in the context of improving the quality of both financial and tax reporting.

Amin M.

Anja De Waegenaere, Richard C. Sansing, and Jacco L. Wielhouwer, "Who Benefits from Inconsistent Multinational Tax Transfer-Pricing Rules?"
(2006) vol. 23, no. 1 *Contemporary Accounting Research* 103-31

This game-theoretical study examines a multinational corporation's decision to report high or low income in one of two tax jurisdictions, and the decision of the tax authority in that jurisdiction to accept or audit the corporation's reported income. The reference to inconsistency in the title alludes to the situation where transfer-pricing rules result in two or more countries trying to tax the same income. The conventional wisdom questioned by this study is whether double taxation attributable to inconsistency in transfer-pricing rules is always detrimental to taxpayers and beneficial to governments. The theoretical results of this study suggest that a taxpayer's expected tax liability could be decreased (or increased) by shifting more (or less) reported income to the low-tax-rate country, and the government's audit costs could also increase (or decrease) in such a setting. Thus, inconsistency (or double taxation) could be good for multinationals and bad for governments. The authors also identify settings where inconsistencies in transfer-pricing rules clearly help governments to increase tax revenues and decrease audit costs, thereby explaining why governments may not coordinate their rules and practices too closely.

Amin M.

Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "The Demand for Tax Haven Operations" (2006) vol. 90, no. 3 *Journal of Public Economics* 513-31

In this article, the authors' analysis of US affiliates reveals that tax havens are more likely to be used by multinationals that are larger, conduct more research and development, have more intrafirm trade, and have more subsidiaries. Tax havens can help to reallocate profits away from high-tax jurisdictions and into low-tax jurisdictions, as well as reduce home-country taxation of foreign income. The evidence suggests that larger tax haven countries serve primarily to reallocate profits, while smaller tax haven countries serve primarily to facilitate deferral of US taxation of foreign income. Desai et al. also document that the demand for tax haven operations is driven in part by sales and investment growth in neighbouring non-haven countries.

Amin M.