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## CURRENT TAX READING

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**Lawrence Zelenak and Marvin A. Chirelstein, “Tax Shelters and the Search for a Silver Bullet”** (2005) vol. 105, no. 6 *Columbia Law Review* 1939-66

**Brian Galle, “Interpretative Theory and Tax Shelter Regulation”** (2006) vol. 26 *Virginia Tax Review* (forthcoming)

**South African Revenue Service, *Tax Avoidance and Section 103 of the Income Tax Act, 1962: Revised Proposals*** (Pretoria, SA: South African Revenue Service, Legal and Policy Division, September 2006), 31 pages, available on the Web at <http://www.sars.gov.za/>

**Julie Cassidy, “To GAAR or Not To GAAR—That Is the Question: Canadian and Australian Attempts To Combat Tax Avoidance”** (2004-2005) vol. 36, no. 2 *Ottawa Law Review* 259-313

**Angelo Nikolakakis, “Evans v. Desmarais: Surplus Stripping After Canada Trustco and Mathew”** (2006) vol. 13, no. 2 *International Tax Planning* 916-29

In the legal literature, there are two dominant types of writing on the subject of tax avoidance. One type is normative, or policy based, in the sense that it addresses two questions: Why does tax avoidance present a problem? And how should policy makers and/or the courts respond to tax avoidance? The other type of writing analyzes tax-avoidance cases to discern trends in judicial reasoning. It seems that the policy-based writing takes centre stage only where tax avoidance is perceived to be out of control; otherwise, doctrinal writing focused on case analysis tends to dominate.

The US controversy over corporate tax shelters provides a recent example of this suggested relationship between the health of the tax-avoidance industry and the amount of policy-based writing on the subject. There is now an extensive literature in the United States considering possible responses to the corporate tax-shelter industry. This literature has grown exponentially since the late 1990s and the earliest court

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decisions considering the effectiveness of certain shelter transactions. The first two articles listed above are relatively recent additions to the literature.

Zelenak and Chirelstein propose the adoption of legislation that would (1) deny the deduction of losses “substantially in excess of any measurable reduction in the taxpayer’s net worth,”<sup>1</sup> and (2) deny any deduction or exclusion from gross income where the result is effected through the allocation of non-economic income to a tax-indifferent party. The proposal targets transactions whose purpose is to create a tax credit, deduction, or loss. This feature is the common element of corporate tax-shelter transactions, which otherwise differ greatly in their structure. Zelenak and Chirelstein explain that their proposal is intended to provide “a silver bullet (or perhaps a broad spectrum antibiotic) which would kill a wide variety of tax shelters” while leaving “little to judicial discretion.”<sup>2</sup> They argue that, in this respect, the legislative changes they recommend parallel the adoption of the passive loss restrictions as part of the US 1986 tax reform. The latter sucked much of the air out of the personal tax-shelter industry in the United States.

Although Galle’s article is ostensibly a response to Zelenak and Chirelstein, it is a limited one since he agrees with the general thrust of their proposal. Galle’s principal criticism (if it can, in fact, be called that) is that Zelenak and Chirelstein reject the codification of some form of economic substance doctrine. The articulation of such a doctrine by the US judiciary may explain why policy makers have not seen fit to include a general anti-avoidance rule (GAAR) in the Internal Revenue Code. The corporate tax-shelter industry has been propelled, to some extent at least, by a clear trend in US tax jurisprudence in favour of a literalist interpretive approach in a tax-avoidance context. In particular, US courts have tended to reject the application of an overriding standard, such as a business purpose doctrine, and have begun to embrace a literalist approach to the interpretation and application of specific provisions implicated by a tax-avoidance transaction. Galle argues that a close reading of interpretive theory supports the notion that a literalist court could not reject the application of an economic substance doctrine if it were codified in the tax legislation. He also emphasizes the need for an explicit exception for tax expenditure provisions from the application of the mechanical rule proposed by Zelenak and Chirelstein. But they too recognize the need for such an exception, with the only difference between their proposal and Galle’s being its legislative form.

The third publication listed above—a brief document released by the South African Revenue Service—follows up on an earlier discussion paper proposing extensive changes to the GAAR in South Africa.<sup>3</sup> The earlier paper was more detailed and included the necessary policy framework. This latest document consists of a new set

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1 At 1951-52.

2 At 1951.

3 South African Revenue Service, *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* (Pretoria, SA: South African Revenue Service, November 2005), reviewed in this feature (2006) vol. 54, no. 2 *Canadian Tax Journal* 551-70, at 551-53.

of changes, and accompanying explanations, that respond to a number of comments and suggestions made in the context of public consultations on the discussion paper. The revised version of the updated South African GAAR would apply to deny any tax benefit realized by an “impermissible avoidance arrangement.” The targeted transactions are those that are entered into primarily to provide the tax benefit and that either lack “commercial substance” or frustrate the purpose of any provision of the income tax legislation. The proposed GAAR differs from the existing provision, as well as the earlier proposal, mainly in its focus on the lack of commercial substance as fatal to a tax-avoidance transaction. The apparent targets of this aspect of the legislation are the South African counterparts to the kind of transactions that are the product of the US corporate tax-shelter industry. The proposed South African GAAR provides some relatively detailed guidance as to when commercial substance may be found to be lacking; however, the guidelines are not as detailed as those in the earlier proposals. In particular, the number of enumerated factors is reduced from 11 to 5.

The Cassidy article and the Nikolakakis comment both lie squarely within the body of legal literature that describes and analyzes the execution of anti-tax-avoidance rules or doctrines by the courts. Cassidy is an Australian tax academic. She provides an illuminating comparison of the structural features of the Canadian GAAR in section 245 of the Income Tax Act (ITA)<sup>4</sup> and the Australian GAAR in part IVA of the Income Tax Assessment Act 1997 (ITAA). The comparative format she chooses is especially interesting. She breaks down the two GAARs in terms of their comparable structural features: the definition of an avoidance transaction in the context of a series of transactions; the definition of a tax benefit; the purpose test; and the exclusion of transactions explicitly sanctioned by the tax statute. She discusses each of these structural features as they have been interpreted and applied by the Canadian and Australian courts. The discussion is followed in each instance by a comparison of the differences between the statutes and the interpretive approaches used by the courts in the two countries.

Cassidy prefers the broader definition of a tax benefit in section 245, as well as the approach to the application of the GAAR in the context of a series. Under part IVA of the ITAA, Australian courts have concluded that the conditions of application, particularly the purpose test, must be applied to the series as a whole, rather than to each step independently as is required under paragraph 245(3)(b) of the ITA. Not surprisingly, however, Cassidy observes that the misuse or abuse exception has been interpreted by Canadian courts in a manner that has made section 245 underinclusive, which suggests that the much narrower exception in part IVA of the ITAA for explicit tax-preference provisions is preferable. Somewhat surprisingly, she argues that a misuse or abuse exclusion would be the more defensible approach if policy makers could have some confidence that the courts would apply it purposively. Cassidy wrote her article before the GAAR decisions of the Supreme Court of Canada

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

in *Mathew v. The Queen*<sup>5</sup> and *The Queen v. Canada Trustco Mortgage Co.*;<sup>6</sup> however, those decisions and the subsequent GAAR case law only seem to confirm her general observations.

The Nikolakakis comment focuses on two of the subsequent GAAR decisions at the Tax Court of Canada, involving surplus-stripping transactions: *Evans v. The Queen*<sup>7</sup> and *Desmarais v. The Queen*.<sup>8</sup> Nikolakakis is a prominent Canadian tax lawyer who has set himself the Herculean task of squaring the diametrically opposed decisions in these two cases. He provides a careful reading of the judgments in the two cases and draws out the implications of each for a set of hypothetical, but realistic, transactions. He concludes that the correct interpretation and application of the GAAR in a surplus-stripping context probably lies somewhere in between the decisions in *Evans* and *Desmarais*, with the former being underinclusive and the latter overinclusive.

T.E.

**Shee Boon Law, “The Choice of Fixed Accounting Ratios as Safe Harbours in Thin Capitalisation Rules—Some Guidance from Commercial Debt Contracts”** (2006) vol. 21, no. 2 *Australian Tax Forum* 363-86

Thin capitalization legislation attempts to identify the extent to which corporate debt provided by significant shareholders may be considered to be disguised equity and the associated interest expense may be denied deductibility to the debtor. Two very different approaches are reflected in the tax legislation of different countries. Under an arm’s-length standard, the particular circumstances of a corporate debtor are examined to determine whether an “independent banker” would have provided the debt finance. Under a fixed debt-equity ratio (which is characteristic of the approach in subsections 18(4) to (6) of the ITA, for example), a debt-equity ratio is specified and any debt in excess of the ratio is considered to be disguised equity. This “one size fits all” approach is rationalized on the basis of administrative simplicity: the costs of administering a fixed ratio are much lower than the costs of determining an appropriate ratio for particular issuers in different circumstances under an arm’s-length standard. However, the use of a fixed ratio is criticized as either underinclusive or overinclusive, as compared with a flexible arm’s-length standard, depending on the specified ratio that is to be applied.

This article examines the empirical evidence on debt-equity ratios specified in commercial debt contracts to determine whether the use of fixed ratios in the Australian, New Zealand, and US legislation is underinclusive or overinclusive. The author

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

6 2005 DTC 5523; [2005] 5 CTC 215 (SCC).

7 2005 DTC 1762; [2006] 2 CTC 2009 (TCC).

8 2006 DTC 2376; [2006] 3 CTC 2304 (TCC).

finds that the ratio used in the Australian and New Zealand legislation (that is, 3:1) is generally consistent with the ratios that lenders require in commercial debt contracts with arm's-length borrowers. However, this legislated ratio tends to be underinclusive because, for tax purposes, it is based on all assets of the borrower; in contrast, for the purposes of imposing borrowing restrictions under commercial debt contracts, only tangible assets are used. The author's findings do not necessarily extend to countries (such as Canada) that focus only on certain shareholder-held debt in the application of a specified debt-equity ratio. Notably, both Australia and New Zealand apply the 3:1 ratio on the basis of all debt of a corporate issuer.

T.E.

**Howell H. Zee, "VAT Treatment of Financial Services:  
A Primer on Conceptual Issues and Country Practices"**

(2006) vol. 34, no. 10 *Intertax* 458-74

This article provides an accessible survey of the conceptual issues and some countries' practices in the treatment of financial services under a value-added tax (VAT) or goods and services tax (GST). Zee begins with a brief review of an issue that has been debated recently in the academic literature: whether financial services are properly considered taxable consumption under a VAT. He concludes that the better view is that they are properly taxable. The difficult issues that arise in adopting this view concern the measurement of value added by financial service providers and its allocation to consumers where prices are implicit in financial margins. In the face of this difficulty, the dominant approach, which is used under the GST in Canada, is the exemption of financial services, with no relief for tax paid on inputs consumed by financial service providers. This approach is seen to distort patterns of consumption, both because of the unrelieved tax that is embedded in the prices charged by financial service providers and because of the failure to tax the value of consumption by households.

After describing these conceptual issues, Zee reviews the practices in a number of countries that are intended to address such distortions attributable to an exemption system. The review includes the partial input tax recovery methods used in Australia and Singapore, as well as the zero-rating of the business consumption of financial services used in New Zealand; but the largest portion of the review is devoted to a description of the cash flow method developed by Poddar and English,<sup>9</sup> and Zee's own reverse-charge modification of that method.<sup>10</sup> Zee's approach is intended to

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9 See Satya Poddar and Morley English, "Taxation of Financial Services Under a Value-Added Tax: Applying the Cash-Flow Approach" (1997) vol. 50, no. 1 *National Tax Journal* 89-111, reviewed in this feature (1997) vol. 45, no. 4 *Canadian Tax Journal* 876-90, at 880.

10 Howell H. Zee, "A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax" (2005) vol. 58, no. 1 *National Tax Journal* 77-92.

realize the same full taxation result as the cash flow method, but at a lower compliance cost (thus addressing the principal problem of that method). It is probably fair to say that the reverse-charge methodology requires further development before any definite conclusions can be reached regarding its feasibility. In the interim, the incomplete approaches used by Australia, Singapore, and New Zealand appear to be the more viable responses intended to address some of the distortions caused by exemption, although they do lack the theoretical elegance of either the cash flow method or the reverse-charge modification articulated by Zee.

T.E.

**Hugh J. Ault, “Improving the Resolution of International Tax Disputes”**

(2005) vol. 7, no. 3 *Florida Tax Review* 137-51

Hugh Ault is a professor at the Boston College Law School and a senior adviser to the Organisation for Economic Co-operation and Development (OECD) Centre for Tax Policy and Administration. In this brief article, he reviews the existing mutual agreement procedure (MAP) provided for in bilateral tax treaties as a dispute resolution mechanism. Ault argues that the principal problem with the MAP process is its failure to guarantee a conclusion. He notes that, while the OECD project on the MAP process proposes some notable improvements,<sup>11</sup> it fails to address this particular problem. Ault then describes various “supplementary” dispute resolution techniques and suggests that arbitration, in particular, holds the most promise as a means of resolving international tax disputes.

T.E.

**Mark Burton, “The Australian Small Business Tax Concessions—Public Choice, Public Interest or Public Folly?”** (2006) vol. 21,

no. 1 *Australian Tax Forum* 71-130

Tax preferences for small businesses litter the tax systems of almost all countries. Yet the evidence supporting such preferences is weak or non-existent. This subject thus provides fertile ground for the study of the effect of interest-group behaviour on the legislative process. Burton’s article describes the relevant Australian experience. Not surprisingly, his survey of the supporting evidence for the array of tax preferences for small businesses in the Australian tax system leads him to characterize it as “partial and flimsy, to say the least.”<sup>12</sup> This survey is followed by a lengthy account of the legislative process that has produced the tax preferences. Burton rejects interest-group behaviour as an explanation for the legislative outcomes, favouring instead a

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11 Organisation for Economic Co-operation and Development, *Improving the Process for Resolving International Tax Disputes* (Paris: OECD, Centre for Tax Policy and Administration, 2004).

12 At 72.

theory of “bounded rationality.” However, this explanation is not especially clear, let alone compelling as an alternative to interest-group behaviour. Moreover, it is not clear how bounded rationality affects the choice of policy instrument intended to correct the legislative pathology.

T.E.

**Tax Council Policy Institute Seventh Annual Policy and Practice Symposium,  
“The Corporate Tax Practice in the Age of Transparency: A Path Forward”**

(2006) vol. 84, no. 6 *Taxes: The Tax Magazine* 27-139

Most of this issue of *Taxes* consists of written reproductions of eight panel discussions devoted to various topics affecting corporate tax practice in the United States. The panel discussions were held at the annual symposium of the Tax Council Policy Institute, which is an association of tax professionals practising as employees of corporate taxpayers. The report of the symposium proceedings also includes a brief introduction and the results of a survey of senior tax executives at Fortune 500 corporations.

T.E.

**Sandra Eden, “An Unlucky Configuration”**

[2006] no. 2 *British Tax Review* 150-69

This article analyzes the income tax treatment of compensation for breach of contract in the United Kingdom. According to Eden, this treatment has “all the ingredients of a star-crossed chart: the capital/revenue divide, confused underlying principles, difficult case law and a particularly tricky extra-statutory concession are placed in relation to each other to provide a particularly inauspicious configuration.”<sup>13</sup> With the possible exception of the presence of an extrastatutory concession, this description of the UK income tax treatment of contractual compensation payments could apply equally to the treatment in Canada, or in any number of other Commonwealth countries. Two aspects of the UK approach are similar and notable. The first is the treatment of damages received for breach of a contract made in the course of business. The characterization of these receipts as business revenue is relatively uncontentious. The second is the treatment of contractual damage payments outside the business context. It is perhaps not an overstatement to say that the treatment of these payments in the United Kingdom and many other countries is a mess, in terms of both conceptual coherence and policy coherence.

Eden provides a useful review of the state of the law in the United Kingdom. Unfortunately, she does not provide much in the way of proposals for reform.

T.E.

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13 At 150.

**Daniel M. Schneider, “Using the Social Background Model To Explain Who Wins Federal Appellate Tax Decisions: Do Less Traditional Judges Favor the Taxpayer?”** (2005) vol. 25, no. 1 *Virginia Tax Review* 201-49

Daniel Schneider has pioneered empirical research on the influence of the social background of US judges on their decisions in tax cases.<sup>14</sup> In this article, he applies a “personal attributes model” to judges at the appellate level to test two hypotheses:<sup>15</sup>

1. The social background of the judge influences who wins tax cases.
2. A judge with a less traditional background is more likely to decide in the taxpayer’s favour than a judge with a more traditional background.

Schneider characterizes social background on the basis of several factors, including gender, race, and education (elite or non-elite). He finds that both hypotheses are supported by the evidence. In particular, identity as a female is associated with pro-taxpayer outcomes. Non-white racial identity and a non-elite education also are correlated with pro-taxpayer outcomes, as is appointment by a Democratic president. However, data from an earlier study by Schneider<sup>16</sup> indicated that some of these correlations were stronger at the trial level. For example, a judge’s level of seniority was more important to the outcome at the trial level. On the other hand, a judge’s gender and educational background were stronger explanatory variables at the appellate level.

T.E.

**Deborah A. Geier, “The Taxation of Income Available for Discretionary Use”** (2006) vol. 25, no. 3 *Virginia Tax Review* 765-834

One of the more contentious aspects of the *Report of the Royal Commission on Taxation* (the Carter report) was its justification of a progressive rate structure based on the concept of “discretionary income.”<sup>17</sup> With appropriate acknowledgment of the report, Geier argues that the debate in the United States over the choice of income or consumption as the ideal tax base is really about the attempt to protect non-discretionary

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14 See Daniel M. Schneider, “Statutory Construction in Federal Appellate Tax Cases: The Effect of Judges’ Social Backgrounds and of Other Aspects of Litigation” (2003) vol. 13 *Washington University Journal of Law and Policy* 257-304; “Assessing and Predicting Who Wins Federal Tax Trial Decisions” (2002) vol. 37, no. 2 *Wake Forest Law Review* 473-529; and “Empirical Research on Judicial Reasoning: Statutory Interpretation in Federal Tax Cases” (2001) vol. 31, no. 2 *New Mexico Law Review* 325-58.

15 For an application of the personal attributes model to judicial decision making in tax cases at the Supreme Court of Canada and the Tax Court, see Thaddeus Hwong, “A Quantitative Exploration of Judicial Decision Making in Canadian Income Tax Cases” (unpublished PhD dissertation on file with the author).

16 Schneider, “Assessing and Predicting Who Wins Federal Tax Trial Decisions,” supra note 14.

17 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen’s Printer, 1966), 1-24.

consumption, either current or deferred, from taxation. She proposes eliminating various personal tax credits and deductions under the US income tax and replacing them with a standard deduction that would effectively provide a zero tax rate for non-discretionary consumption. The proposed deduction would avoid the problems associated with the reasoning in the Carter report. In particular, Carter argued that, as one moves up the income scale, more discretionary income is available, so that progressively higher rates of tax can be applied. The principal problem with this argument is that there is no obvious link between the percentage of discretionary income and the specified tax rate. Geier's proposal is more modest: it posits a median amount of non-discretionary expenses, which would provide the basis of the effective zero rate realized through a basic income deduction. The concept of discretionary income is not used to justify the choice of rate structure beyond this basic zero rate.

Geier's proposal has some important second-order policy implications. For example, she argues that the reduced tax rate for dividend income and capital gains, as well as the exemption of gains realized on the sale of a principal residence, are indefensible. She also argues that the policy rationale for her proposed standard deduction suggests that gifts received above a minimum annual amount should be taxable to the recipient.

T.E.

**Steven A. Dean, "Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification"**

(2005) vol. 34, no. 2 *Hofstra Law Review* 405-67

The author of this article uses the US "check-the-box" regulations for entity classification as a case study of what he calls "attractive complexity." By this term, he means tax complexity that taxpayers do not object to because the available benefits exceed the associated compliance costs. Dean contrasts attractive complexity with "burdensome complexity," which taxpayers object to because the available benefits (if any) do not exceed the associated compliance costs. Dean argues that attractive complexity can send false signals to tax policy makers, who may believe that there is no deadweight loss attributable to complex provisions if the affected taxpayers do not object to them.

This insight is an important one, at least as it applies to technical tax provisions, such as the check-the-box regulations. It does not seem to apply as compellingly to complex provisions that can be characterized as tax-expenditure provisions. In the latter case, the complexity of the provisions and the associated compliance burden should be conceptualized as the cost of delivering the spending program through the tax system, and that cost should be compared with the cost of delivering the program directly instead. The so-called false signals that Dean attributes to provisions that are attractively complex do not seem to be relevant to an analysis of the delivery costs of spending programs.

In this respect, Dean arguably fails to recognize the limits of his insight when he applies it to simplification proposals put forward by the President's Advisory Panel

on Federal Tax Reform<sup>18</sup> in the areas of tax-preferred savings and charitable giving. Tax relief in each of these areas can be characterized as the equivalent of a direct spending program, with costs of delivery through the tax system that should be compared with the costs of non-tax alternatives.

T.E.

**Eric D. Chason, “Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season”** (2006) vol. 67, no. 2 *Ohio State Law Journal* 347-99

The author of this article argues for the accrual taxation of deferred compensation plans in the hands of the employee. Accrual taxation would extend to both the amount of employer contributions and the return earned in the plan. As a second-best alternative, Chason would impose tax on withdrawals at the highest marginal tax rate applicable to individuals. Current treatment under the US Internal Revenue Code defers taxation in the hands of the employee until withdrawal, but also defers the employer’s deduction for the offsetting expense until that time. Chason argues that the temporal shifting of deferred compensation is no different than the rate shifting that income splitting is intended to access; however, specific anti-avoidance rules prevent the latter but not the former. This analogy follows from an assumption that deferred compensation makes sense only if the employee will be subject to tax at lower rates on future withdrawals.

T.E.

**Joshua D. Blank, “Confronting Continuity: A Tradition of Fiction in Corporate Reorganizations”** [2006] no. 1 *Columbia Business Law Review* 1-79

This article critically reviews the “continuity-of-interest” doctrine developed by the US judiciary as an overlay to the corporate reorganization provisions in the Internal Revenue Code. The doctrine requires that continuity of shareholder interest must be maintained to qualify for rollover treatment under various provisions in the Code. Blank argues that the doctrine does not adequately distinguish between reorganizations and purchase and sale transactions in the context of mergers involving share-for-share exchanges. He proposes that it should be replaced, in this context, by a requirement that the acquiring corporation must carry on the business of the target corporation for at least two years following a merger. Even where this condition is satisfied, however, rollover treatment would be provided only if the positions of the shareholders of a target corporation did not change substantially as a result of an exchange of shares of the target for shares of the acquiring corporation.

T.E.

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18 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), 75-78 and 114-24, reviewed in this feature (2006) vol. 54, no. 1 *Canadian Tax Journal* 345-58, at 354-55.

**Alex Raskolnikov, “Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty”**

(2006) vol. 106, no. 3 *Columbia Law Review* 569-642

In this article, Raskolnikov argues that the nominal penalty structure for tax avoidance and tax evasion does not adequately take into account the probability of detection, which affects the expected amount of the penalty. In these circumstances, an illegitimate deduction is more difficult to detect on a taxpayer’s return. Raskolnikov proposes a self-adjusting penalty structure whereby the amount of any penalty would increase by a specified percentage of the amount of a legitimate deduction of the same kind. When the amount of the nominal penalty is increased in this way, the amount of the expected penalty is increased where the probability of detection is low. The increased expected cost would presumably alter avoidance and evasion behaviour, at least to the extent that such behaviour is undertaken on the basis of a rational calculus that compares the expected benefits with the expected costs.

Raskolnikov’s analysis and proposal appear to be more compelling in the context of tax evasion, since detection is a significant problem. The same problem is addressed effectively in the context of tax avoidance through information reporting. With information reporting, the more serious problem in a tax-avoidance context is not, in fact, the application of any penalty structure, but rather the inconsistent decisions of the courts in characterizing avoidance as illegitimate. This characterization issue is arguably a much more significant factor in a taxpayer’s calculation of expected costs and benefits.

T.E.

**Richard Wood, “Financial Capital and Taxation Policy”**

(2006) vol. 27, no. 2 *Fiscal Studies* 127-55

The author of this article is a member of a group at the Australian Treasury department working on the taxation of financial arrangements project. After a lengthy gestation period, the project produced comprehensive legislation classifying corporate securities as debt or equity, along with a set of rules governing the treatment of foreign exchange gains and losses. A later stage of the project has produced proposed legislation governing the timing of the recognition of gains and losses on financial instruments, along with a regime for hedge tax accounting.

This article focuses primarily on the timing issue and, in particular, proposes a distinction between accrual and realization treatment based on the volatility of a particular security. There is also some discussion of the role of a hedge tax accounting regime in the characterization of gains and losses as income or capital amounts. In addition, the article reviews the use of the “contingency principle” to draw the distinction between debt and equity. This principle is reflected in the comprehensive classification legislation referred to above.

T.E.

**Arthur J. Cockfield, “The Rise of the OECD as Informal ‘World Tax Organization’ Through National Responses to E-Commerce Tax Challenges”**

[2006] vol. 8 *Yale Journal of Law & Technology* 136-87

The OECD has achieved considerable influence in the past 10 to 15 years in the development of national country practices across a range of international tax issues. In this article, Cockfield reviews the OECD's influence in the particular case of the challenges presented by electronic commerce. He argues that the lack of specific legislative rules, or even any stated administrative practice, in most member countries is attributable to the ability of the OECD to build consensus and implement multilateral coordination. Cockfield concludes that the OECD is increasingly acting as a de facto world tax organization on many issues. Although this role is an informal one, he suggests that it is to be preferred to a formal organization (as argued for by some commentators), which could impose binding rules on participating countries.<sup>19</sup>

T.E.

**Philip B. Shane and Toby Stock, “Security Analyst and Stock Market Efficiency in Anticipating Tax-Motivated Income Shifting”**

(2006) vol. 81, no. 1 *The Accounting Review* 227-50

The 1986 Tax Reform Act in the United States reduced statutory corporate income tax rates by 12 percentage points over a two-year phase-in period, providing strong incentives for firms to save taxes by deferring earnings from the fourth quarter of the high tax rate year to the first quarter of the low tax rate year. Generally, however, firms may be reluctant to shift income to the extent that financial analysts and investors do not recognize the temporary income effects of such tax-motivated income shifting. Information asymmetry and adverse selection may cause both analysts and investors to discount management's claims that lower than expected earnings resulted solely or mainly from tax-motivated income shifting. This study investigates the extent to which financial analysts and investors anticipate and correctly interpret the temporary income effects of tax-motivated income shifting during periods of declining statutory tax rates.

The results confirm that firms did shift significant amounts of income in order to benefit from declining statutory tax rates. However, financial analysts were not able to anticipate the income shifting, resulting in unusually large negative fourth quarter earnings forecast errors (actual earnings minus forecasted earnings). Furthermore, analysts were not able to learn about such tax-motivated income shifting soon enough, because the forecasted first quarter earnings in the low tax rate period were unusually lower than the actual reported earnings, and the absolute values of forecast errors did not decline from the fourth quarter of the high tax rate period to the

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<sup>19</sup> See, for example, Adrian Sawyer, “Developing an International (World) Tax Organisation for Administering Binding Rulings and APAs—The Way Forward” (2006) vol. 21, no. 2 *Australian Tax Forum* 287-330.

first quarter of the low tax rate period. This suggests that analysts do not understand or do not act to adjust temporary income effects arising from tax-motivated income shifting.

Market investors also failed to understand the temporary earnings shifts and reversals during periods of declining statutory tax rates. The study results show negative abnormal returns around announcements of earnings in the fourth quarter tax-reduction period and positive abnormal returns around announcements of earnings during the first quarter of the following fiscal year, with the differences in these two adjacent quarterly abnormal returns being statistically significant. While investors reacted in the same direction as analysts, they overreacted to the forecast errors. The study results show that analysts' earnings forecast errors explain about half of the abnormal returns associated with firms' fourth quarter and following year first quarter earnings announcements. Thus, analyst inefficiencies explain only part of the market inefficiency in anticipating temporary declines and subsequent increases in earnings arising from tax-motivated income shifting during periods of declining statutory tax rates. Such inefficiencies reflect information problems (such as adverse selection) that lead to financial reporting (or non-tax) costs that can inhibit firms from implementing optimal tax planning. Analyst learning could improve market efficiency and allow firms to pursue their optimal tax strategies in the interests of their stakeholders.

Amin M.

**Andrew P. Schmidt, "The Persistence, Forecasting, and Valuation Implications of the Tax Change Component of Earnings"**

(2006) vol. 81, no. 3 *The Accounting Review* 589-616

Financial reporting standards in both Canada and the United States require corporations to disclose (in their financial statement notes) a reconciliation of income tax expense resulting from applying the statutory tax rate (STR) to pre-tax income with the reported amount of income tax expense for the year that reflects the effective tax rate (ETR). Material items accounting for the difference between the STR and the ETR have to be clearly reported, and often include items such as tax loss carryforward benefits and tax credits (for research and development or for foreign income).

ETRs have been shown to be convenient levers for managing or smoothing earnings. Dhaliwal, Gleason, and Mills find that firms resort to lowering their reported ETR when they are just short of meeting analyst forecasts.<sup>20</sup> ETRs are useful levers of manipulation because income taxes are usually material, and reported income tax expense can have a significant impact on reported earnings. For example, McGill and Outslay refer to Tyco International Ltd.'s assertion that reducing the reported

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20 Dan S. Dhaliwal, Cristi A. Gleason, and Lillian F. Mills, "Last-Chance Earnings Management: Using the Tax Expense To Meet Analysts' Forecasts" (2004) vol. 21, no. 2 *Contemporary Accounting Research* 431-59.

ETR by about 7 percentage points via tax-sheltering activity increased earnings, which in turn increased Tyco's market capitalization by almost \$5 billion.<sup>21</sup> ETRs are also increasingly becoming performance measures of in-house tax departments in their role as profit centres. Thus, ETR reconciliations reflect, in part, the effects of tax planning designed to optimize reported earnings, and not just the company's income tax liability. 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 extent to which firms are willing to pay in order to report higher book income.<sup>22</sup> Evidence of widespread earnings manipulation has resulted in increased scrutiny of book-tax differences and their impact on earnings quality.

Two aspects of earnings quality include the extent to which changes in components of earnings have a persistent impact on future earnings and the extent to which forecast earnings are impounded into stock prices. This study examines both the earnings persistence and the pricing implications of changes in the tax component of earnings. The study finds a positive, significant association between the tax change components of earnings (found in the ETR note) and future earnings, confirming that ETR-related earnings changes are not transitory. The study also finds that future earnings implications of tax-related earnings information are priced by the market. This type of research helps in understanding the role of tax information in improving forecasts of reported incomes and their valuation implications.

Amin M.

**Dan Dhaliwal, Shane Heitzman, and Oliver Zhen Li, "Taxes, Leverage, and the Cost of Equity Capital"** (2006) vol. 44, no. 4 *Journal of Accounting Research* 691-723

This empirical study finds that the cost of equity capital increases with leverage (proxy for risk), decreases with corporate tax rates (which mitigate the leverage-related risk premium), and increases with shareholder-level personal tax rates. The firm's cost of equity capital is innovatively estimated by the expected return implied by an accounting-based valuation model based on stock price, dividends, book value of equity, and forecasted future earnings. These results offer direct evidence that tax implications at both corporate and individual levels affect firm value, and therefore the cost of equity capital.

Amin M.

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21 Gary A. McGill and Edmund Outslay, "Lost in Translation: Detecting Tax Shelter Activity in Financial Statements" (2004) vol. 57, no. 3 *National Tax Journal* 739-56, at 751-52.

22 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, at 387.

**David A. Guenther and Richard Sansing, “Fundamentals of Shareholder Tax Capitalization”** (2006) vol. 42, no. 3  
*Journal of Accounting and Economics* 371-83

This study examines how shareholder-level taxes affect stock prices in a setting where firms choose their investment and dividend (payout) policies, and taxable and tax-exempt shareholders have a choice between competing investments. In the authors' analytical model, shareholder-level personal taxes induce firms to forgo dividends and invest in projects that might be rejected if they had to be financed with new equity. This “trapped equity” problem may be mitigated by Canadian income trusts that structure themselves to seek new equity every time they wish to grow or expand.

Shareholder-level taxes also reduce the variance (or risk) of after-tax returns (on dividends) for taxable investors. These taxable investors also bid up the stock prices, because dividends are tax-favoured relative to interest (in both Canada and the United States). If the stock has a sufficiently low level of risk, only taxable investors will hold the stock, and mostly for the tax-favoured nature of the return rather than for risk-sharing considerations. Tax-exempt investors will not be willing to pay as much for low-risk stocks since they do not value the tax-favoured returns. If the stock is sufficiently risky, both taxable and tax-exempt investors will hold the stock for risk-sharing reasons. The presence of tax-exempt investors mitigates, but does not eliminate, shareholder-level tax capitalization for risky stocks. Prices of risky dividend-paying stocks reflect the relative risk tolerance of taxable and tax-exempt investors, as well as the tax-favoured returns enjoyed by taxable investors.

Amin M.

**John R. Graham and Alan L. Tucker, “Tax Shelters and Corporate Debt Policy”**  
(2006) vol. 81, no. 3 *Journal of Financial Economics* 563-94

Credible public information on tax shelters is hard to find since firms do not publicize their use and tax authorities keep their investigations confidential. The growth of tax shelters has been fuelled by the low probability of detection. Bankman asserts that tax-shelter activity is further fuelled by the relative ease with which shelter promoters obtain favourable opinion letters from legal advisers (which offer protection from penalties if the shelter is ruled to be illegal) and by weakening business norms in the context of the attractive economics of sheltering income.<sup>23</sup> Bankman estimates that tax shelters allow US firms to avoid more than \$10 billion in federal income taxes annually, while Bankman and Simmons report that California's one-time tax amnesty extinguished \$30 billion in tax shelters.<sup>24</sup> Tax shelters are generally

23 Joseph Bankman, “The New Market in Corporate Tax Shelters” (1999) vol. 83, no. 12 *Tax Notes* 1775-95.

24 *Ibid.*, at 1775; and Joseph Bankman and Daniel Simmons, “Terminating Tax Shelters: Has California Broken the Legislative Logjam?” (2003) vol. 101, no. 9 *Tax Notes* 1111-15, at 1111.

regarded as the major reason for the decline in income tax payments by US corporations. For example, S&P 500 firms' income tax expense dropped from 29 cents per dollar of reported earnings in 1994 to 18 cents in 2004.<sup>25</sup>

Using an archival search of Tax Court records and the financial press, this study identifies 44 tax shelters (involving 43 firms) that were investigated or filed suit, or both, during the 1975-2000 period. The authors investigate the magnitude of the tax-sheltering activity and its association with corporate debt policy. While the sample is not representative, and therefore the results cannot be generalized, it does consist of firms known to be engaged in tax shelters. Other studies have had to infer sheltering activities by firms in their samples.<sup>26</sup>

The tax shelters in this non-representative sample are large. The median shelter would completely shield income equal to 9 percent of asset value. In comparison, a firm with a 30 percent debt-to-assets ratio and a 10 percent coupon rate would produce interest deductions that would shelter income of only 3 percent of assets. The results also show that companies appear to substitute between the tax shields provided by tax shelters and debt interest. Firms use less debt when their non-debt tax shields are large. In the years in which tax shelters are in use, sheltering firms' debt ratios are more than 800 basis points lower than the debt ratios of similar-size same-industry firms that do not use tax shelters. The substitution seems even more pronounced given that the debt ratios of these matched pairs are indistinguishable a few years before the shelters are implemented. Holding all else constant, compared with non-shelter firms, shelter firms are significantly less likely to issue debt.

The authors also point out that by substituting for debt shields, sheltering could increase financial slack, enhance credit quality, reduce the risk of covenant violation, reduce expected bankruptcy costs, and reduce the cost of debt, all of which could increase stock prices. The evidence in this study shows that shelter firm credit ratings improve by one grade relative to matched non-shelter firms, presumably owing to reduced leverage. The reduction of effective tax rates associated with offshore or off-balance-sheet activity can also increase reported earnings, and thereby stock prices. However, these benefits need to be weighed against the potential risk and tax penalties associated with engaging in tax shelters.

The above results suggest that a firm's low level of debt may not be an anomaly even if its marginal tax rates are high. This is because firms may have substitute tax shields such as employee stock options (in the United States, where they are deductible for tax purposes) or defined benefit pension plans. For example, Graham, Lang, and Shackelford show that debt levels at S&P 100 and Nasdaq 100 firms appear to be conservative if stock option deductions are ignored, but not otherwise.<sup>27</sup> Stefanescu

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25 Graham and Tucker, at 565, figure 1.

26 For example, Mihir A. Desai, "The Divergence Between Book and Tax Income," in James Poterba, ed., *Tax Policy and the Economy*, vol. 17 (Cambridge, MA: MIT Press, 2003), 169-206.

27 John R. Graham, Mark H. Lang, and Douglas A. Shackelford, "Employee Stock Options, Corporate Taxes, and Debt Policy" (2004) vol. 59, no. 4 *The Journal of Finance* 1585-1618.

documents a similar result for firms that use defined benefit pension plans.<sup>28</sup> Other substitutes, such as off-balance-sheet tax deductions, may not be easily observable to researchers and may therefore be ignored in empirical studies that seek to explain corporate debt policy. This study is useful in drawing attention to tax shield substitutes that are difficult to detect and in documenting their magnitude.

Amin M.

**Dmitri Romanov, “The Corporation as a Tax Shelter: Evidence from Recent Israeli Tax Changes”** (2006) vol. 90, nos. 10-11 *Journal of Public Economics* 1939-54

This study examines the behavioural response to an increase in Israel’s marginal tax rate of 15.42 percentage points for business income of self-employed persons. The results show that this tax change in 2002 triggered an abrupt addition of approximately 4,500 corporations (a 5 percent increase in the size of the corporate sector), most of which were professional and health service businesses, which were formerly operated in unincorporated forms. Setting up corporations allowed self-employed individuals to convert their high-taxed labour income into tax-favoured dividend income. Owner-managers in Canada are also changing their salary-dividend mix in response to recent reductions in the statutory tax rate for dividend income.

Amin M.

**Kenneth J. Klassen and Richard Sansing, “A Model of Dynamic Tax Planning with an Application to Estate Freezes”** (2006) vol. 28, no. 1 *The Journal of the American Taxation Association* 1-24

In a typical estate freeze, common shares are exchanged by the parents (current business owners) for voting preferred shares with a value equal to the fair market value at the time of exchange. New common shares are then issued to the children (heirs) at nominal value. Such an estate freeze ensures that any growth from common shares after the date of the freeze is not subject to income tax on the parent’s death, but instead taxes are deferred until the children eventually sell their shares in the company.

Analysis of data from a survey of family-controlled Canadian private corporations indicates that the current owners are more likely to implement an estate freeze in the following circumstances: (1) if the children are more likely to retain their common shares for a long period, thereby increasing the tax deferral benefit of the freeze; (2) if the current owner is older and thus less likely to want to reverse the freeze; (3) if the expected costs of the estate freeze are high; and (4) if the expected costs of not being able to sell the business through other channels are high.

Amin M.

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28 I. Stefanescu, “Capital Structure Decisions and Corporate Pension Plans” (unpublished manuscript, University of North Carolina, Chapel Hill, NC).

**Michael J. Brunetti, “The Estate Tax and the Demise of the Family Business”**

(2006) vol. 90, nos. 10-11 *Journal of Public Economics* 1975-93

On the death of the owner of a family business, if the business has insufficient liquid assets, it may have to be sold by the heirs to pay estate taxes. While there is evidence that business owners purchase more life insurance than non-business owners,<sup>29</sup> there is no empirical evidence on whether estate taxes force business sales. This study examines the extent (if any) to which the estate tax in California increases the probability of sale of businesses and farms.

Data on business sales, estate and inheritance taxes paid, and the appraised value of all of a decedent's assets are collected from probate court records for the period from 1979 to 1982. Probit models are estimated to compare business sales before and after the large federal and state tax changes in 1982. While the results show a strong positive relationship between the estate tax and business sales, the empirical results do not support lack of liquidity as the cause of business sales.

Amin M.

**Reginald Mombrun, “Let's Protect Our Economy and Democracy:**

**The Case for Keeping the Estate Tax”** (2006) vol. 84, no. 9

*Taxes: The Tax Magazine* 29-48

This comprehensive review article examines arguments for and against the permanent repeal of the estate tax in the United States.

The author begins by describing the “political puzzle” of repealing the estate tax, the history of the tax, and the impact of repeal. He then discusses the following arguments in favour of repeal:

- Death should not be a taxable event.
- The estate tax is inefficient.
- The tax is unpopular.
- It causes economic distortions.
- It is unfair and offensive to capitalism.
- The United States has “outgrown” the estate tax.
- The estate tax does not meet the criteria for a “good” tax.

These are countered by the following arguments in favour of retaining the tax:

- The estate tax provides an incentive to work and prevents wasteful lives.
- It reinforces equality of opportunity.

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29 Douglas Holtz-Eakin, John W. R. Phillips, and Harvey S. Rosen, “Estate Taxes, Life Insurance, and Small Businesses” (2001) vol. 83, no. 1 *The Review of Economics and Statistics* 52-63.

- The estate tax is payment for a debt owed to the government.
- The tax prevents individuals and families from amassing large fortunes.
- Repeal of the estate tax would have a negative impact on family farms, small businesses, the states, and charities.

The author concludes, “While there are good arguments favoring repeal of the estate tax, the arguments opposing repeal are, on balance, stronger.”<sup>30</sup>

**Richard Sansing and Robert Yetman, “Governing Private Foundations Using the Tax Law”** (2006) vol. 41, no. 3  
*Journal of Accounting and Economics* 363-84

Approximately 66,000 private foundations in the United States own financial assets worth about \$0.5 trillion. Private foundations serve as conduits that transfer private wealth from donors today to charitable beneficiaries in the future. This is done in a way that secures a charitable contribution deduction for the donor at the time of transfer into a private foundation, even though funds may not be given to any public charity until much later. The investment income earned by the foundation is virtually tax-exempt. Thus, the foundation breaks the contemporaneous link between the charitable deduction to the donor and the eventual disbursement to a public charity.

To avoid excessive accumulation of funds inside foundations, two governance mechanisms are instituted through the tax law. The minimum distribution requirement compels a foundation to spend at least 5 percent of its investment assets on charitable activities each year. The dual excise tax rate regime lowers the tax rate on investment income from 2 percent to 1 percent for foundations that increase their distributions relative to their historical average.

This study examines approximately 3,800 tax returns of private foundations between 1994 and 2000 to examine the effects of the above provisions on the distribution policies of private foundations. Results show that the average distribution is 8.7 percent of investment assets, with approximately four-sevenths of the sample limiting their distribution to the 5 percent minimum requirement. Foundations distributing the minimum required were more “passive” in terms of management expenditures and had no new source of donations or inflows. Foundations distributing substantially more than the minimum requirement had more professional management and were more likely to have new sources of donations and better investment yields.

The dual tax regime encourages foundations to increase their distributions (to get the 1 percent tax rate), but also discourages excessive distributions, since a higher historical average would make it harder to qualify for the 1 percent tax rate in future

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30 At 43.

years. Results show that larger foundations are better able to take advantage of the dual tax rate regime. Most foundations seem to ignore the two-tier tax rate, instead choosing to focus on payout strategies (*vis-à-vis* the minimum distribution requirement). The authors conclude that these two laws serve an important role in the governance of private foundations, especially passive foundations that do not have professional management or new sources of funds.

Amin M.