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Current Tax Reading

Co-Editors: Tim Edgar, Jinyan Li, Alan Macnaughton, and
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With this issue of the journal, we welcome Jinyan Li as co-editor of the Current Tax Reading feature. Of Osgoode Hall Law School, York University, Professor Li has written widely in several areas of taxation and promises to bring to the feature a variety of interesting and useful reviews of the current tax literature.

The Canadian Tax Foundation and its members gratefully acknowledge the contribution of David Duff of the Faculty of Law, University of Toronto, who is retiring as co-editor of the Current Tax Reading feature. Since 2001 Professor Duff's topical and incisive reviews have helped to guarantee the continued success of this valuable feature.

David G. Duff, "Justice Iacobucci and the 'Golden and Straight Metwand' of Canadian Tax Law" (2007) vol. 57, no. 2
University of Toronto Law Journal 525-79

This is one of several essays published in a special issue of the *University of Toronto Law Journal* in honour of Frank Iacobucci, the former chief justice of the Supreme Court of Canada. David Duff writes that, following his appointment to the court in 1991, Justice Iacobucci "dominated Canadian income tax law as no other member of the Court before him ever did."[1] Duff also attributes an important change in the court's approach to statutory interpretation to Justice Iacobucci:

> Justice Iacobucci's tax judgments effected a fundamental shift in the Supreme Court of Canada's approach to Canadian tax law—away from the emphasis of the late 1970s to the early 1990s on the purpose of the relevant legislation and the economic or commercial reality of transactions toward an emphasis on the statutory text and the legal form of transactions.[2]

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1 At 526.

2 Ibid.

In his article, Duff discusses the shift and the motivations for it. He first surveys the traditional Anglo-Canadian and American judicial approaches to tax statutes, and then the Supreme Court of Canada's approach to statutory interpretation from the late 1970s to the early 1990s. To illustrate the transformation from a purposive to a plain meaning interpretation, Duff reviews four of Justice Iacobucci's decisions: *Antosko* (1994),[3] *Duha Printers* (1998),[4] *Ludmer* (2002),[5] and *Stewart* (2002).[6] He suggests that Justice Iacobucci's approach was motivated by several related values or principles: judicial restraint and legislative supremacy; legal certainty, individual liberty, and the rule of law; and taxpayers' entitlement to take advantage of tax law to minimize taxation.

J.L.

Peter J. Merrick, *The Essential Individual Pension Plan Handbook*
(Markham, ON: LexisNexis Canada, 2007), 350 pages

This handbook for tax and financial advisers provides a clear and straightforward introduction to a complex subject. The conclusions are simply stated and easy to find, and the supporting reasoning and numerical examples are helpful. For example, one section heading states, "Under the Age of 40 IPPs Are Ineffective and Detrimental for Tax-Efficient Retirement Savings," and the source of this in the factor of 9 is clearly explained and illustrated. The author is skilful in using language that will catch the reader's attention, such as suggesting that only tax plans that are sanctioned by the Canada Revenue Agency (CRA) should be presented to clients,[7] or that "[a]n advisor who gains one Individual Pension Plan client, aged 49, today will create over $300,000 in commissionable and fee income over the next 15 years."[8] The book's main deficiency is that it contains very few statutory references or footnotes to support the author's arguments and to assist the reader in pursuing more in-depth research.

Alan M.

3 *Antosko v. The Queen*, [1994] 2 SCR 312.

4 *Duha Printers (Western) Ltd. v. The Queen*, [1998] 1 SCR 795.

5 *Ludco Enterprises Ltd. v. The Queen*, [2001] 2 SCR 1082.

6 *Stewart v. The Queen*, [2002] 2 SCR 645.

7 At iii.

8 At vii.

François Vaillancourt, Jason Clemens, and Milagros Palacios, *Compliance and Administrative Costs of Taxation in Canada*
(Vancouver: Fraser Institute, April 2007)

Statistics Canada, "Survey of Regulatory Compliance Costs,"
The Daily, December 12, 2006

Canada Revenue Agency, *Helping Small Businesses by Reducing the Compliance Burden: Report of the Canada Revenue Agency's Action Task Force on Small Business Issues* (Ottawa: CRA, March 2007), 18 pages

The first of these publications, by Vaillancourt et al., is not based on any new taxpayer surveys, but rather makes a credible attempt to obtain a current Canadian estimate of the compliance costs of taxpayers and the administrative costs of governments, by combining past survey research with reasonable updating assumptions. Costs are given by ranges rather than specific figures because of the large number of assumptions involved. The main results are that total compliance costs are much higher than administrative costs (a range of $16 billion to $25 billion versus a range of $3 billion to $6 billion) and compliance costs derive more from business taxes than from personal income taxes (a range of $13 billion to $19 billion versus a range of $3 billion to $5 billion). Per capita total compliance and administrative costs are estimated to be in the range of $585 to $955.

Perhaps because compliance costs are perceived to be low relative to the revenue raised, and of little public concern, there has been much less research on this issue in Canada than in some other countries (notably Australia). An important initiative that should help to address this problem in the future is Statistics Canada's "Survey of Regulatory Compliance Costs." The survey covers various types of paperwork burden, including tax, for establishments with fewer than 500 employees in five industries and annual revenue between $30,000 and $50 million. A preliminary release of aggregate estimates of compliance costs from the survey in this issue of *The Daily* shows these costs to be $305 per employee, 72 percent of which is tax-related.

These Statistics Canada data were too recent to be included in the study by Vaillancourt et al. When detailed information from the survey is released, a much better estimate of compliance costs should be possible.

It is less clear whether these new data will actually influence government policy. The CRA's report on the small business compliance burden, released in March 2007, refers to the Statistics Canada survey as an input into the CRA's performance measurement framework for compliance burden reduction, but does not indicate any relationship between the survey's findings and the CRA's action plan.

Alan M.

United States Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* (Washington, DC: Department of the Treasury, July 23, 2007), 52 pages

Given the ongoing debate over whether Canadian corporate tax rates are too high or too low, it is interesting to see a report from outside Canada comparing corporate tax rates in competing countries. Comparing statutory corporate income tax (CIT) rates in 2005, this US Treasury report concludes that "[t]he United States has the second-highest CIT rate (39 percent) in the OECD after Japan (40 percent)."[9] Canada, with a rate of 36 percent, ranks 5th out of 19 countries. However, the definition of taxable income is at least as important as the corporate tax rate, and the United States and Japan are both more generous than Canada on that score. Therefore, it is important to combine both effects through the effective marginal tax rate. By this measure, the US Treasury concludes that Germany has the highest tax rates among the G7 countries, and Canada is not far behind.

Alan M.

Lawrence Lokken, "Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)" (2006) vol. 59, no. 2 *SMU Law Review* 751-72

In 2005, the President's Advisory Panel on Federal Tax Reform proposed to replace the present credit system for taxing foreign-source income of US corporations with a territorial or exemption system.[10] Under the proposed exemption system, a US person's income from active business operations in foreign countries, whether carried on directly or through a subsidiary corporation, would be exempted from US taxation. Why wouldn't a US corporation want its foreign income to be exempt from US tax? What could be better than a complete tax exemption? Lokken's article addresses these questions.

To provide some background, under the US tax system, domestic corporations are taxable on their worldwide income. In order to prevent double taxation and achieve capital export neutrality, a domestic corporation is entitled to claim a credit for foreign income taxes paid on foreign income. In the case of dividends received from a foreign corporation, in addition to the direct foreign tax credit, an "indirect foreign tax credit" is available if a domestic corporation owns at least 10 percent of a foreign corporation's voting stock. Technically, the domestic corporation is deemed to have paid a rateable share of the foreign income taxes paid by the foreign distributing corporation. US taxation of unrepatriated earnings of US-owned foreign corporations is limited by the controlled foreign corporation (CFC) rules (which are similar to the

9 At 34.

10 United States, 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).

Canadian foreign accrual property income rules). In essence, the CFC rules apply to passive income (including dividends, interest, and royalties) and certain base-company income (that is, income from sales and service transactions that are not sufficiently connected to the CFC's home country).

There is a major difference between the US rules and the Canadian rules with respect to the treatment of active business income earned by foreign corporations. Under the Canadian system (generally referred to as the exemption system), active business income earned by a foreign affiliate in a designated treaty country is included in the affiliate's "exempt surplus" account, and dividends paid out of that account are non-taxable to the Canadian corporate shareholder. Under the US system, dividends paid out of active business income of a foreign corporation are taxable, and the domestic corporate shareholder can only claim an indirect foreign tax credit.

The proposal by the president's advisory panel is broader than the Canadian exemption system in that it is not limited to income earned in treaty countries or income earned through a foreign affiliate. Earlier in 2005, the staff of the Joint Committee on Taxation[11] suggested a similar shift to an exemption system on the basis of two arguments. First, the credit system allows deferral of US taxation of foreign earnings of US-owned foreign corporations, and thus distorts business decisions on where and how to invest those earnings. (Presumably, the earnings are not repatriated to the United States for tax reasons.) Second, the credit system often allows US multinational corporations to achieve more favourable US tax results than they could obtain under an exemption system. Lokken's critique of the proposal focuses on the second justification.

Lokken first explains how US multinational corporations are able to achieve more favourable US tax results—that is, pay less US tax—under the present system than they would under an exemption system. He attributes these results to the numerous tax minimization techniques used by US corporations and suggests that the cure is to change the existing rules. One technique is to separate foreign income taxes from the income on which those taxes were imposed, through the use of a hybrid entity under the check-the-box rules. Lokken provides the following example:

Example 1

USCo, a Delaware corporation, owns 51% of the interests in the profits and capital of a partnership, *PRS*, which is organized under the laws of foreign country *X*. The remaining interests in the partnership are owned, directly and indirectly, by unrelated residents of country *X*. For year 1, *PRS* has net income of $196 from active business operations in country *X*, but makes no distributions to its partners. *PRS* is a pass-thru entity under the tax laws of country *X*, and *USCo* is legally liable for country *X* tax of $30 on its share of *PRS*'s profits. As required by country *X* law, *PRS* withholds this tax from

11 United States, Staff of the Joint Committee on Taxation, *Options To Improve Tax Compliance and Reform Tax Expenditure*, JCS-02-05 (Washington, DC: Joint Committee on Taxation, January 27, 2005).

> *USCo*'s share of the profits. *PRS* elects to be taxable as a corporation for U.S. tax purposes, but because it is, for these purposes, a foreign corporation with no U.S. trade or business and no income from U.S. sources, it owes no U.S. tax. . . .
>
> In [this example], country *X* law imposes liability on *USCo* for country *X* income tax of $30 on *USCo*'s 50% share of *PRS*'s profits for year 1. Under the legal liability rule, *USCo* is deemed to have paid country *X* tax of $30 for year 1, even though the tax is actually paid by *PRS* on *USCo*'s behalf and even though the United States has not taxed either *PRS* or *USCo* on the income that country *X* has taxed.[12]

Lokken considers the results in the above example to be contrary to the basic function of the foreign tax credit to alleviate double taxation. Because the income of PRS is taxed by country X, it is not taxed by the United States until it is distributed to USCo; therefore, no double taxation occurs for year 1, and no credit should be allowed for that year. Replacing the credit system with an exemption system would certainly address this problem, because the country X income would be exempted from US tax and country X tax would not be relevant under US tax law. However, Lokken argues that the US Treasury can cure the problem by simply changing the check-the-box regulations.

Another technique is to generate foreign-source income with no foreign income taxes in order to circumvent the credit limitation rules. The example used by Lokken to illustrate this technique extends the facts described in example 1, as follows:

> In addition to its interest in *PRS*, as assumed in Example 1, *USCo* owns valuable intellectual property that it and its affiliates use throughout the world. *USCo* licenses country *X* rights to this property to *FCo* and, for year 1, receives royalties from *FCo* of $50. Under country *X* tax law, *PRS* is allowed a deduction for the royalties, and because country *X* has an income tax treaty with the United States following the U.S. Model Income Tax Convention, country *X* imposes no withholding tax on *USCo*'s royalty income.[13]

Under US source rules, USCo's royalty income of $50 is from a foreign source because it is received for the use of intellectual property outside the United States. If USCo's pre-credit US tax is 35 percent of taxable income, its credit limitation is $17.50, and its foreign tax credit is $17.50, being the lesser of worldwide foreign income taxes paid ($30) and the limitation ($17.50). In effect, the credit allowed to USCo is an example of cross-crediting: foreign income taxes on one category of income (PRS's business income) are credited against US tax on another category of income (USCo's royalty income). USCo is allowed a credit for year 1 taxes only because its active business and royalty income and foreign income taxes on this income are aggregated in applying the credit rules. Lokken suggests that this cross-credit problem can be dealt with by keeping royalty income in a separate, passive income basket, as opposed to the general limitation basket.

12 At 759-60.

13 At 764.

The main argument in this article is that deficiencies in the present worldwide base/credit system do not provide a strong reason for replacing it with an exemption system. The deficiencies are not inherent in the current system, and they can be corrected without changing the fundamental premises of the US international tax system.

J.L.

Ruth Mason, "The Tillinghast Lectures: A Decade of International Tax Law Proposals," introduction to Ruth Mason, *The Tillinghast Lecture 1996-2005* (New York: New York University School of Law, 2007). Available online at http://www-ssrn.com/

If you have missed one or more of the annual Tillinghast lectures published in the *Tax Law Review*, you can save some time by reading Ruth Mason's excellent overview of the first 10 lectures (1996-2005). Mason succinctly describes the main points of each lecture and provides her own commentary. In her view, the influence that the lectures have attained can be attributed to the lecturers' willingness to think afresh and challenge orthodox notions concerning pressing contemporary issues—notably, how international income should be taxed, and how to cope with the special policy problems posed by an increasingly integrated global economy. Some lecturers have questioned such basic principles as the use of source and residence as bases for the taxation of multinational business enterprises; others have explored whether bilateral tax treaties are necessary and, if so, how they can be adapted to better suit modern transactions; and several have discussed the gaps and overlaps that occur under national tax laws and tax-planning opportunities offered by the existing laws. Mason points out that nearly all of the 10 lectures have touched on international organizations such as the Organisation for Economic Co-operation and Development, the European Union, the World Trade Organization, and the North American Free Trade Agreement, reflecting the growing importance of such organizations to international taxation. Mason also notes another important characteristic of the lectures: in addition to criticizing the status quo, each dedicates significant space to discussing what improvements could be made, and how.

The first 10 lectures are the following:

1. Charles Kingson, "Taxing the Future" (1996)
2. John F. Avery Jones, "Are Tax Treaties Necessary?" (1997)
3. H. David Rosenbloom, "International Tax Arbitrage" (1998)
4. H. Onno Ruding, "Tax Harmonization in Europe: The Pros and Cons" (1999)
5. Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy" (2000)
6. Stephen E. Shay, "What's Source Got To Do With It?—Source Rules and U.S. International Taxation" (2001)
7. J. David B. Oliver, "Tax Treaties and the Market State" (2002)

8. Paul McDaniel, "Trade Agreements and Income Taxation: Interactions, Conflicts and Resolutions" (2003)
9. Wolfgang Schön, "The Odd Couple: A Common Future for Financial and Tax Accounting" (2004)
10. Mary Bennett, "Nondiscrimination in International Tax Law: A Concept in Search of a Principle" (2005)

J.L.

Jean Hindriks and Gareth D. Myles, *Intermediate Public Economics*
(Cambridge, MA: MIT Press, 2006), 724 pages

This book is an introduction to public economics for students who have completed courses in intermediate microeconomic and macroeconomic theory. Many points are made with the use of diagrams rather than mathematics, although formal derivations are used for more complex topics such as the theory of optimal taxation. In conformity with current teaching of the subject, public economics is broadly interpreted to include such topics as voting, poverty, and social security; less than a quarter of the book is devoted to traditional topics such as taxation and fiscal federalism. In lieu of footnotes for sources, short lists of further readings are provided. Problems to assign to students are given at the end of each chapter.

Alan M.

Jeffrey R. Kling, "Methodological Frontiers of Public Finance Field Experiments" (2007) vol. 60, no. 1 *National Tax Journal* 109-27

James Alm and Sarah Jacobson, "Using Laboratory Experiments in Public Economics" (2007) vol. 60, no. 1 *National Tax Journal* 129-52

Steven D. Levitt and John A. List, "Viewpoint: On the Generalizability of Lab Behaviour to the Field" (2007) vol. 40, no. 2 *Canadian Journal of Economics* 347-70

It is a common practice for economic researchers in taxation to choose a particular change in the tax system and examine whether taxpayer behaviour is different after the change than it was before. Thus, for example, if savings increase after a reduction in marginal tax rates, the increase may be attributed to the tax change. There are many difficulties with this approach to tax research, including the possibility that changes in other factors (such as the level of unemployment or economic growth) might have occurred at the same time. As a result, some economists have looked for a way of conducting a study in which individuals can be randomly assigned to treatment and control groups, for which the tax change is present or absent. These are called experiments, and can occur in either a real-world (field) setting or a more contrived (laboratory) setting.

The article by Jeffrey Kling examines the growing set of field experiments that have been conducted in the area of public finance. Some intriguing findings have resulted—for example, that explicit government matching of charitable contributions of individuals is a better way of increasing charitable contributions than the usual tax rebates. However, field experiments have been used far less frequently than laboratory experiments. The latter are much lower in cost and allow researchers to measure certain effects that would not otherwise be feasible (for example, by varying penalty rates for tax evasion randomly across taxpayers). Alm and Jacobson review applications of laboratory experiments, especially in the area of tax compliance.[14] Both of these articles, as well as the more general article by Levitt and List, conclude that experiments have much to contribute to the analysis of the effects of policy changes.

Alan M.

Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know, and What Can Be Done?* IMF Working Paper WP/07/31
(Washington, DC: International Monetary Fund, 2007), 33 pages

Fraud against the value-added tax (in Canada, the goods and services tax) is much more spectacular than fraud against the income tax. It is particularly striking in that it results in not just the inappropriate reduction of tax, but direct payments to the fraudster. However, Keen and Smith remind us that $1 of either type of fraud is $1 taken from the government treasury, and hence has the same economic effects. Keen and Smith review the sources of value-added tax fraud and conclude that many of them are specific to the European Union. Hence, they are less likely to occur in Canada.

Alan M.

Christine Neill, *Canada's Tuition and Education Tax Credits* (Montreal: Canada Millennium Scholarship Foundation, May 2007), 44 pages

Joseph Berger, Anne Motte, and Andrew Parkin, *The Price of Knowledge 2006-07: How Governments Support Students* (Montreal: Canada Millennium Scholarship Foundation, June 2007), 32 pages

Governments support post-secondary students through loans, grants, scholarships, and tax assistance. These two studies find that more than two-thirds of federal government support consists of tax assistance,[15] delivered principally through the tuition and education tax credits. Tax assistance is also high at the provincial level.

14 For a Canadian application, see Viswanath Umashanker Trivedi, Mohamed Shehata, and Stuart Mestelman, "Attitudes, Incentives, and Tax Compliance" (2005) vol. 53, no. 1 *Canadian Tax Journal* 29-61.

15 Berger et al., at 9.

The amounts of this support are quite sizeable relative to tuition fees, and vary by province. For example, in Ontario in the 2006-7 academic year, the average undergraduate tuition fee plus ancillary fees amounted to $5,889, but the student's net cost was reduced by over one-third, to $3,849, by the federal and provincial tuition and education tax credits. In Quebec, the effect is more pronounced because tuition fees are lower. Although this lowers the tuition tax credit proportionately, the federal education tax credit remains the same. (Quebec does not have a provincial education tax credit.) Thus, in Quebec, the gross cost of tuition and ancillary fees averaged $2,540, but the net cost to the student was reduced by more than one-half, to $1,202, by the tuition and education credits.[16]

Both of these studies criticize tax assistance for students on distributional grounds; because higher-income families send a higher proportion of their sons and daughters to university, families with incomes in the top quartile claim credits worth at least twice as much as those in the lowest quartile.[17] The authors question whether the existing credits affect access to post-secondary education, and consider some alternatives. For example, the credits might be made refundable, or they could be abolished and replaced by increased student loans or direct grants to students.

Alan M.

Jack Selody, *Vulnerabilities in Defined-Benefit Pension Plans*, Bank of Canada Discussion Paper 2007-3 (Ottawa: Bank of Canada, 2007), 16 pages

David Laidler and William B.P. Robson, *Ill-Defined Benefits: The Uncertain Present and Brighter Future of Employee Pensions in Canada*, C.D. Howe Institute Commentary no. 250 (Toronto: C.D. Howe Institute, June 2007), 22 pages

For the past few years, defined-benefit pension plans have been under stress in Canada and other countries. Although the situation has improved with the recovery of equity markets, this may be only a temporary respite. The Bank of Canada and the C.D. Howe Institute indicate their concern in these research studies.

The Bank of Canada paper expresses concern with the burden on pension plan sponsors. Increasing longevity of pension plan members and low bond market returns have created a funding deficit. Contributions have been slow to respond, leading to large funding deficits. The solutions recommended are varied, but one of the key recommendations is to give pension plan sponsors more access to any actuarial surplus in the plan; sponsors would be less reluctant to raise contributions if they knew that any surplus created would accrue to them rather than employees. This is a problem for pension regulators, since the surplus rules relate to pension law rather than tax law.

16 Neill, at 8.

17 Ibid., at 18.

The C.D. Howe paper also focuses on the access-to-surplus problem, but points out that tax law is part of the problem—specifically, because of the rule that sponsors of defined-benefit plans may not contribute to a plan where the assets exceed 110 percent of the liabilities. Although there is an obvious concern that sponsors would use any extra room as a way to shelter corporate profits from taxation, the authors of the study "are not convinced that the problem this rule seeks to address is a real one,"[18] and they suggest a higher limit. They also suggest that money-purchase plans should be made more attractive so as to offer an alternative to defined-benefit plans.

Alan M.

Sotiris Karkalakos and Christos Kotsogiannis, "A Spatial Analysis of Provincial Corporate Income Tax Responses: Evidence from Canada" (2007) vol. 40, no. 3 *Canadian Journal of Economics* 782-811

Following on research by Hayashi and Boadway[19] on the relationship between federal corporate tax rates and those of the various provinces, Karkalakos and Kotsogiannis revisit this issue to include measures of the geographic proximity of provinces. In addition, they study the interaction between a province's own-source revenues and its entitlement to equalization from the federal government. They find clear evidence of interactions among most provinces and between the provinces and the federal government, and they find that in most provinces equalization entitlements are negatively related to corporate tax rates. The interaction between Canada and the United States at a provincial/state level is left to future research.

Alan M.

Stanley Lubman, "Looking for Law in China" (2006) vol. 20, no. 1 *Columbia Journal of Asian Law* 1-92

Stanley Lubman has both studied and worked with Chinese law for the past four decades, and yet he is still searching for a coherent and consistent system of law in China. In this extensive article, he offers insights into critical Chinese institutions and practices that mark the legal environment, and particularly its development since 1979, when China first gave foreign direct investment a hesitant welcome. Lubman analyzes the high degree of legal uncertainty that foreign investors and their Chinese counterparts have encountered, and describes how they have coped with it. He predicts that Chinese law relating to foreign investment will likely continue to exhibit "rolling uncertainty" for the foreseeable future. The main reason is

18 Laidler and Robson, at 9.

19 Masayoshi Hayashi and Robin Boadway, "An Empirical Analysis of Intergovernmental Tax Interaction: The Case of Business Income Taxes in Canada" (2001) vol. 34, no. 2 *Canadian Journal of Economics* 481-503.

that the broader agenda of economic and legal reform in China is a work in progress, as the country's leaders search for a model that will mesh "socialism" with a market economy.

Part I of the article provides an excellent review of legal reforms since 1979. Lubman notes that virtually every element of contemporary Chinese law was either revived or newly created during the last 25 years. To illustrate the breadth of these legal reforms, he traces the evolution of the rules dealing with contracts, business organizations, and foreign direct investment—areas obviously critical for the market economy. After reviewing the development and operation of legal institutions (especially the courts) in China, he identifies some notable characteristics of Chinese legislation and the organization of the party-state that are causes of continuing legal uncertainty. These include legislative techniques, formalism, lack of transparency, multiple and often inconsistent sources of law, and the operation of a fragmented bureaucracy endowed with broad discretion.

Part II of the article surveys some of the strategies adopted by foreign investors and their Chinese counterparts to cope with legal uncertainty. These strategies include evasion of the law with the approval of senior Chinese officials; reliance on overseas Chinese connections and intermediaries; reliance on locally encouraged violations of central law and policies; reliance on localism and the local approval process; and relationships (*guanxi*).

In conclusion, Lubman notes that a "liberal-democratic rule of law is unlikely to evolve in China,"[20] but Western concepts of law are not irrelevant. Meanwhile, the search for law in China has become more interesting, because the party-state itself has now joined in the quest.

J.L.

Daniel Shaviro, "Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?" *Tax Law Review*, forthcoming (New York University Law and Economics Research Paper no. 07-12; available on the Web at http://sssrn.com/)

The United States' international tax system is often defended on the ground of worldwide welfare. A US taxpayer should face the same worldwide tax rate on foreign as on domestic investments, so that the taxpayer will be likely to favour those investments that offer the highest pre-tax returns. This equivalence is achieved mainly by capital export neutrality, which requires a combination of worldwide taxation and a foreign tax credit system. But why would one expect US policy makers to be selfless in pursuit of worldwide welfare as opposed to US national welfare? Michael Graetz remarked in 2001 that "this nation's international tax policy [should instead] be fashioned to advance the interests of the American people."[21]

20 At 92.

21 Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) vol. 54, no. 3 *Tax Law Review* 261-336, at 281.

In this article, Daniel Shaviro maintains that worldwide welfare should remain a normative standard in US international tax policy because capital export neutrality and capital import neutrality are, in fact, tools for promoting national welfare in the broader setting of a global "prisoner's dilemma." Shaviro discusses two of the core prisoner's dilemmas in international tax policy: double taxation and tax harmonization. A basic prisoner's dilemma is described succinctly as follows:

> In the classic setup, two partners in crime are being held and interrogated by the police in separate rooms. Each must decide whether to confess, and in so doing implicate the other, or to stonewall the police. If both hold out, the police will be unable to prove the crime but will convict each on some lesser charge, resulting in short jail terms. If only one prisoner confesses, he or she will get to turn state's witness and be set free after sending the other one to prison for a long time. If both confess, no testimony will be needed, and each will be sentenced to a medium-length jail term.
>
> Each prisoner faces a choice of cooperating and defecting from the other prisoner's standpoint (i.e., cooperating with the police constitutes "defecting"). What gives the prisoner's dilemma its bite is the fact that, while collectively the prisoners would be best off cooperating with each other and stonewalling the police, each of them, considered in isolation, is better off defecting no matter what the other does. By defecting you eliminate any jail term if the other prisoner cooperates, and you shorten your jail term if he or she defects. Thus, if they cannot observe each other and coordinate their behavior, their pursuit of rational self-interest may have the pathological effect of leaving them worse-off than if they had acted altruistically.[22]

In order to deal with the prisoner's dilemma in international taxation, Shaviro suggests an international tax norm based on worldwide welfare to supplement bilateral treaties. Worldwide welfare norms can serve a valuable purpose, even from a purely national perspective. In contrast to beggar-thy-neighbour strategies, they can strengthen the impetus for cooperation among countries, thereby making all countries better off.

J.L.

Thomas C. Pearson, "Preparing Multinational Companies for Transfer Pricing Audits of Intangibles" (2006) vol. 2, no. 2 *International Law & Management Review* 159-200

Transfer-pricing audits are occurring more frequently across the globe. From 2000 to 2003, nearly half of all parent corporations of multinational companies underwent a transfer-pricing audit somewhere in the world. Three-quarters of multinational companies surveyed by Ernst & Young in 2003 expected a transfer-pricing audit during the next few years.[23] Although transfer-pricing audits for intangibles are, in

22 At 5.

23 Ernst & Young, *Transfer Pricing 2003 Global Survey* (Ernst & Young, 2003), 7.

many cases, the most difficult, according to the author this is "the first law review article to provide in-depth information and advice on transfer pricing audits for intangibles."[24]

After a review of issues related to preparation for audits and the required analysis and documentation, Pearson identifies a number of "justifiable audit triggers" and offers some practical insights. For example, he notes that in Canada, the CRA aggressively investigates intragroup costs allocated among related entities solely on the basis of revenues. China primarily targets companies with sustained losses. New Zealand singles out commissionaire arrangements, stock option recharges, and head office charges. The United Kingdom identifies a number of transfer-pricing audit triggers, including complexity of transactions, significant monetary values, changes in the audited entity's taxable income, and the restructuring of multinational group operations. Pearson suggests advance pricing arrangements as a viable option.

J.L.

24 At 163.