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Current Tax Reading

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Organisation for Economic Co-operation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Studies no. 17 (Paris: OECD, 2007), 188 pages, ISBN 978-92-64-03837-0

This latest instalment in the OECD's tax policy study series should be standard reading for anyone interested in the current state of thinking on the income taxation of foreign direct investment from the perspective of both capital-importing and capital-exporting countries. The most notable part of the study is arguably the final chapter, which critically reconsiders the approach of existing effective tax rate models in light of aggressive tax-planning techniques used by multinational corporate groups to reduce both source-country and residence-country taxes on cross-border direct investment. These techniques include the use of hybrid instrument and hybrid entity structures, as well as third-country financing affiliates in "double-dip" financing structures. Hybrid instruments or entities are typically characterized and treated inconsistently by source- and residence-country tax systems. Double-dip financing structures involve deductions for the same interest expense in residence and source countries. Such structures are the target of recent legislation in Canada denying the interest expense deduction in the context of outbound direct investment.[1]

Existing models that attempt to estimate effective tax rates on foreign direct investment are criticized for their overly simplistic assumptions. These include direct holding and fixed capital structures; immediate repatriation of equity income; no management of foreign tax credits in foreign tax credit jurisdictions; and an absence of hybrid financial instruments and entities. After reviewing the limited empirical evidence on the increasing use of aggressive tax-planning techniques, the study develops an alternative approach intended to incorporate the impact of these techniques on

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1 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"), section 18.2; added by SC 2007, c. 35, applicable in respect of interest and other borrowing costs paid or payable in respect of a period or periods that begin after 2011.

effective tax rates. Not surprisingly, estimated average and marginal effective tax rates on cross-border direct investment are significantly lower. For national policy makers, these much lower estimates have potentially significant consequences for their estimates of the responsiveness of foreign direct investment to proposed reform measures intended to alter effective tax rates.

Reconsideration of the modelling of effective tax rates on foreign direct investment is preceded by a thorough review of the current state of the empirical literature on the effects of taxation on flows of such investment. The review is supplemented with an overview of various models used to analyze the relationship between tax and foreign direct investment. The study emphasizes the care to be exercised in using both the empirical studies and the models. The existing empirical evidence certainly supports the perception that location decisions for an increasing range of foreign direct investment are responsive to tax differences. But the evidence is far from complete, and there remains a range of foreign direct investment that is either location-specific or firm-specific and is not as responsive to tax differences.

Another portion of the study describes the considerations that national tax policy makers perceive as relevant in the design of tax regimes for inbound and outbound direct investment. These considerations were identified during a round table discussion among OECD member-country tax officials. The study provides a fascinating glimpse into the kinds of strategic behaviour that countries engage in, as well as the legislative options that figure prominently in the policy thinking of a number of national policy makers. Perhaps most importantly, the study makes it pretty clear that the debate over foreign tax credit and exemption systems for outbound direct investment has waned considerably, with member-country practice reflecting the dominance of exemption systems. The policy debate appears to be shifting to expense allocation rules, source-country treatment of royalty and intragroup interest payments, and the use of controlled foreign corporation (CFC) legislation in the face of competition by source countries for mobile forms of foreign direct investment. It is notable that there is no discussion of possible policy responses to hybrid financial instruments and hybrid entities.

T.E.

David A. Weisbach, "The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax"
(2007) vol. 60, no. 4 *Tax Law Review* 215-62

Herwig J. Schlunk, "Rationalizing the Taxation of Reorganizations and Other Corporate Acquisitions" (2007) vol. 27, no. 1 *Virginia Tax Review* 23-81

For tax practitioners, the statutory rules governing the treatment of corporate reorganizations are among the more important income tax provisions. It is therefore somewhat surprising that those rules remain undertheorized in the tax literature. In exploring the possible policy rationales for the corporate reorganization rules in the

United States, these two articles make important contributions to a literature that remains all too thin.

Weisbach critically examines a fundamental feature of corporate income tax systems that makes the treatment of corporate reorganizations especially troublesome. This feature, which he labels "dual ownership," is the ability to hold business assets either directly or through a subsidiary. Weisbach's principal point is that dual ownership creates complexity because "it creates the possibility of multiple realizations of the same economic income."[2] This possibility means that a realization-based income tax must be applied to both the income produced by business assets at the corporate level and the gain or loss on shares at the shareholder level. In this respect, Weisbach shows that a tax on share gains is required in order to ensure that the corporate-level income tax on asset sales cannot be avoided by selling shares. He makes this point in the context of the comprehensive business income tax (CBIT) proposed by the US Treasury department in a 1992 report.[3] The principal feature of the CBIT is consistency of treatment of corporate interest and dividends, which is realized by (1) denying the deduction of interest on corporate debt in computing corporate-level income, and (2) excluding dividends and interest from the income of shareholders and debtholders. Weisbach illustrates how the simplicity gains of such an approach are eroded by a need to tax share sales consistently with asset sales.

The need to tax share sales gives rise to complex rules, both to distinguish taxable sales from tax-free contributions of capital and other reorganization transactions, and to distinguish dividends from returns of share capital that reduce cost base. Similarly complex rules are required to ensure that the cost base of shares and the cost base of corporate assets are consistent. Weisbach argues that the resolution of these issues involves a level of complexity that the US tax system has largely avoided by opting for partial solutions. He reviews some corporate tax reform alternatives, emphasizing that all of them fail to address this "irreducible complexity."

Schlunk focuses on the treatment under US income tax law of corporate reorganization transactions for shareholders who are individuals. He argues that the relevant legislation in the United States has remained remarkably stable because it has offered shareholders a functional election to have share sales treated as taxable or non-taxable transactions. Schlunk observes, however, that the increasingly dominant presence in publicly traded share markets of tax-indifferent shareholders, such as tax-exempt organizations, mutual funds, non-residents, and hedge funds, has eliminated this functional electivity for shareholders who are taxable individuals. He proposes a relaxation of the corporate reorganization rules to permit non-recognition treatment for any individual whose shares are sold or exchanged as part of a merger or

2 At 215.

3 United States, Treasury Department, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, DC: US Government Printing Office, 1992).

acquisition, provided that the shareholder receives shares in the acquiring corporation. Non-recognition treatment would also be extended to the involuntary receipt of non-share consideration, provided that the consideration was reinvested.

T.E.

Robin Banerjee and William Robson, "Lifting the Lid on Pension Funding: Why Income-Tax-Act Limits on Contributions Should Rise"
(C.D. Howe Institute, April 15, 2008) (e-brief available in PDF at http://www.cdhowe.org)

Canada's Income Tax Act denies the sponsor of a defined benefit pension plan a deduction for a contribution to the plan if and when the plan assets exceed the recorded liabilities by 10 percent. Such a measure is presumably designed to curb excessive deductions by the sponsoring corporation. However, the authors of this study argue that plan sponsors will not make excessive contributions since they would rather reinvest or pay dividends, and other regulations prevent deliberate overcontributions to designated plans. For example, pension plans are reluctant to build up surpluses for fear that they may lose access.

The authors of this study argue that the 10 percent limit contributes to the underfunding of defined benefit plans, since the recent volatility of asset prices and interest rates often makes the contribution limit binding. Allowing sponsors to contribute more than necessary during good times would allow them to time their investment acquisitions better, and enjoy the longer compounding periods.

The 10 percent rule might not be an issue if most defined benefit plans matched their assets to their liabilities (obligations to pensioners). However, perfectly matching assets and liabilities requires excessive contributions that may not be necessary given long horizons. Long time horizons enable pension plans to better tolerate short-term volatility and require relatively less short-term liquidity. Being able to tolerate such short-term illiquidity and volatility allows pension plans to acquire their investments for less (since many other investors would rather pay more—or sell for less—to get rid of short-term illiquidity and volatility) and thereby earn higher returns.

However, such investment planning requires pension plans to contribute when they see investment opportunities specific to their matched portfolios. By preventing contributions when surpluses reach 10 percent, the Act constrains pension plans from pursuing their optimal investment strategies, or creates perverse incentives to overstate liabilities so that the cap is not binding. Banerjee and Robson argue that income tax legislation should not impede prudent funding of pension plans.

Banerjee and Robson run simulations to assess the impact of no cap, the 10 percent contribution limit, and a proposed 25 percent contribution limit. Under the no cap scenario, their numerical assumptions result in the plan being underfunded about 40 percent of the time, with deficits exceeding 5 percent occurring more than 30 percent of the time. With the 10 percent contribution limit, the simulated plan ends up being underfunded 46 percent of the time, and deficits exceeding 5 percent occur more than 35 percent of the time. For the scenario with a 25 percent contribution limit, funding deficits are as rare as they are when there is no contribution limit at all.

Since asset-liability mismatches in pension plans are not likely to be eliminated, and asset prices and interest rates could become more volatile, Banerjee and Robson argue for policies that do not foster underfunding of defined benefit plans.

Amin M.

Reuven S. Avi-Yonah, James R. Hines Jr., and Michael Lang, eds., *Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence* (The Netherlands: Kluwer Law International, 2007), 482 pages, ISBN 978-90-411-2552-1

Ruth Mason, "Made in America for European Tax: The Internal Consistency Test" (2008) vol. 49, no. 4 *Boston College Law Review* 1-55

The tax decisions of the European Court of Justice (ECJ) have generated considerable controversy. The court's jurisdiction in tax cases derives from the European Community Treaty, which provides for references from the national courts of member states to determine the compatibility of national tax laws with EC law. The ECJ has used this jurisdiction to create a body of jurisprudence characterized by an expansive non-discrimination constraint on national tax laws as they affect the right to the free movement of goods, services, workers, and capital across the borders of member states. Many commentators have criticized this jurisprudence for what is seen to be undue interference with the sovereign right of member states to tax.

The compilation edited by Avi-Yonah, Hines, and Lang (all of whom are tax academics) consists of 12 papers presented at the law school of the University of Michigan in October 2005. Although the title suggests an exclusive focus on the tax jurisprudence of the ECJ and the US Supreme Court, many of the papers go beyond this comparison and examine the legal and economic aspects of the different international institutions that are an important part of the background for the relevant jurisprudence. The collection includes the following authors and papers:

- Claudio Sacchetto, "ECJ Direct Tax Cases and Domestic Constitutional Principles: An Overview"
- Michael Lang, "Double Taxation and EC Law"
- Kees van Raad, "Nondiscrimination from the Perspective of the OECD Model and the EC Treaty: Structural and Conceptual Issues"
- Walter Hellerstein, "The US Supreme Court's State Tax Jurisprudence: A Template for Comparison"
- Charles E. McClure Jr., "The Long Shadow of History: Sovereignty, Tax Assignment, Legislation, and Judicial Decisions on Corporate Income Taxes in the US and the EU"

- Tracy A. Kaye, "Tax Discrimination: A Comparative Analysis of US and EU Approaches"
- Michael J. Graetz and Alvin C. Warren Jr., "Income Tax Discrimination and the Political and Economic Integration of Europe"
- Michel Aujean, "The Future of Non-Discrimination: Direct Taxation in Community Law"
- Servaas van Thiel, "The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most Favoured Nation Treatment and a Prohibition of Double Burdens?"
- Albert J. Radler, "Most-Favoured Nation Principle and Internal Market: Some Afterthoughts to Case *D*"
- Ruth Mason, "US Tax Treaty Policy and the European Court of Justice"
- Reuven S. Avi-Yonah, "What Can the US Supreme Court and the European Court of Justice Learn from Each Other's Tax Jurisprudence?"

Ruth Mason's article in the *Boston College Law Review* is very different in its focus from her paper in the book, cited above, and it excludes much of the important background that is the subject of some of the other papers. Mason explores the appropriateness for the ECJ of an interpretive approach similar to that articulated by the US Supreme Court in tax jurisprudence that has considered the effect on state taxes of the commerce clause under the US constitution. She notes that this jurisprudence addresses a conceptual issue similar to that addressed by the ECJ, namely, the scope of any constraint on state taxes imposed by the jurisdiction of the US federal government to regulate interstate commerce. In contrast to the ECJ tax jurisprudence, the US Supreme Court has approached the issue of state tax discrimination by adopting a narrow interpretation of the commerce clause, and on this basis has consistently upheld state tax laws with a differential impact on interstate commerce. Mason argues that the US approach could provide a more conceptually defensible argument for the ECJ's approach in interpreting the discriminatory effect of differential tax laws of member states. In particular, the more restrained approach of the US Supreme Court would ensure that decisions concerning the economic integration of Europe are left primarily to the political process.

T.E.

United Kingdom, HM Treasury and HM Revenue & Customs, *Principles-Based Approach to Financial Products Avoidance: A Consultation Document* (London: HM Treasury, December 2007), 27 pages, ISBN 978-1-84532-383-7

David P. Hariton, "Equity Derivatives, Inbound Capital and Outbound Withholding Tax" (2007) vol. 60, no. 2 *The Tax Lawyer* 313-50

United States, Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (Washington, DC: Joint Committee on Taxation, 2008), 34 pages

Axel Hilling, *Income Taxation of Derivatives and Other Financial Instruments—Economic Substance Versus Legal Form: A Study Focusing on Swedish Non-Financial Companies*, JIBS Dissertation Series no. 042
(Linköping, Sweden: Jönköping International Business School, 2007), 225 pages, ISBN 91-89164-79-2

Despite considerable attention in the literature, the income tax treatment of financial instruments remains a black hole for many national policy makers. Indeed, only a handful of countries have comprehensive legislative regimes for financial instruments. Most countries rely instead on a mix of general rules and principles relevant to the computation of business income, financial accounting practice, interest income and expense regimes, and specific legislation applicable to specific debt and non-debt instruments. Even where comprehensive legislation is adopted for the basic building block financial instruments (forwards, options, and fixed-payment debt), differences in the treatment of dividends and interest, as well as a preferential tax rate for capital gains, create tax-avoidance opportunities using hybrid and synthetic financial instruments. Because financial accounting rules do not, and should not, address these kinds of arrangements, tax policy makers must invariably wade in with some form of legislative response. In the absence of narrowly targeted responses, the obvious alternative is reliance on judicial anti-avoidance doctrines or a general anti-avoidance rule to protect the revenue base.

The first of the four publications reviewed here—a consultation document released jointly by the UK Treasury and Revenue & Customs, describes another possible approach to avoidance arrangements using financial instruments: principles-based legislative drafting. Under this approach, tax policy makers articulate general principles for the treatment of financial instruments in the legislation. The detailed application of those principles is left to be worked out through the tax administration and compliance process. The New Zealand accruals regime is probably the best example of this approach, along with certain aspects of Australia's financial arrangements legislation. However, the UK consultation document differs from these existing legislative examples by attempting to apply principles-based drafting in a tax-avoidance context. This is quite different from the development of recognition rules in a non-avoidance context. Presumably as a legislative experiment, the UK consultation document proposes draft legislation for "financial products avoidance" that attempts to either disguise interest as some other form of tax-preferred return, or convert an income amount to a disposition gain eligible for capital gains treatment. The principles-based draft legislation is intended to replace existing targeted anti-avoidance legislation. The general principle governing the draft legislation addressing disguised interest is expressed as follows: "A return designed to be economically equivalent to interest is to be taxed in the same way as interest."[4] The general principle governing the draft legislation intended to address dispositions of

4 UK consultation document, at paragraph 2.5.

income interests is expressed thus: "Receipts which are derived from a right to receive income and do not involve any loss of capital are economic substitutes for income and are to be treated for tax purposes as income."[5] In both cases, the draft legislation is accompanied by commentary and guidance, including its application in some illustrative situations.

Compared to the alternative of detailed, prescriptive legislation, principles-based drafting has a deceptively alluring appeal. Superficially, it appears much simpler and principled in its approach. But as with many things in life, the devil is in the details. Income tax systems characterized by differences in tax treatment for different financial returns require an exercise in line drawing that, in the context of specific financial instruments or avoidance transactions, often has a built-in element of arbitrariness, in the sense that there is no obvious connection between the relevant general principles and the details of the particular instruments or transactions. However, line drawing cannot be avoided by drafting legislation at the level of general principles and leaving the content of those principles to be determined through the administrative process.

The second publication, the article by David Hariton, is an excellent case study of what is arguably the empty promise of principles-based drafting. The US approach to the income tax treatment of financial instruments can properly be characterized as rules-based and prescriptive. One particularly difficult challenge has been the application of non-resident withholding tax to dividends in the presence of the exemption from such tax for interest paid to arm's-length creditors (commonly referred to as "portfolio interest"). Hariton illustrates in considerable detail how the portfolio interest exemption has created a market for synthetic equity, in the form of equity derivative instruments, in an effort to avoid non-resident withholding tax on dividends. He argues that maintenance of such a tax in the presence of the portfolio interest exemption is untenable, since it is impossible to draw a defensible tax-law boundary between synthetic equity positions that should be treated as a direct interest in shares and other such positions that should be excluded from this characterization. It appears that the use of principles-based drafting focused on financial instruments that provide a return economically equivalent to dividends would not alter Hariton's conclusion. In short, it is hard to see how the required line-drawing exercise would be executed satisfactorily simply because this kind of general principle is expressed in legislation imposing non-resident withholding tax on dividends.

The entire range of problematic tax-law boundaries that are characteristic of the income tax treatment of financial instruments is evident in both the report of the US Joint Committee on Taxation and Hilling's monograph. The former is useful primarily for its concise and accessible overview of the economics of financial innovation and the detailed US tax legislation governing recognition of gain or loss on the basic

5 Ibid., at paragraph 3.6.

building block instruments. The report was intended to provide this necessary background information as the basis for recent hearings before the Subcommittee on Select Revenue Measures regarding the tax treatment of certain derivative instruments. A principal focus of the hearings was the treatment of prepaid forward contracts and mandatory convertible debt, which is the subject of legislative proposals requiring the accrual of interest income.[6]

Hilling's monograph covers much the same conceptual ground as the joint committee's report, but it provides more detailed coverage of the economics of financial innovation, along with a discussion of certain legislative possibilities in the context of the Swedish income tax system. One of the more interesting chapters focuses on the relationship between Swedish income tax law and international accounting standard IAS-39, which considers financial accounting practices for derivative and other financial instruments based on their economic substance. For those who believe that income tax law should follow the financial accounting treatment of financial instruments, IAS-39 represents leading-edge thinking. In the absence of the adoption of fundamental reform measures eliminating some important tax-law boundaries, Hilling is suitably skeptical of the ability of financial accounting to solve all of the problems of conventional approaches to the income taxation of financial instruments.

T.E.

Daniel Shaviro, "The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal"
Georgetown Law Journal (forthcoming)

Judith Freedman, "Financial and Tax Accounting: Transparency and 'Truth,'" in Wolfgang Schoen, ed., *Tax and Corporate Governance*
(New York: Springer, 2008), 71-92

The relationship between tax and financial accounting is a longstanding policy issue that has recently risen to prominence in the United States as a result of the corporate tax-shelter market and the "Enron-style" accounting scandals. One consequence of these two developments is the "tax-book gap," the label used to describe the excess of financial accounting income over taxable income. The tax-shelter market has widened this gap through its supply of various transactions intended to reduce taxable income without affecting financial accounting income. Financial accounting manipulation, exemplified by the Enron-style scandals, has similarly increased the gap by inflating financial accounting income without affecting taxable income; the result is to enhance share value without incurring the cost of additional tax payable.

Greater conformity of tax and financial accounting can be seen as an attempt to suppress the incentives that underlie these particular causes of the tax-book gap. In

6 A Bill To Amend the Internal Revenue Code of 1986 with Respect to the Treatment of Prepaid Derivative Contracts, HR 4912, 110th Cong. (2007).

effect, closer alignment would eliminate the benefit of corporate tax-shelter transactions that have no consequences for financial accounting income. Similarly, the benefit of financial accounting manipulation would be reduced by additional tax payable associated with inflated financial income. In contrast to the experience in the United States, the debate over the relationship between tax and financial accounting in most other countries continues to be framed in familiar and more pedestrian terms. Proponents of greater conformity tout the compliance cost savings of a "one-book approach." But such savings can be realized only at the expense of subsuming the very different goals of tax and financial accounting that are the cause of different standards, principles, and rules.

These two articles reflect the framing of this debate in the United States, on the one hand, and the rest of the world, on the other. Shaviro begins with a lengthy exploration of the reasons why tax and financial accounting might differ. His conclusion is a familiar one: The fundamentally different purposes of tax and financial accounting mean that they will differ. Shaviro argues that the strongest case for complete conformity is its effect as a constraint on the incentives of corporate managers to undertake transactions that produce high accounting income and low taxable income. He finds such conformity to be a much less desirable and effective constraint on the use of tax incentives by politicians, given the existing insularity of financial accounting practice in relation to the political process. As an alternative to a pure one-book or pure two-book approach, Shaviro proposes a partial conformity approach that is quite different from existing forms of partial conformity. He suggests that large, publicly traded corporations should be required to adjust their taxable income by an amount equal to 50 percent of the difference between taxable and financial accounting income. The adjustment would be designed to close the tax-book gap and would be entirely arbitrary, on the theory that some unquantifiable portion of the gap is attributable to either tax-shelter transactions or financial accounting "sleights of hand."

Freedman provides a careful and thoughtful review of the relationship between tax and financial accounting income, drawing primarily on the UK experience as an illustrative example. After reviewing the familiar reasons for differences in tax and financial accounting practices, she pointedly notes that the practices in EU countries are properly characterized by partial conformity—a characterization that is not always fully understood by US commentators. This partial conformity is focused on the treatment of particular items of revenue and expense. In this respect, Freedman argues that one of the more difficult aspects of any conformity requirement is its implementation as the outcome of the judicial interpretation and application of general rules for the computation of business income, rather than the outcome of explicit legislation. It is interesting that Freedman observes, in passing, Shaviro's suggested adjustment. She notes, in particular, its very different concept of partial conformity and its unclear normative basis. There is no question that the content of the kind of partial conformity that is characteristic of practices in many countries, as well as its normative basis, is very different from that envisioned by Shaviro.

T.E.

Edward D. Kleinbard, *Rehabilitating the Business Income Tax*, Discussion Paper 2007-09 (Washington, DC: Brookings Institution, 2007), 60 pages

Edward Kleinbard is a well-known US tax lawyer, and currently serving as counsel to the Joint Committee on Taxation. Kleinbard has written extensively on the taxation of financial instruments and financial institutions, but he may be most famous for the development of his cost of capital allowance (COCA) system as a corporate tax reform.[7] The organizing idea of the COCA system is its consistent treatment of corporate debt and equity, which is realized by imputing a risk-free return to equity. This return is deductible in computing income at the corporate level and is included in income by debtholders and shareholders. Although different in some important respects, the idea underlying the COCA system may also be recognized by readers familiar with the allowance for corporate equity (ACE) system, which was developed by the UK Institute for Fiscal Studies[8] and was implemented in Croatia, with mixed results.

This discussion paper is Kleinbard's most detailed articulation of the COCA system, which he now calls the business enterprise income tax (BEIT). After describing the conceptual basis of the BEIT, Kleinbard makes the case for its adoption by comparing it with the current US corporate tax system. In addition to treating corporate debt and equity consistently, the BEIT would apply comprehensively to a broad range of non-corporate enterprises, thereby realizing consistency of treatment of business organizations as well as business acquisitions. Separate parts of the paper consider the international aspects of the BEIT (the subject of an earlier article by Kleinbard)[9] and some difficult transitional issues. For interested readers, *Tax Notes* recently published a lively debate between Kleinbard, Alvin Warren, and Daniel Shaviro over the merits of the BEIT.[10]

T.E.

Michael S. Kirsch, "Taxing Citizens in a Global Economy"
(2007) vol. 82, no. 2 *New York University Law Review* 443-530

This article makes an exhaustive—and exhausting—case for using citizenship as the basis for the taxation of the worldwide income of individuals. Kirsch acknowledges

7 See, for example, Edward D. Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System" (May 1991) vol. 69 *Texas Law Review* 1319-68; and Edward D. Kleinbard, "Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System" (1989) vol. 67, no. 12 *Taxes: The Tax Magazine* 943-61.

8 Institute for Fiscal Studies, Capital Taxes Group, *Equity for Companies: A Corporation Tax for the 1990s*, IFS Commentary no. 26 (London: Institute for Fiscal Studies, 1991).

9 Edward D. Kleinbard, "Throw Territorial Taxation from the Train" (2007) vol. 114, no. 5 *Tax Notes* 547-64.

10 Alvin C. Warren Jr., "The Business Enterprise Income Tax: A First Appraisal" (2008) vol. 118, no. 9 *Tax Notes* 921-24. See also Edward D. Kleinbard, "BEIT Proponent Kleinbard Responds to Warren's Critique" (2008) vol. 118, no. 10 *Tax Notes* 1043-48; and Daniel Shaviro, "Why the BEIT Proposal Shouldn't Be Discounted" (2008) vol. 118, no. 10 *Tax Notes* 1048-50.

that the United States remains an outlier in its use of citizenship as a jurisdictional rule. Nonetheless, he argues that an increasingly global economy supports this practice, and he rejects recent calls from the business community in the United States to abandon citizenship in favour of residence-based taxation or, alternatively, to eliminate the existing limit on the amount of foreign-source earned income of US citizens that is exempted from US tax.

Although the analysis is extensive and thoughtful, Kirsch's normative arguments for the use of citizenship as a jurisdictional rule are ultimately unconvincing. Residence-based taxation identifies the centre of interests (economic, social, and familial) of an individual, and is conventionally justified on the basis that the country in which these interests are located provides a level of public goods and services sufficient to support taxation of worldwide income. Citizenship is clearly a more tenuous method of establishing this link. However the argument is framed, taxing non-resident citizens on their worldwide income can be accepted only if it is believed that citizenship is a defensible proxy for the receipt of a level of public goods and services sufficient to justify the jurisdictional claim. Kirsch's historical review of the adoption of citizenship as a jurisdictional principle in the United States, although interesting in its own right, does very little to strengthen his fundamental proposition. For residence-based systems, an interesting possibility is the use of citizenship to tax investment income on a worldwide basis, particularly in light of the fact that this type of income, unlike earned income, is subject to little, if any, taxation at source. The prospect that some individuals might choose to renounce their citizenship in order to avoid the assertion of this more limited jurisdictional claim is presumably the reason for its rejection by national policy makers. The only empirical evidence of this kind of tax-driven behaviour is, of course, the US experience.

Given Kirsch's defence of the worldwide taxation of non-resident citizens, it is not surprising that he mounts a vigorous rejection of competitiveness concerns as the basis for the exemption of foreign-source earned income. This part of the article has relevance beyond the US context, since many of the same arguments are commonly cited in support of provisions, such as Canada's overseas employment tax credit,[11] that exempt limited amounts of foreign-source earned income from residence-based taxation. Because Kirsch supports the elimination of the foreign earned income exclusion in the United States, he concludes with a review of possible relieving provisions, generally in the form of income deductions, to recognize certain unique circumstances faced by non-resident citizens.

T.E.

11 Section 122.3 of the Act.

Walter Loukota and Markus Stefaner, eds., *Taxation of Artistes and Sportsmen in International Tax Law* (Vienna: Linde, 2007), 504 pages, ISBN 978-3-7073-1205-8

This book consists of 23 papers on various aspects of the taxation of international artists and athletes: 20 of the papers focus on various provisions of article 17 of the OECD model tax treaty;[12] the other 3 discuss some value-added tax issues. The papers were all written by LL.M. students in the program in international tax law at the Vienna University of Economics and Business Administration. A notable feature of the program is the requirement for students to write papers on various aspects of a selected topic. On entering the program, full-time students (one-year completion period) are assigned the same general subject. Part-time students entering the program at the same time (two-year completion period) are assigned another subject. The students are introduced to the subject in an intensive course, which is followed by development of their papers on different aspects of the subject, under academic supervision.

T.E.

Adam Chodorow, "Maaser Kesafim and the Development of Tax Law" (January 2007) vol. 8 *Florida Tax Review* 153-208

Six years ago, Susan Pace Hamill published an article in which she drew on Judeo-Christian ethics as the normative basis for a progressive income tax.[13] The genesis of Adam Chodorow's article may be (in part at least) the perceived need for academics to carve out their own little niche in the literature; regardless, here we learn how a Jewish tithing practice can contribute to tax reform. Presumably, we still have some way to go before tax-policy junkies turn reflexively to religious faith for guidance in the exceedingly secular world of tax reform, but who knows? Maybe someday in the future, this will become a touchstone for tax academics and policy makers, not unlike the Haig-Simons comprehensive tax base in the 1960s and 1970s.

Facetiousness aside, this article is a worthwhile read, whether or not you are convinced that tax reformers have anything to learn from tithing, or any other religious practices or principles. Chodorow provides an accessible account of the development of the Jewish practice of maaser kesafim, which involves tithing from all types of income. Perhaps not surprisingly, a deep and rich jurisprudence shows that many of the same issues arise under modern income tax systems. Chodorow argues that very

12 Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital: Condensed Version (Paris: OECD, July 2005).

13 Susan Pace Hamill, "An Argument for Tax Reform Legislation Based on Judeo-Christian Ethics" (2002) vol. 54, no. 1 *Alabama Law Review* 1-112, reviewed in this feature (2004) vol. 52, no. 1 *Canadian Tax Journal* 315-25, at 315-16. See also Susan Pace Hamill, "An Evaluation of Federal Tax Policy Based on Judeo-Christian Ethics" (2006) vol. 25, no. 3 *Virginia Tax Review* 671-764.

different historical circumstances permit the identification of universal elements of income taxation, including questions and issues that persist under ancient and modern tax systems.

Chodorow makes three general points. First, maaser kesafim is inconclusive on the choice of a flat or a progressive rate structure. Second, the basic structure of the US income tax and maaser kesafim is remarkably similar, and raises many of the same contentious issues. Third, maaser kesafim suffers from a level of complexity similar to the modern income tax, suggesting that adoption of a consumption tax as a replacement would not escape many of the pressures that produce complexity. Chodorow is silent, however, on the need for judicial anti-avoidance doctrines or a general anti-avoidance rule under Jewish tithing practices. Perhaps faith holds considerable explanatory power for this notable difference.

T.E.

Zhonglan Dai, Edward Maydew, Douglas A. Shackelford, and Harold H. Zhang, "Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?"
(2008) vol. 63, no. 2 *The Journal of Finance* 709-42

News of reductions in capital gains taxes can increase demand for investments and thereby increase asset prices; in effect, the anticipated reductions get capitalized in asset prices. Capital gains taxes also decrease supply: those who hold assets are reluctant to realize their gains since capital gains taxes are triggered only on realization. This lock-in effect deters investors from switching into new and potentially more productive investments because such action would be subject to taxation. For example, switching investments from a capital property that appreciates at a rate of 8 percent to another that appreciates at a rate of 9 percent may not be desirable, since the tax levied on the sale of the first property implies a reduction in the after-tax amount available to invest in the second property.

Suppose a taxpayer has a $12,000 stock portfolio that was worth $10,000 when she first acquired it. The stock portfolio is expected to grow by an additional 8 percent over the next year. If the taxpayer continues to hold her portfolio, by the end of that year it will have grown to $12,000 × 1.08 = $12,960. Her portfolio adviser suggests an alternative investment that is expected to yield 9 percent; however, she will have to liquidate her existing portfolio and pay taxes of $400 (20% capital gains tax rate × ($12,000 – $10,000)). If she follows this route, she can invest $11,600 ($12,000 proceeds of sale – $400 capital gains taxes) at 9 percent to yield $12,644 in one year. Therefore, this taxpayer is better off sticking to her current portfolio earning 8 percent than switching portfolios and triggering taxes.

The authors of this study examine the demand-side capitalization effect and a supply-side lock-in effect to assess the net effect surrounding a change in tax legislation (the US Taxpayer Relief Act of 1997). The authors evaluate the returns and trading volume surrounding the 1997 reduction in capital gains tax rates. They find that the capitalization effect dominated in the week following the news that the capital gains tax rate was widely expected to decline (but before the law took effect), and that the lock-in effect dominated in the week after the reduced tax rate became law.

Stock prices often reflect factors that may not be incorporated in any particular theory. However, the authors' hypothesized capitalization and lock-in effects as the forces driving stock prices seem compelling, given their following empirical findings:

1. Non-dividend paying stocks had a more pronounced capitalization effect than dividend-paying stocks.
2. Stocks with larger historical price gains and higher individual (as opposed to pension fund or corporate) ownership had a more pronounced lock-in effect and experienced lower returns.
3. Trading volume was higher just before and just after the tax rate decline came into effect, presumably reflecting a rebalancing of investors' portfolios.

Amin M.

Jim Hsieh and Qinghai Wang, "Insiders' Tax Preferences and Firms' Choices Between Dividends and Share Repurchases" (2008) vol. 43, no. 1 *Journal of Financial and Quantitative Analysis* 213-44

William J. Moser, "The Effect of Shareholder Taxes on Corporate Payout Choice" (2007) vol. 42, no. 4 *Journal of Financial and Quantitative Analysis* 991-1020

Insiders (management and directors) have a strong influence over their firm's dividend payout policies. For example, chief executive officers holding significant amounts of employee stock options are known to have lower dividend payouts, in part because their stock options are not dividend-protected. Dividend payments are known to reduce stock prices, and thereby the values of the underlying options.

Hsieh and Wang investigate whether firms' choices between dividend payouts and share repurchases are also influenced by insiders' shareholdings and their personal tax preferences. The authors find that a higher incidence of insider share ownership (and the implied tax liabilities) is positively associated with the firm's propensity to repurchase shares instead of paying dividends. Furthermore, a (positive) change in insider ownership is associated with a (positive) change in share repurchases. The evidence is compelling, since this association becomes more statistically significant during periods when dividends are more tax-disadvantaged relative to capital gains. This evidence is part of the growing literature documenting how corporate decisions are influenced by insiders' personal considerations (or self-interest).

Moser also examines insiders' influence, with the same results, but his study focuses on differences in tax rates between dividends and capital gains (the dividend tax penalty). He finds that increases in the dividend tax penalty are associated with shareholder distributions in the form of share repurchases rather than dividends. This association is empirically stronger when ownership is held by shareholders who are not taxed lightly on dividend income.

Amin M.

Jay Soled, "Homage to Information Returns" (2007) vol. 27, no. 2 *Virginia Tax Review* 371-97

William L. Burke, "Tax Information Reporting and Compliance in the Cross-Border Context" (2007) vol. 27, no. 2 *Virginia Tax Review* 399-436

Information reporting, especially third-party reporting, is an effective tax-compliance tool. Administrative and compliance costs are seen, however, to limit its use to employment income and a range of investment income. Soled considers a number of areas in which technological advancements have arguably made an expanded information-reporting requirement feasible in a purely domestic context. Burke considers a range of strategies designed to enhance cross-border information reporting, particularly in the context of outbound portfolio investment.

T.E.

John G. Head and Richard Krever, "Taxing Capital Income" (2007) vol. 22, no. 2 *Australian Tax Forum* 83-103

This paper was presented at a symposium held at the University of New South Wales on April 2-3, 2007. The subject of the symposium was reform of the Australian personal income tax. The paper provides a comprehensive and accessible review of the case for the taxation of capital income. Head and Krever have been vigorous proponents of such taxation in the comprehensive income tax tradition. Although they continue to argue that capital income should be taxed, they concede that the attempt to do so in a comprehensive manner presents some difficulties. They review a number of second-best responses to these difficulties, such as the Nordic dual income tax systems, the CBIT, and the ACE system, all of which involve the taxation of some portion of capital income on a cash-flow basis at the entity level, rather than taxation on an accrual basis at the personal level. In their assessment of these alternatives, Head and Krever adopt a position of agnosticism, concluding that each has its own particular advantages and disadvantages.

T.E.

Erik M. Jensen, "Taxation and Doing Business in Indian Country" (2008) vol. 60, no. 1 *Maine Law Review* 1-95

This article provides a comprehensive review of the overlapping US federal, state, and tribal taxing powers as they affect inbound investment on aboriginal land ("Indian country"). Although the taxation landscape, as well as the relevant non-tax law, is different in the United States than in Canada, some of the issues are sufficiently similar that Canadian readers should find the article of interest. As Jensen states in the introduction:

> For better or for worse, law review articles are not like the works of John Grisham. In particular, they are usually not read cover to cover; even my mother is unlikely to read every word of this one. Like my mother, you, the reasonable reader, can pick and

choose among topics, depending on your desires and needs. If you already understand the federal plenary power doctrine, for example, skip that part of the article. But, if you are interested in taxation in Indian country, there ought to be *something* of interest in the following pages.

T.E.

Michael Smart, "Raising Taxes Through Equalization"
(2007) vol. 40, no. 4 *Canadian Journal of Economics* 1188-1212

Many federations offer equalization grants to their provincial or state governments so that all citizens of the federation can arguably enjoy a similar standard of living. The equalization payment is often based on the difference between a provincial (or state) government's tax base and the average tax base of all other provinces (states), multiplied by some target tax rate. Smart argues that such equalization payments may lead local or provincial governments to increase their own tax rates, thereby shifting economic activity to other regions and shrinking their own tax base. This results in a higher equalization grant, compensating in part for the deadweight loss of the tax increase. An empirical examination of Canadian equalization transfers from 1972 to 2002 reveals that provinces receiving equalization payments did increase their tax rates.

Amin M.

Joseph J. Doyle Jr. and Krislert Samphantharak, "$2.00 Gas! Studying the Effects of a Gas Tax Moratorium" (2008) vol. 92, no. 3 *Journal of Public Economics* 869-84

This study examines the effects of sales taxes on retail prices. Following a significant increase in gasoline prices in 2000, Illinois and Indiana temporarily suspended their gasoline sales tax and subsequently reinstated the tax. Using a dataset of daily prices at the gas-station level, the authors find that only 70 percent of the tax suspension was passed on to consumers in the form of lower prices, while 80-100 percent of the tax reinstatement was passed on to consumers in the form of higher prices. The study further finds that prices passed on to consumers are lower near state borders, while the tax reinstatement-driven higher prices pervade up to an hour's drive into neighbouring states.

Amin M.

Leah Brooks, "Volunteering To Be Taxed: Business Improvement Districts and the Extra-Governmental Provision of Public Safety"
(2008) vol. 92, no. 2 *Journal of Public Economics* 388-406

Government expenditures dictated by the median voter may leave some citizens dissatisfied with the level of public services. Brooks offers an example of business improvement districts (BIDs) in California, in which neighbourhood property owners volunteer to pay regular contributions to the cost of acquiring additional policing (a collective good) to safeguard against crime and vandalism. A California state law makes such collective contributions to the BID budget mandatory when approved by a majority of property owners. The study reveals that BIDs are statistically associated with crime rates that are 6-10 percent lower than

- the rates in the same neighbourhood before the BID was established;
- the rates in neighbourhoods that considered but did not adopt a BID; and
- the rates in neighbourhoods that never considered a BID.

If the only benefit from BID expenditure is assumed to be violent crime reduction, then BIDs spent $21,000 to avert one violent crime, compared with the $57,000 social cost of a violent crime. The $21,000 cost is an overstatement in this context to the extent that the reduction of violent crime is not the only benefit of BID spending.

Amin M.

Paul C. Lau, Gary Sauder, and Sandy Soltis, "New Chinese Law Means Higher Tax To Do Business in China" (2008) vol. 86, no. 4 *Taxes: The Tax Magazine* 33-44

This article provides an overview of China's new enterprise income tax law, which came into effect on January 1, 2008, and its effects on how foreigners do business in China. Besides contrasting the old tax law with the new one, the article elaborates on the following topics in the context of current US tax rules:

- types of business entities used by foreigners in China
- research and development tax incentives
- special provisions for venture capitalists
- anti-avoidance rules
- transfer-pricing rules and adjustments
- transfer-pricing documentation
- thin capitalization rules
- taxation of interest, dividends, and capital gains
- tax planning by US entities doing business in China
- repatriation to the United States
- controlled foreign corporation rules
- passive foreign investment company rules
- C corporation versus non-C corporation shareholders

The article provides useful coverage from the perspective of a reader familiar with the US tax system. As well, the authors' footnotes offer a glimpse into the provisions of the Chinese tax code.

Amin M.