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Current Tax Reading

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Canada Revenue Agency, *Investigations Manual* and *Audit Manual*;
available through various electronic tax services

According to a federal government Web site, the Canada Revenue Agency (CRA) has over 100 manuals—guides provided to CRA employees that explain the application of laws and CRA administrative rules.[1] Since these manuals are often the best source of information about how the CRA is applying the law, it is surprising how little attention has been given to them.[2] So far, it appears that only two of these manuals have been released: the *Investigations Manual* (October 2007) and the *Audit Manual* (December 2008). Both were written specifically for audits of small and medium-sized businesses, although the information contained in them has a broader application. The information seems generally up to date, and contains only a few references to the Canada Customs and Revenue Agency.

The versions that are released to the public are sanitized ("severed") to eliminate the most sensitive information. Thus, only 23 of the 40 chapters of the *Audit Manual* have been released, and some pages in the released chapters are blanked out; for example, in the chapter of the *Audit Manual* that provides sector profiles, the risk assessment section on pharmacists consists of 6 pages that contain only one word: "protected."

The *Investigations Manual* provides a wealth of detail about the CRA's views on topics such as searches and seizures, requirements for information and production of documents, examination of taxpayer documents, solicitor-client privilege claims,

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1 Available online at http://www.infosource.gc.ca/inst/nar/fed09-eng.asp.

2 One exception is the discussion of the *Taxpayer Operations Manual*, which has now apparently ceased publication, in William Innes and Janice McCart, "Transfer-Pricing Disputes: Access to and Disclosure of Information" (1995) vol. 43, no. 4 *Canadian Tax Journal* 821-68, at 836-37.

exchanges of information with provinces and foreign countries, non-filer prosecutions, and fraudulent tax returns and refunds.

The *Audit Manual* is even more voluminous, totalling 1,877 pages, although its depth of coverage varies considerably from topic to topic. Fairness and client rights merit only 16 pages, but the following chapters each exceed 100 pages in length: conducting an audit, finalizing an audit, specific audit guidelines and checklists, audit techniques, goods and services tax (GST) and harmonized sales tax (HST), prepayment review, income/supplies, and sector profiles. Net worth assessments, for example, command 30 pages of text and 50 pages of numerical examples with filled-in worksheets.

Alan M.

Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008); available online at http://www.apcsit-gcrcfi.ca/06/index-eng.html, 115 pages, including appendixes

The Advisory Panel on Canada's System of International Taxation was established in November 2007. Its mandate was to recommend ways to improve the competitiveness, efficiency, and fairness of Canada's system of international taxation, minimize compliance costs, and facilitate administration and enforcement by the CRA. The panel released a consultation paper in April 2008 and undertook a consultation process afterward. Its final report, which was published in December 2008, contains eight chapters, four appendices, and recommendations. As noted below, some of the recommendations have already been adopted by the minister of finance in the 2009 budget, which was tabled on January 27, 2009.

Chapter 1 stresses the importance of competitiveness as a goal and guiding principle for Canadian international taxation. The panel considers the Canadian international tax system to be "a good one that has served Canada well."[3] Its recommendations seek not to reform but to improve the existing system.

Chapter 2 describes the current economic environment, including the changing global landscape, the financial market downturn, and the fact that Canada is a "relatively small trading nation." It also describes the stock and benefits of foreign direct investment, both inbound and outbound. The panel accepts the argument that tax policy plays an important role in affecting both the competitiveness of Canadian companies that invest abroad and the overall attractiveness of Canada as a place to invest.

Chapter 3 sets out six principles to guide Canadian tax policy makers:

- competitiveness compared with the tax systems of Canada's major trading partners;
- a level playing field for foreign investors and domestic investors;

3 At paragraph 1.12.

- the protection of the Canadian tax base;
- simplicity and clarity;
- full consultation;
- regular comparison of the Canadian tax system and the systems of Canada's major trading partners.

While addressing the principle of competitiveness, the panel makes a brief reference to the theory of capital export neutrality, capital import neutrality, and capital ownership neutrality. However, it acknowledges the impossibility of fulfilling the three neutrality standards with a single set of tax rules. It reiterates the importance of competitiveness by stating that countries will consider many factors other than neutrality in designing their tax systems, and competitiveness is one of these factors.

Chapter 4 is a key chapter. It reviews the current taxation of outbound direct investment and makes seven recommendations, each of which is reproduced and discussed below:

1. "*Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.*"[4] This recommendation was widely anticipated by the tax community. If the recommendation is adopted into law, active business income earned outside Canada by a foreign affiliate of a Canadian corporation will be exempt from Canadian tax when the income is earned as well as when the income is repatriated to Canada. Such an exemption will no longer be conditional on the existence of a double taxation treaty or tax information exchange agreement (TIEA) between Canada and the country in which the foreign affiliate is resident. The panel does not recommend, however, that the exemption apply to foreign active business income earned through a foreign branch. Therefore, the use of a legal construct remains critical in the application of the exemption.
2. "*Pursue tax information exchange agreements . . . on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA is not obtained.*"[5] The effect of this recommendation is to exempt active business income earned by foreign affiliates anywhere outside Canada from Canadian tax. If the rules that protect the Canadian tax base are not strengthened and the sourcing rules are not adequate, this recommendation may lead to significant erosion of the Canadian tax base by sourcing income to low-tax countries. Without TIEAs, it would be difficult for the CRA to obtain tax information from low-tax countries that have bank secrecy laws.
3. "*Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate when the shares derive all or substantially all of their value from active business assets.*"[6] To some extent, this recommendation is

4 Recommendation 4.1.

5 Recommendation 4.2.

6 Recommendation 4.3.

similar to the domestic lifetime capital gains exemption under section 110.6 of the Income Tax Act[7] for shares of qualifying small business corporations: the treatment of the shares is tied to the treatment of the underlying business income. Since the active business income of foreign affiliates is exempt from Canadian taxation when it is earned and repatriated, the policy rationale that justifies the exemption seems also to justify the non-taxation of capital gains.

4. *"Review the 'foreign affiliate' definition, taking into account the [p]anel's other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments."*[8] The panel suggests that if the definition is tightened, a flexible approach—for example, 10 percent of the votes, share capital, or value—is preferred.
5. *"In light of the [p]anel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis."*[9] This recommendation has been adopted by the government in the 2009 budget. The budget states that the government will review the existing "foreign investment entity" rules and the non-resident trust proposals in the light of the panel's recommendations and other submissions before proceeding with measures in this area. It further provides that the government will consider the panel's recommendations relating to foreign affiliates before proceeding with the remaining February 2004 proposals.
6. *"Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses."*[10] The panel raises the concern that the current erosion rules under the foreign accrual property income (FAPI) regime prevent Canadian businesses from effectively managing global supply chains. It suggests that the investment business rules should exclude businesses that are carried on through multiple entities with a total of more than five full-time employees. The panel also recommends retaining the current rules that exempt interaffiliate payments from FAPI and increasing the $5,000 de minimis exemption. This recommendation is consistent with the panel's emphasis on competitiveness.
7. *"Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 of the Income Tax Act should be repealed."*[11] Controversy about the government's proposed restriction on interest deductibility was the main

7 RSC 1985, c. 1 (5th Supp.), as amended. In subsequent references in this feature, the Income Tax Act is referred to as "the ITA."

8 Recommendation 4.4.

9 Recommendation 4.5.

10 Recommendation 4.6.

11 Recommendation 4.7.

> reason that the panel was established. The issue of interest deductibility was apparently raised at every consultation meeting and in many submissions to the panel. "Members of the business community strongly oppose any restriction on interest expense incurred to invest in foreign affiliates."[12] The panel found the submissions persuasive; so has the government. The 2009 budget adopts the panel's recommendation and proposes that section 18.2 be repealed in respect of interest and other borrowing costs paid or payable for periods that begin after 2011.

Chapter 5 discusses inbound tax issues and makes three recommendations. Two recommendations relate to thin capitalization rules: reduce the debt-to-equity ratio from 2:1 to 1.5:1,[13] and extend these rules to cover partnerships, trusts, and Canadian branches of non-resident corporations.[14] The panel also addresses the so-called debt-dumping problem—that is, "situations where a foreign-controlled Canadian corporation is leveraged with related or third-party borrowings . . . so that the resulting interest expense significantly reduces the corporation's Canadian taxable income."[15] It recommends the introduction of specific anti-avoidance rules.[16] Regarding the issue of treaty shopping, the panel concludes that "Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping"[17] and makes no specific recommendations.

Chapter 6 addresses issues related to non-resident withholding taxes. The panel appreciates the view that lower corporate tax rates are effective in attracting foreign direct investment and the Canadian withholding taxes are generally credited in the investor's residence country; however, the panel "believes that further reducing withholding taxes is desirable for Canada."[18]

Chapter 7 addresses administrative and legislative process issues. The panel recommends that immediate action be taken to enhance mutual responsibility and cooperation among taxpayers, tax advisers, and the CRA.[19] It also advocates the allocation of more resources for administering the international tax system. The panel suggests that the government consider the recommendations in the transfer-pricing subcommittee report[20] as a basis for consultations in this area. These recommendations

12 At paragraph 4.164.

13 Recommendation 5.1.

14 Recommendation 5.2.

15 At paragraph 5.48.

16 Recommendation 5.3.

17 At paragraph 5.68.

18 At paragraph 6.20 and recommendation 6.1.

19 Recommendation 7.1.

20 Advisory Panel on Canada's System of International Taxation, *The Administration of Canada's Transfer Pricing Rules: Issues and Recommendations* (Ottawa: Department of Finance, 2008); available online at http://www.apcsit-gcrcfi.ca/06/rr-re/2950_FC_CSIT_RR1_E_V4.pdf.

address the issues of dispute resolution, centralization and consistency, and greater guidance on administrative matters. The panel notes that determining arm's-length prices for intangibles is difficult for a variety of reasons and encourages the government to examine the application of the transfer-pricing rules to intangibles in order to measure Canadian-source income properly.[21]

Chapter 8 highlights issues that the panel wants the government to monitor in the future. These matters include source rules; the tax treatment of interest, rents, and royalties received from foreign affiliates (which are economic substitutes for dividends); allowance for corporate equity (which is the economic substitute for interest deduction); and tax consolidation for corporate groups.

Overall, the final report addresses the concerns of the business community by emphasizing the need for competitiveness within the Canadian tax system and recommending measures to enhance competitiveness, such as broadening the exemption system, repealing section 18.2, and imposing no restrictions on interest deductibility (except in the case of debt dumping). The panel mentions its concern about protecting the Canadian tax base, but makes few specific recommendations to prevent erosion. It should be applauded, though, for identifying many of the important policy and technical issues in Canada's international tax system and offering its solutions to some of them.

J.L.

Charles Bérubé and Pierre Mohnen, "Are Firms That Receive R & D Subsidies More Innovative?" (2009) vol. 42, no. 1 *Canadian Journal of Economics* 206-25

Government subsidies, which are intended to influence business decisions, can be delivered in the form of tax incentives or government grants. Businesses generally prefer tax incentives because the criteria for their application are more objective, and hence the receipt of a subsidy is more certain. In principle, grants allow for more assessment of the quality of research and development (R & D) projects, but critics doubt that this principle holds true in practice. As an empirical contribution to the debate, the authors of this article use Statistics Canada's "Survey of Innovation 2005" to analyze whether firms that receive both R & D tax credits and R & D grants report more innovations in products and processes than firms that receive R & D credits only. The authors' analysis reveals that the former group reports more innovations, more world-first innovations, and more success in commercializing innovations. However, the chosen data record only the presence or absence of grants, and thus it is impossible to determine whether or not success in innovation increases with the number of grants received.

Alan M.

21 At paragraphs 7.33 and 7.34.

Canada, Parliamentary Budget Officer, *Stakeholder Consultation Summary*
(Ottawa: Office of the Parliamentary Budget Officer, August 15, 2008);
available online at http://www2.parl.gc.ca/Sites/PBO-DPB/
index.aspx?Language=E, 32 pages

Ramnarayan Mathilakath, Ashutosh Rajekar, and Sahir Khan,
Fiscal Impact of the Canadian Mission in Afghanistan (Ottawa:
Office of the Parliamentary Budget Officer, October 9, 2008);
available online at http://www2.parl.gc.ca/Sites/PBO-DPB/
index.aspx?Language=E, 78 pages

As promised in the Federal Accountability Act,[22] which became law in December 2006, the government appointed a parliamentary budget officer (PBO) in March 2008. The PBO's mandate is to provide independent analyses of federal finances, and accordingly the office of the PBO has begun to produce reports. The *Stakeholder Consultation Summary* compares the PBO's role with that of the Congressional Budget Office in the United States, which implies that the office of the PBO could find itself in direct conflict with the Department of Finance. As the summary candidly states, "Accessing information will be a challenge."[23]

So far the office of the PBO has been primarily concerned with broad macroeconomic projections; however, the Afghanistan report suggests that the office could become involved in analyzing more detailed questions. The report on the mission in Afghanistan attempts to measure the incremental cost of the war effort beyond normal military expenditures. It also attempts to measure future Afghanistan-related disability and health claims. These cost estimates far exceed the information that would otherwise be released to Parliament and the public.

Tax issues are clearly within the mandate of the office, but no initiatives have been undertaken in this area so far.

Alan M.

Canada, Department of Finance, "Considerations in Setting Canada's Corporate Income Tax Rate," in *Tax Expenditures and Evaluations 2008*
(Ottawa: Department of Finance, 2008), 35-53, ISBN 978-0-660-19877-4

Ministers of finance frequently refer to international competitiveness as a factor in designing the Canadian tax system, but until now there has been no extended discussion of what this means. This document breaks the concept into two parts: (1) competitiveness with respect to Canada's top existing trading partners (as determined from a table of the top 10 sources and destinations of Canadian direct investment), and (2) competitiveness with respect to the 30 countries that are members of the Organisation for Economic Co-operation and Development (OECD) and

22 SC 2006, c. 9.

23 At 26.

the large (and rapidly growing) emerging economies of Brazil, Russia, India, and China. For each of the two sets of countries, the document compares both the statutory tax rates and the marginal effective tax rates (rates that combine differences in tax bases and tax rates).

Tax considerations are revealed most clearly in the table of outbound investment: 21 percent of this investment is from the Bahamas, Barbados, Bermuda, and the Cayman Islands, four countries with such a limited economic base that they must be conduits to other locations.[24]

Alan M.

Expert Commission on Pensions, *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules* (Toronto: Queen's Printer, 2008); available online at http://www.pensionreview.on.ca/english/report/Pensions_Report_Eng_web.pdf, 222 pages

The Ontario Expert Commission on Pensions (OECP) was established in November 2006 by the minister of finance, who is the minister responsible for pensions. The commission's mandate was to "examine the legislation that governs the funding of defined benefit pension plans in Ontario, the rules relating to pension deficits and surpluses, and other issues relating to the security, viability and sustainability of the pension system in Ontario."[25] The commission was chaired by Harry Arthurs, former dean of Osgoode Hall Law School and president of York University. The commission published its initial discussion paper in March 2007. It then undertook an extensive consultation process, involving representatives of various stakeholder groups as well as members of the public, and commissioned 17 studies by Canadian and foreign researchers. The final report contains 10 chapters and 142 recommendations.

Chapter 1 describes the challenges facing the commission and sets out the assumptions and principles underlying the report. It describes the first two principles as follows: "public policy in Ontario ought to maintain and encourage [defined benefit] pension plans"[26] and "public policy initiatives ought to focus on creating a positive environment in which [defined benefit] plans will flourish."[27] Chapters 2 to 8 discuss what occupational plans do, the decline of defined benefit (DB) plans, the funding problem, plan failure, restructuring, pension regulation, and governance. Chapter 9 stresses the need for innovation in plan design. Chapter 10 recommends ways of moving forward.

Tax policy is discussed in terms of its interaction with pension policy as well as its impact on the decline in DB plans, funding, and plan design. With respect to the interaction between tax policy and pension policy, the report notes that the ITA

24 At 50.

25 See the Expert Commission of Pensions Web site at http://www.pensionreview.on.ca/english/termsofReference.html.

26 At 20.

27 At 21.

provides important tax incentives to employers by treating contributions as a deductible business expense and to workers by sheltering their deferred income from taxation until they retired. However, the Ontario pension policy "has paid a price" for its dependence on federal tax incentives. Tax considerations often determine the design of pension funds and the levels of contribution and benefit. In cases in which the ITA requires sponsor action that may be deemed to be contrary to good pension policy, Ontario lacks the constitutional power to alter or neutralize the ITA provisions.

The effect of tax policy on the decline in DB plans is examined in several aspects. First, the 1991 tax reform that equalized the treatment of DB plans, defined contribution (DC) plans, and registered retirement savings plans (RRSPs) in terms of contributions likely explains the rapid expansion of these alternative approaches to retirement savings. Although it is less clear that this expansion occurred at the expense of the DB system, there is no doubt that some sponsors and some workers—especially younger workers—prefer DC plans and group RRSPs, which typically involve lower contributions. The commission notes that the ITA "has also perhaps exerted a drag on pension coverage by too narrowly defining which plans are eligible for registration, and hence for favourable tax treatment."[28] These constraints appear to inhibit innovation in plan design. For example, cash balance plans, which attract extensive enrolment in the United States, cannot be established in Canada because they are not contemplated by the ITA. Finally, the ITA funding rules and investment policies may also have contributed to the DB decline. Under the ITA, sponsors are permitted to shelter their annual contributions only to a maximum of 110 percent, or 120 percent of plan liabilities (depending on certain plan features and circumstances). These fixed limits reduce a plan sponsor's ability to "smooth" funding by overcontributing in good times and undercontributing in bad times. "It is quite possible that these provisions—especially in combination with the legal rules regarding surplus withdrawals—represent a deterrent for employers wishing to initiate or continue plans, and in that respect, they contribute to the decline of DB coverage."[29]

The report concludes that the limit on maximum pension benefits is "too low," and the limit on contributions adversely affects funding over time.[30] It recommends that the Ontario government persuade the federal government to increase benefits and contributions, and to consider policies that encourage participation by workers and employers in DB plans or their functional equivalents.[31] It also advises the Ontario government to approach the federal minister of finance with a view to removing any other tax obstacles to innovation in plan designs.[32]

28 At 48.

29 At 48-49.

30 At 84.

31 Recommendations 4-24 and 10-1.

32 Recommendation 9-1.

In the light of the current economic climate and the rising underfunding problems of many DB plans, it will be interesting to see whether the provincial and federal government implement the commission's recommendations.

This report is the first review of Ontario's occupational pension system in over 20 years. Its analysis is thorough, drawing from factual findings, academic research, and empirical evidence. The writing style is accessible. As the title of the report suggests, the wide-ranging recommendations attempt to achieve "a fine balance." The report is a must-read for anyone who is interested in pension issues.[33]

J.L.

Jinyan Li, "Tax Expenditure Analysis of Employer-Sponsored Registered Pension Plans" (39 pages) and **"Impact of Tax Policy on Coverage and Funding of Corporate-Sponsored Pension Plans"** (34 pages), reports prepared for the Ontario Expert Commission on Pensions, 2007; available online at http://www.blakes.com/english/practiceareas/pensionsOECP/pensions_OECP.asp

The tax expenditure analysis report provides data on the revenue cost of the tax incentives for registered pension plans and RRSPs, together with some information on plan participation. Econometric analyses are not discussed. The coverage and funding report provides summary information about the effect of tax policy on these issues.

Alan M.

Gilbert Metcalf and David Weisbach, *The Design of a Carbon Tax*, AEI Center for Regulatory and Market Studies Working Paper no. 09-05 (Washington, DC: AEI Center for Regulatory and Market Studies, January 2009); available online at http://www.ssrn.com, 62 pages

Although the authors of this comprehensive work do not discuss the British Columbia carbon tax or the failed federal Liberal proposal in the 2008 election, they provide an excellent information source for evaluating these initiatives. Generally, the authors would make different design choices.

Three design issues are discussed: the tax base, the tax rate, and trade between countries with and without an adequate carbon tax. The authors favour the taxation of energy companies to minimize the number of taxpayers and the consequent compliance and administration costs. They also recommend combining a carbon tax with income tax initiatives that are just sufficient to offset the carbon tax's regressivity, thereby avoiding any net change in income distribution. Finally, they advocate border tax adjustments to prevent so-called carbon leakage—that is, the shifting of production to countries that lack an adequate carbon tax mechanism.

Alan M.

33 Jinyan Li, the author of this review and a co-editor of Current Tax Reading, wrote two independent research papers (reviewed below) for the Ontario Expert Commission on Pensions.

Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" (2008) vol. 98, no. 2 *American Economic Review* 79-83

The Department of Finance includes a warning in each tax expenditure account that the numbers should not be totalled because the extra revenue raised by abolishing multiple tax expenditures may be more or less than the sum of the individual tax expenditure amounts. Including such a warning is a decidedly less helpful approach to the issue than simply calculating and reporting the extra revenue, which the Department of Finance could easily perform with its microsimulation model of tax returns. In the absence of such reporting, it is interesting to examine the results of a similar exercise in the United States. The authors estimate that simultaneously abolishing all non-business tax expenditures would raise about 8 percent more revenue than the sum of the individual estimates for each provision.

Alan M.

Ilan Benshalom, "The Quest To Tax Interest Income in a Global Economy: Stages in the Development of International Income Taxation" (2008) vol. 27, no. 3 *Virginia Tax Review* 631-708

The author of this article discusses the development of interest income sourcing rules in the United States and argues that the current rules are inadequate. Interest is generally sourced to the residence country of the debtor. Many countries exempt interest from withholding tax under either domestic law or treaty rules, which results in the non-taxation of interest in the source country. In the meantime, interest payments are generally deductible by a corporate debtor in computing its profit. The author maintains that the anti-avoidance rules, such as surplus stripping (or thin capitalization), are ineffective in protecting the tax base of the source country because they fail to distinguish between related and unrelated debt, and foreign and domestic debt.

The author traces the development of the interest allocation rules to three phases of international taxation in the United States: the revenue phase (between World War I and World War II), the trade phase (from World War I to the 1990s), and the anti-avoidance phase (from the late 1980s to the present time). The author's historical analysis leads to the conclusion that "fiscal and equitable considerations played too small a role" and that "notions of liberalizing cross-border trade and investment have infiltrated the debate in an unbalanced and hazardous way, leading to a severe erosion of the income tax base."[34] The author predicts that the base erosion problem will be exacerbated if more countries shift to a territorial system that exempts residents' foreign income. He suggests a replacement of the current rules with a comprehensive set of formulary sourcing measures for assuring proper allocations of income derived by multinational enterprises from related and unrelated financial transactions and assets.

J.L.

34 At 635.

Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal To Adopt a Formulary Profit Split," University of Michigan Law and Economics, Olin Working Paper no. 09-003; University of Michigan Public Law Working Paper no. 138 (December 2008), 67 pages

Brian Lebowitz, "Profit Sharing as New World Order in International Taxation" (2008) vol. 52, no. 7 *Tax Notes International* 585-606

The authors of these two papers advocate the adoption of a formulary allocation of business profits to replace the current arm's-length methods. They also inject some interesting and novel arguments and design insights into the debate about formulary apportionment. One of the authors, Michael Durst, is the former director of the Advance Pricing Agreements Program of the Internal Revenue Service. His practical experience and the insights he draws from this experience will presumably make it somewhat difficult to criticize the proposed formulary apportionment method as being merely academic.

The authors argue that the current system is flawed. According to Avi-Yonah, Clausing, and Durst, the current system is "notoriously complex," "raises relatively little revenue," and "provides an artificial tax incentive to earn income in low-tax countries, rewards aggressive tax planning, and is not compatible with any common metrics of efficiency."[35] Lebowitz criticizes the arm's-length principle on several grounds. First, it is based on a "faulty premise" that multinational groups of corporations can be viewed as the economic equivalent of a group of independent, separately managed companies. Second, it requires a "hypothetical inquiry" that involves finding real answers to hypothetical questions, such as what would happen if, contrary to fact, a group of related companies were unrelated and acting at arm's length toward each other. Third, it requires fact-based answers even when questions are hypothetical; this requires taxpayers to answer "conceptually flawed and incompletely specified hypothetical questions using largely nonexistent information."[36] Fourth, the application is tied to prices, which are inherently ephemeral. And finally, there are limits of law: "Prices are facts, and there are limits on the extent to which legal rules can be used to determine facts."[37]

The formulary allocation system proposed by Avi-Yonah, Clausing, and Durst, and Lebowitz will allocate to a country (for example, the United States) a fraction or share of the consolidated worldwide income of a multinational group of corporations. Avi-Yonah, Clausing, and Durst propose to determine the fraction by the sum of two factors: a fixed return on the expenses in a country, and the share of worldwide sales in this country. They maintain that this method is similar in many significant respects to the current "residual profit split" method used in the US transfer-pricing

35 At 1.

36 At 587.

37 Ibid.

regulations and the OECD guidelines.[38] The expense factor would assign to each country an estimated market return on the tax-deductible expenses incurred by the multinational group in that country (a share of the so-called routine income). The sales factor would assign the residual income to countries in accordance with the group's relative sales in each country. As a threshold issue, Avi-Yonah, Clausing, and Durst adopt the notion of "activity"; income from each business activity of a multinational group would be divided among the countries in which the activity is conducted. The activity would be treated as a single taxpayer, and its income would be calculated by subtracting worldwide expenses from worldwide income, based on a global accounting system, without regard to legal distinctions among units. The resulting net income would be apportioned among taxing jurisdictions based on a formula. Each jurisdiction would then apply its own tax rate to the apportioned income.

Lebowitz also suggests that the profit share percentage of each country be determined by reference to expenses and sales. He provides a nuanced analysis of what constitutes expense and how to source sales. For example, with respect to expenses related to intangibles, he explains that simply owning intangible assets in a country will not affect tax liability, except to the extent of expenses incurred in the country to maintain the ownership or enhance the value of the assets. With respect to interest expense, he suggests two plausible treatments: (1) allocate it in proportion to other expenses, which are what the underlying debt finances, or (2) disregard it.

Avi-Yonah, Clausing, and Durst have drafted a statutory rule for the implementation of the proposed method that is modelled closely on the existing residual profit-split method. The authors argue that there is no immediate need for renegotiating bilateral tax treaties. They see no reason why the United States and its treaty partners cannot agree, under the "competent authority" process, to interpret their treaties to accept the reformed apportionment approach as the closest feasible, and administrable, approximation to the arm's-length results envisioned in articles 9 and 7 of the OECD model.[39] Lebowitz seems to suggest that the proposed formulary apportionment system can work only if it is widely adopted by countries by means of a convention.

J.L.

Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, *Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience* (Paris: OECD, 2008), 82 pages

It is clear from this report that the OECD countries do not agree on very much when measuring tax compliance. However, one common dislike is found in the estimates of the underground economy based on currency demand equations (which measure

38 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf).

39 OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf).

tax evasion as a function of the unexplained need for cash balances): "when applied, they produce for most countries spectacularly high estimates of [the size of the underground economy] which have no sound scientific base but which, nevertheless, attract much attention from the media and other parties."[40] The OECD countries differ on the subject of whether, at the current state of knowledge, it even makes sense to produce measurements of the tax gap; the United Kingdom and the United States produce these estimates, but Canada does not do so.[41]

Instead, the CRA produces a number of smaller measures of compliance, which it views as having more direct policy relevance. Three examples follow:

- In 2004, 94 percent of adults over 18 years of age filed a tax return, but only 76 percent of new immigrants did so. Furthermore, the participation rate among new immigrants fell 6 percentage points from 2002 to 2004, while the overall rate rose slightly.[42]
- Overclaiming (unspecified) key tax credits and deductions, as measured by random audits, rose steadily from 5.4 percent in 1997 to 12.1 percent in 2004.[43]
- Rates of payments by the statutory due date from 2002-3 to 2006-7 showed no time trend for individuals, but the rate for taxable corporations fell from 93 percent to 85 percent, and the rate for employers fell from 90 percent to 88 percent.

Alan M.

Organisation for Economic Co-operation and Development, Forum on Tax Administration, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series* (Paris: OECD, 2009), 215 pages

This OECD publication, now in its third edition, has become an indispensable source of information on tax administration around the world. There are 46 tables, each attempting to cover the practices of 43 countries as reported directly by the countries' tax administrations. Economists are just starting to produce research projects that attempt to explain the differences among countries.

In this paper, the OECD reports some intriguing case studies of individual countries. For example, consider Denmark's personal income tax system. In 1988, the drift away from self-assessment began with the government using tax-slip data to pre-fill some fields of paper tax returns before sending them for approval to taxpayers. In 2008, the government said goodbye to personal tax returns completely; individuals

40 At 17.

41 At 24-26.

42 At 52.

43 At 54.

can receive an online notice of assessment with an online link to the underlying data.[44]

A significant frustration with this OECD report is that it contains little analysis to explain the source of the differences among countries. The following represents merely a few of the findings that one would like to understand:

- Tax refunds as a percentage of gross tax collections in Canada are much lower than in the United States for personal income tax (13 percent vs. 18 percent) but much higher for corporate income tax (20 percent vs. 7 percent).[45]
- The value of tax debt as a percentage of annual net revenue varies tremendously among countries. Based on visual estimates from a figure, the statistics are: Germany, 1 percent; United States, 4 percent; Canada, 8 percent; Mexico, 16 percent; Portugal, 37 percent; and the Slovak Republic, 49 percent.[46]
- Canada's rate for the e-filing of value-added tax (GST) returns is relatively low at approximately 11 percent. Most countries are in the 20 to 40 percent range, and Mexico's rate is over 50 percent.[47]

Alan M.

Graeme S. Cooper, ed., *Executing an Income Tax* (Sydney: Australian Tax Research Foundation, 2008), 332 pages

This collection of eleven papers is chiefly concerned with the drafting of tax law. As the editor acknowledges, the topic may surprise many non-Australians. Contrary to the general view in other countries, many people in Australia believe that the way a tax law is written can accomplish a great deal of good.[48] As a result, one might expect that there is much to learn from Australian drafting practice and the associated literature. Judging from the negative tone of many of the articles in this book, however, the lessons may concern what not to do. For example, Brian Arnold compares the controlled foreign corporation legislation in Canada and Australia, and finds that the Canadian approach is generally better. Similarly, Graeme Cooper discusses the Australian use of the second person—you—in drafting tax law. This expression may be appropriate if an individual taxpayer is reading tax law for information about her own situation, but surely it is more commonly tax advisers and employees of large corporations who read this legislation. Further, in more complicated situations there can be confusion about who "you" is, and so the legislation is in the strange position of having to define the term: "the expression *you* . . . applies to entities generally, unless its application is expressly limited."[49]

44 At 164.

45 At 100.

46 At 103.

47 At 169.

48 At 4.

49 At 171, citing section 4.5 of the Income Tax Assessment Act 1997.

One chapter diverges from the main thrust of the book to propose a verbal model that predicts when a particular provision in the law will produce high compliance costs (both in dollars and in time) for taxpayers.[50] The model is based on data requirements and uncertainty. Data requirements are divided into nine categories, ranging upward from data required for financial statements (such as payroll tax), data required for financial statements but not required in the detail necessary for tax (such as data concerning non-deductible fines and penalties), data existing within a business but not a part of the business's double-entry accounting system, and so on. Uncertainty is divided, somewhat less successfully, into six categories: strong match to an explicit rule in the legislation, match by strong analogy to an explicit rule in the legislation, and so on. It would be interesting to try to test the chapter's compliance cost scale on actual provisions in the law.

Alan M.

Susan Morse, Stewart Karlinsky, and Joseph Bankman, "Cash Businesses and Tax Evasion" *Stanford Law and Policy Review* (forthcoming)

The authors of this article report on 275 field-study interviews with owners of cash-oriented businesses and with certified public accountants and bankers who serve cash-business clients. In place of the usual academic approach of asking a fixed set of questions, the authors rely on less structured interviews. Their qualitative approach provides fascinating reading as the participants explain in some detail how cash-based cheating occurs. The authors were surprised by the frankness of the comments made by those interviewed, which the authors attribute to the low incidence of audits and audit-related penalties. The main lesson derived from this article is the importance of opportunity in the prevalence of tax evasion. It is also interesting how cash-based businesses focus on underreporting cash receipts; overstating deductions seems to play a relatively minor role.

Alan M.

John R. Graham, Michelle Hanlon, and Terry J. Shevlin, "Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits," paper written for presentation at the "Mobility and Tax Policy: Do Yesterdays' Taxes Fit Tomorrow's Economy?" conference at the University of Tennessee, October 3, 2008; available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316576, 51 pages

This paper investigates whether, how, and to what extent US tax law distorts the mobility of capital within firms. The authors surveyed tax executives to examine their firms' response to the one-time dividend received deduction legislated in the American Jobs Creation Act of 2004.[51] They find evidence that is consistent with

50 Michael Brown, "Modelling Tax Compliance Tasks for Large Business," 307-28.

51 Pub. L. no. 108-357.

the proposition that the US tax on repatriated earnings creates a significant barrier to mobility. They also dispute the claims that the repatriation tax is easy to avoid. The authors' empirical data show that firms hold large cash balances overseas, many firms have excess tax credits, and over $300 billion in cash was repatriated when the US tax rate was dropped significantly as part of the American Jobs Creation Act of 2004. The authors conclude that the current US policy of taxing the worldwide profits of US multinationals has a substantial lockout effect.

J.L.

Organisation for Economic Co-operation and Development, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* (Paris: OECD, September 19, 2008); available online at http://www.oecd.org/dataoecd/59/40/41346644.pdf, 59 pages

In this discussion draft, the OECD defines "business restructuring" as "the cross-border redeployment by a multinational enterprise of functions, assets and/or risks."[52] The document deals with four types of restructuring: (1) conversion of full-fledged distributors into limited-risk distributors or commissionnaires for a related party that may operate as a principal; (2) conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers for a related party that may operate as a principal, (3) rationalization and/or specialization of operations (manufacturing sites and/or processes, research and development activities, sales, and services), and (4) transfers of intangible property rights to a central entity (such as a so-called IP company) within the group. The draft report does not cover corporate reorganizations such as mergers and acquisitions. The OECD recognizes the fact that a business restructuring may involve cross-border transfers of valuable intangibles. It also notes that business restructurings often result in the reallocation of profits from the entity or entities that are restructured to the principal or entrepreneur because of the redeployment of functions, assets, and risks. And it observes that this reallocation raises concerns about tax-base erosion for host countries.

The draft report is composed of four issues notes. The first issues note provides general guidance on the allocation of risks between related parties. It suggests that an analysis of whether risks have been shifted in a business restructuring must commence with the contractual terms that define how risks are to be allocated between the related parties. However, these allocations can be challenged if the contractual terms are not followed or if the arrangements lack economic substance.

The second issues note discusses the application of the transfer-pricing guidelines to the business restructuring itself. In particular, it examines the circumstances in which the restructured entity would receive compensation at arm's length for the transfer of functions, assets, or risks; indemnification for the termination; or substantial renegotiation of existing arrangements. Whether arm's-length compensation

52 At 6.

is required for restructuring must be determined by reference to a full understanding of the transaction. It is interesting that the issues note recognizes that business restructuring leads to a reallocation of profit/loss potential as a result of a reallocation of risks. However, the profit/loss potential is not an asset in itself, but a potential that is carried by some rights or other assets. The arm's-length principle does not require compensation for loss of profit/loss potential per se. The question is whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm's length. The answer to this question depends on a number of factors, including but not limited to: (1) the realistically available options, assessed on the basis of the rights and other assets of each party at the outset of the restructuring that determine the business opportunity asset of either; (2) the expected return to the transferor and transferee after the restructuring; and (3) the compensation that may be required to appropriately remunerate the transferor's surrender of the business opportunity asset.

The third issues note discusses the application of the arm's-length principle and the transfer-pricing guidelines to post-restructuring arrangements. The general approach is that the same principles apply to post-restructuring transactions as to comparable transactions that were structured as such from the beginning.

The fourth issues note discusses the exceptional circumstances in which a tax administration may consider not recognizing a transaction or structure adopted by a taxpayer on the basis of an analysis of the existing transfer-pricing guidelines. In general, taxpayers are free to organize their business operations as they see fit, and tax administrations do not have the right to dictate to a taxpayer how to design its structure or where to locate its business operations. However, tax administrations have the right to determine the tax consequences of the structure put in place by a taxpayer. The issues note makes it clear that the fact that a related-party arrangement is not seen as an arrangement between independent parties does not in itself mean that the arrangement is not at arm's length.

The release of this discussion draft is very timely. Cross-border business restructuring has been increasing, and the application of the arm's-length principle has caused some uncertainties to both taxpayers and tax administrations. The discussion draft explicitly recognizes the difficulty of applying the arm's-length principle to multinational corporate groups, and attempts to apply this principle to restructuring transactions in a "pragmatic and realistic manner."

J.L.

Michael S. Kirsch, "The Limits of Administrative Guidance in the Interpretation of Tax Treaties," Notre Dame Law School Legal Studies Research Paper no. 09-02; available online at http://ssrn.com/abstract=1332123, 63 pages

The author of this paper examines the increasingly important role of administrative guidance in interpreting double taxation treaties in the United States, particularly in response to the increasingly sophisticated business structures and cross-border transactions used by multinational corporations. The author provides a good review of treaty interpretation principles and US case law on treaty interpretation, especially with respect to the weight of informal technical explanations.

The author argues that the Treasury's traditional ad hoc approach based on informal technical explanations is entitled to little, if any, deference in interpreting previously negotiated bilateral treaties. However, a joint technical explanation, such as the one pertaining to the Canada-US tax treaty, is different. To the extent that a joint technical explanation fills gaps that are not specifically addressed in the text of the treaty, it provides strong evidence of the two countries' mutual understanding, and thus should have significant weight. "Even to the extent the joint technical explanation provides a result inconsistent with a literal reading of the words of the treaty, a court might give significant weight to the joint technical explanation."[53]

J.L.

Katherine Pratt, Jennifer Kowal, and Daniel Martin, "The Virtual Tax Library: A Comparison of Five Electronic Tax Research Platforms"
(2008) vol. 8, no. 9 *Florida Tax Review* 935-93

The authors of this paper provide a helpful analysis of the strengths and weaknesses of the five most common electronic tax services for the United States: LexisNexis, Westlaw, BNA, CCH, and RIA Checkpoint. An example of a stock option problem involving the relatively new section 409A of the Internal Revenue Code illustrates the points made. In particular, the article shows how a researcher can easily reach an erroneous conclusion unless a tax service's discussion of a section mentions the impact of related sections (in this case, commentary on section 83 mentions section 409A).

Alan M.

53 At 31.