Tax-avoidance law in Canada and elsewhere is a mess. It is an incoherent mixture of general anti-avoidance rules and judicial doctrines, specific anti-avoidance rules, disclosure requirements, and penalties. This sorry state of affairs can be traced to a fundamental inability to articulate with any conceptual precision the range of transactions that are suitably subject to prohibition. Various market-driven developments have placed increasing pressure on tax-avoidance law, as the tax-avoidance industry has moved from a “cottage” phase to a full-blown modern market phase. The significant revenue threat presented by the much more sophisticated tax-avoidance sector has forced tax policy makers to react. But in the absence of a clear conceptual understanding of just what the target should be, the responses have been haphazard at best, resulting in much legal uncertainty. Though the current situation is decried by tax practitioners, and is clearly far from ideal, this scattershot approach has at least prevented tax systems from breaking down entirely.

The working paper issued by Finances Québec is a refreshing foray into the tax-avoidance cauldron. Although the working paper focuses on “aggressive tax avoidance,” perhaps somewhat surprisingly, it does not attempt to define in any
conceptual detail what exactly is encompassed by the term. In short, there is no attempt to define in a general conceptual sense those transactions that can be characterized as aggressive. Instead, the working paper describes certain transactions that are apparently considered to be examples of such avoidance. The lack of a clear conceptual understanding of the nature of aggressive avoidance is evident in the last chapter, which includes a consideration of possible clarifications of the general anti-avoidance rule (GAAR) in section 245 of the Income Tax Act as it is incorporated in the Quebec legislation. Instead of a thoughtful consideration of the concept of tax avoidance, there is only a perfunctory discussion of the notion of economic substance drawn from the work of two Canadian commentators. In any event, problems of federal-provincial coordination are cited as prohibitive constraints on unilateral changes to the Quebec version of the GAAR.

The analytically strongest parts of the working paper are the first two chapters, which provide informative reviews of the market forces leading to the proliferation of tax-avoidance transactions and the efforts undertaken by the Quebec tax authorities to combat such transactions. Chapter three then provides a brief review of disclosure, penalties, and limitation periods as second-order responses adopted in certain other countries. These responses are second-order in the sense that they are intended to support application of the substantive law as an exercise in identifying targeted transactions appropriately subject to prohibition. The working paper indicates that actions under consideration by the Quebec government include (1) an early disclosure mechanism; (2) a penalty regime where the GAAR applies; and (3) extension of the statutory limitation period. Possible broad design features of each type of measure are described.

The discussion paper published by the UK Institute for Fiscal Studies provides a useful discussion and analysis of the recent UK experience with tax avoidance. With the notable exception of the United States and the corporate tax shelter phenomenon, there is probably no other country in which there has been so much public discussion of various strategies to combat the tax-avoidance industry. The discussion paper thankfully moves beyond the usual controversy in the United Kingdom over a perceived need for a GAAR. In fact, Bowler suggests that the issue may be moot, given the fact that reliance on broadly worded specific anti-avoidance rules has tended to provide much the same effect as a GAAR. The discussion document candidly acknowledges the unsatisfactory state of UK tax-avoidance law, which is characterized by an array of different strategies and approaches—some legislative,
some administrative, and some procedural. The principal conclusion of the discussion paper is that “there is no ‘golden bullet’ in terms of a legislative, administrative or judicial approach that will solve the ‘tax gap’ problems caused by tax avoidance.”

Consistent with the working paper released by Finances Québec, the body of the UK discussion paper begins with an all-too-brief review of the concept of tax avoidance. Bowler recognizes that the genesis of much tax avoidance is various boundaries in the tax law, but she fails to provide any analysis of how recognition of this important cause might suggest just what range of transactions should be subject to prohibition. The next chapter reviews the various approaches and strategies that have been used by UK tax authorities in combatting tax avoidance. This discussion is followed by a discussion of other possible approaches, such as a GAAR, an abuse-of-law provision, and principles-based drafting. There are also five appendixes. Two of these describe the experience with detailed legislative responses to particular tax-avoidance transactions in the context of employee share awards and stamp duty, respectively. The third appendix reviews different types of specific anti-avoidance rules that have been enacted. The fourth, which may be the most interesting, speculates on the extent to which detailed legislation enacted since 1997 could have been avoided with the adoption of a GAAR. The last appendix provides the standard summary of anti-avoidance techniques, including GAARs, used in other jurisdictions.

Two observations stand out in the UK discussion paper. One concerns transactions whose purpose is to create a tax benefit. These mass-marketed transactions, which are characteristic of almost all of the US corporate tax shelter transactions, have apparently been effectively suppressed in the United Kingdom through adoption of a system of disclosure. The other observation concerns cross-border tax arbitrage, which involves the generation of a tax benefit through the inconsistent classification of a transaction by two countries. The United Kingdom is unusual in enacting legislation specifically intended to prohibit such transactions where they can be considered to have been entered into primarily to deliver a UK tax benefit. The discussion paper nonetheless observes that this response is incomplete. Yet there is no discussion of what might otherwise be done.

Beyond Boundaries consists of 22 papers presented at a two-day conference held in June 2007 and organized by the Oxford University Centre for Business Taxation. The papers are organized under three general headings: (1) “statutory anti-avoidance provisions—old and new”; (2) “tax risk and relationships between taxpayers, revenue authorities, and other stakeholders”; and (3) “directions for the future.” The authors are from a number of countries and include tax practitioners, government officials, and academics in the fields of law and economics. Some of the papers are disappointing in that they are nothing more than brief reprises of some earlier work of the authors. There is nonetheless much new and worthwhile material in many of the papers.

T.E.

3 Bowler, at 7.
The corporate income tax is one of the great enigmas of tax policy. The role of the tax, as well as the distortions that it creates, has been the subject of considerable academic debate. The tax continues, however, to have broad popular support and, therefore, political appeal. The most significant recent development for the corporate income tax as an accepted part of the tax mix of a country is the increasing international mobility of capital. This empirical fact has shifted the debate over the corporate income tax from the domestic to the international context. This shift means that tax policy makers have become much more focused on the use of the corporate income tax as a tax on inbound direct investment. The more traditional focus in a purely domestic context has been the use of the corporate income tax as a withholding mechanism on the capital income of individuals.

Daniel Shaviro’s book reflects clearly these different roles of the corporate income tax. Shaviro provides an engaging review of the traditional role of the corporate income tax in a domestic context, as well as an accessible synthesis of much of the economic literature considering the perceived behavioural distortions of the tax. He emphasizes that much of this literature is problematic because of the modelling difficulties that are presented by the tax significance of the standard tax-law distinctions between corporate debt and equity, and between incorporated and unincorporated entities. Shaviro also reviews the international dimension in two separate chapters. He argues that reform efforts in the United States might more usefully move away from integration of the corporate and investor-level taxes to focus on the following areas of concern: (1) lowering the corporate tax rate to make it more internationally competitive; (2) radically simplifying the US international tax rules in a largely revenue-neutral manner; and (3) addressing the tendency of corporate executives to understate corporate income for tax purposes and overstate it for financial reporting purposes. National tax policy makers in small, open economies, such as Canada’s, have long been preoccupied with the first two directions for reform, while at the same time providing a level of integration that realizes a level of neutrality for the choice of capital structure and organizational form. It may be that the position of the United States as a large capital exporter has allowed it to lag on these pressing tax-policy fronts. Unfortunately, Shaviro does not discuss policy developments in other countries as possible reform models.

The article by Gravelle and Hungerford provides a first-rate critique of a number of recent studies that make some provocative claims about the revenue-raising capabilities of the corporate income tax and the behavioural distortions commonly

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associated with the tax. The authors emphasize a range of methodological problems that undermine severely the claims made in many of these studies. Two claims are especially suspect. One is that the behavioural responses could cause revenue to rise if rates were cut. The other is that the burden of the tax falls exclusively on labour. Gravelle and Hungerford concede, however, that many of the traditional concerns about the distortions caused by the corporate income tax remain valid, although they believe that the magnitude of those distortions is declining. They argue that there are a number of revenue-neutral reforms that could be adopted in an effort to alleviate the remaining distortions. These reforms include some base-broadening measures and reduction of the benefit of debt financing through indexation for inflation. Reduction of the corporate tax rate, driven by concerns about international competitiveness, would provide sheltering opportunities for individuals facing a higher marginal personal rate on dividends and capital gains. Nonetheless, Gravelle and Hungerford suggest that any benefit from reduction of the tax at the corporate level should be offset with increased dividend and capital gains taxes at the personal level. Sheltering opportunities could be addressed, in part at least, by modifying the corporate rate on personal services and investment income.

T.E.


Mergers and acquisitions are usually motivated by synergies arising from market power, efficiency improvements, or taxes. Taxes create synergistic value when losses from one corporation can be offset by gains from another corporation, and thereby shield the merged entity from taxes otherwise payable. Such tax-loss offsetting usually requires the merging entities to be in a related line of business. As the authors of this study point out, there is limited evidence on the relative importance of these three sources of merger gains. The authors examine a sample of 264 large mergers in the United States and estimate the average synergy gains to be 10.03 percent of the combined market value of equity of the merging firms. Their data from Value Line projections enable them to decompose the synergy gains into operating and financial (including tax) components. They find that on average, operating synergies account for approximately 85 percent of all synergy gains (or 8.38 percentage points of the total 10.03 percentage points synergy gains), while tax savings contribute the remaining 15 percent (or 1.64 percentage points). The authors also find that tax synergies play a bigger role in diversifying mergers—in part by stretching the “same-line-of-business” requirement—while operating synergies play a greater role in focused mergers that arise primarily from reduced investments rather than higher incomes. Such operating synergies resulting in improved resource allocation significantly exceed lower taxes and higher market power as motivations for mergers.

Amin M.


The recent commentary on option backdating scandals in both the financial press and the academic literature has focused mainly on the backdating of option grant dates. Assuming a steadily increasing stock price and the practice of granting options at the money, backdating option grant dates (to a period when the stock price was lower) could increase the employee’s benefit. The study by Dhaliwal et al. examines backdating of option exercise dates for exercise-and-hold transactions. Backdating of the option exercise date can reduce the employee’s option exercise benefit and the corresponding personal tax liability.

Dhaliwal et al. empirically document the backdating of option exercise transactions to days with lower stock prices, and find that such backdating was more frequent in the period before the Sarbanes-Oxley Act ("SOX") came into effect on August 29, 2002. SOX shortened the deadline for reporting option exercise from 10 days to 2 days, and increased the monitoring of compliance. Hence, employees had fewer opportunities to backdate their option exercise transactions after SOX.

In the pre-SOX era, 13.55 percent of all exercise-and-hold transactions by chief executive officers (CEOs) occurred on the day with the lowest closing stock price during the month. This is considered to be three times the frequency expected if exercises occur randomly throughout the month. In contrast, only 7.2 percent of such transactions occurred at monthly lows in the post-SOX era.

The amounts involved are fairly modest. For the 776 option exercise transactions done at monthly low stock prices between January 1996 and August 2002, the average (median) estimated tax savings for the CEO was $96,000 ($7,000). The aggregate benefit for all CEOs from the tax savings during this period is estimated to be $74 million. These benefits seem low compared with the risk of detection for most firms.

Since employee stock option exercise benefits are tax-deductible in the United States (unlike Canada), the employer corporation loses the corresponding deduction every time the employee manages to understate his or her option exercise benefit. The authors estimate that the forgone corporate tax benefits associated with the 776 suspect option exercises by CEOs exceeded the $74 million of aggregate benefits estimated to be enjoyed by the CEOs. Furthermore, firms with reported earlier exercises would have to remit their withholding taxes on employees’ option benefits earlier as well.

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Dhaliwal et al. find that backdating of option exercise is more likely in firms with lower marginal tax rates (such as those with non-capital loss carryforwards), since it reduces the cost of this opportunistic behaviour. Such backdating could arguably be more prevalent in Canada since there is no offsetting loss of benefit from the corresponding deduction in respect of the option at the employer level.

Finally, the authors find backdating of option exercises to be more likely in smaller firms, where firm size is considered to be a proxy for the strength of internal control. Better monitoring of such agency costs is recommended as an antidote to opportunistic behaviour by CEOs.

The discussion piece by Armstrong and Larcker examines some of the research design issues in investigating questions of backdating. This article will be of great interest to researchers working in this area.

Amin M.


Accounting choices and pre-tax earnings management can either affect current taxable income (“conforming earnings management”) or not affect current taxable income (“non-conforming earnings management”). The type of pre-tax earnings management (conforming or non-conforming) is inferred by analyzing the restatement of current tax expense for a sample of firms that are known to have restated earnings because of accounting irregularities. Conforming earnings management that increases reported income results in a downward restatement of pre-tax income and current tax expense. In contrast, non-conforming earnings management that increases reported income results in a downward restatement of pre-tax income without a corresponding downward restatement in current tax expense. Thus, analyzing the nature of current tax expense restatements can reveal the type of pre-tax earnings management undertaken by the firm.

Badertscher et al. find that non-conforming earnings management is the more prevalent type of pre-tax earnings management in the sample of firms known to have misstated their earnings. This type of pre-tax earnings management is riskier since firms have to flag non-conforming earnings in their book-tax reconciliations, and large book-tax differences invite greater scrutiny by both tax auditors and external auditors. The authors hypothesize and find that firms with lower net present value of tax benefits given up and/or higher expected detection costs (arising from raising such red flags in their book-tax conformity schedule) rely less on non-conforming pretax earnings management.

For example, firms with non-capital loss carryforwards sacrifice less by increasing taxable income associated with an increase in reported or book income arising from non-conforming earnings management. Similarly, firms with high free cash flows may place a lower value on having to pay higher taxes as a result of increasing taxable
income associated with an increase in reported or book income arising from non-conforming earnings management. The study’s results confirm this hypothesis: firms with lower tax costs (as proxied by firms with non-capital loss carryforwards) rely on significantly less non-conforming earnings management.

The study also hypothesizes that firms that rely on excessive non-conforming earnings management in prior years often create large temporary cumulative book-tax differences that arguably increase the probability of tax audit and detection. Such firms are empirically found to rely on conforming earnings management in subsequent years.

This study indicates that firms often inflate their reported earnings in a non-conforming manner even if such measures also report taxable earnings. This is more likely to occur for firms that have low marginal tax rates, such as firms with non-capital loss carryforwards. Such non-conforming overstatements of reported earnings are curtailed to the extent that the book-tax gap is conspicuously high (as a result of excessive prior overstatements), so as not to attract scrutiny and detection. The study also contributes in documenting the importance of disclosing book-tax differences—including the temporary difference component—since they are instrumental in predicting earnings restatements.

Amin M.


Researchers have argued for public disclosure of corporations’ taxable income or book-tax differences on the grounds that they reveal valuable insights about firm performance. This study examines firm characteristics that make taxable income a sound measure of firm performance. The study finds that firms that engage in a significant amount of tax planning (assumed to be firms in the lowest 20 percent of current effective tax rates) have relatively low information content in their taxable income numbers. However, taxable income numbers offer relatively useful incremental information (over and beyond the accounting income numbers) for firms with low earnings quality (assumed to be earnings composed of relatively large abnormal accruals). This suggests that taxable income may be a valid performance measure for some firms.

Amin M.

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This article provides further empirical evidence that the incidence of source-country withholding taxes on income from inbound portfolio investment falls on issuers resident in small open economies. The authors examine the unique legislative provisions in New Zealand, which provide that, in place of non-resident withholding tax on portfolio interest income, a resident borrower can agree to pay an “approved issuer levy” (AIL). The levy is equal to 2 percent of interest income rather than the 15 percent withholding tax (which is generally reduced to 10 percent by treaty). As a levy, the AIL is not creditable, however, in the country of residence of the lender.

The authors find that New Zealand-resident issuers operating out of New Zealand and paying the AIL face higher rates of interest as compared with resident issuers sourcing New Zealand dollar borrowings from offshore branches not subject to the levy. The evidence is consistent with a grossing up of interest payments to compensate non-resident lenders for the non-creditable AIL, despite the modest amount of the levy. As a means to lower the cost of capital of resident borrowers, a broad portfolio interest exemption, such as that introduced by Canada’s Department of Finance in the March 2007 budget,7 appears to be the most effective tax-policy instrument.

T.E.


The essays in these two volumes provide a rich synthesis of the current state of both the theoretical and the empirical literature relevant to the resolution of many of the major issues facing national tax policy makers. The one caveat to this characterization is a handful of the papers in the Diamond and Zodrow volume, which examine, in varying degrees, aspects of the interminable academic and political debate in the United States over the relative merits and drawbacks of an income versus a consumption tax. This focus is an apparent outcome of a deep pathology that, with a few exceptions, infects US tax academics and politicians. It appears to be another

7 See Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, annex 5 (statement of the government’s intention to eliminate withholding tax on all arm’s-length interest payments made to non-residents once an exemption from withholding tax on both arm’s-length and non-arm’s-length interest is implemented in the Canada-US tax treaty). Effective January 1, 2008, paragraph 212(1)(b) has been amended to eliminate non-resident withholding tax on non-contingent interest paid to an arm’s-length person.
example of US exceptionalism in the sense that virtually all other countries, for all kinds of sound policy reasons, have adopted a mix of taxes that includes personal and corporate income taxes and a broad-based value-added tax or goods and services tax using the invoice/credit method. There is simply no plausible policy explanation for the continued framing of the options in the United States as an all-or-nothing choice between an income and a consumption tax. The continued ignorance of the experience of other countries on the part of US academics and politicians is nothing short of appalling. Non-US readers can skip these particular papers as utterly irrelevant to their own experience. The other papers in both volumes, however, provide a wealth of important and accessible knowledge, albeit focused on the US experience.

The Viard volume consists of 6 papers with accompanying commentaries. The papers are

- Gilbert E. Metcalf, “Environmental Taxation: What Have We Learned in This Decade?”
- Seth H. Giertz, “The Elasticity of Taxable Income: Influences on Economic Efficiency and Tax Revenues, and Implications for Tax Policy”
- Dhammika Dharmapala, “The Impact of Taxes on Dividends and Corporate Financial Policy: Lessons from the 2000s”

The Diamond and Zodrow volume consists of 10 papers (also with commentaries), many of which examine the same material covered in the Viard volume. A couple of papers are notable, however, for a more specific focus on taxation and business investment. There are also two interesting papers on international business issues, one by Arnold Harberger and the other by Harry Grubert and Rosanne Altshuler. Harberger reviews the state of knowledge of the incidence of the corporate income tax in a cross-border setting. His paper is particularly notable because the seminal paper that he published over 40 years ago continues to frame the inquiry into this important issue. The paper by Grubert and Altshuler provides a useful review of the state of the empirical literature considering various behavioural margins affected by international income tax systems. The authors propose the adoption by the United States of accrual

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taxation of the foreign-source business income of US-based multinationals, with a credit for source-country tax paid. Their proposal is designed to be revenue-neutral and, as they persuasively argue, it would eliminate much tax-motivated behaviour. Indeed, the irony of such a theoretically pure system of residence-based taxation is that it is probably the only way to preserve source-country taxation of business income from inbound direct investment. Moreover, the unique position of the United States suggests that a branch-equivalent accrual tax is feasible only if it is enacted by this major capital exporter. As the experience in New Zealand suggests, such a system appears to be untenable for a small open economy.9

T.E.


This article examines the interaction between the market for corporate charters and corporate income tax systems. The authors accept as a normative premise that competition for corporate charters is efficiency-enhancing. Their focus is the extent to which differences in corporate income tax systems can distort the decision to locate a corporation in a jurisdiction with a suboptimal charter regime. The two bodies of law interact in this way only to the extent that overlapping criteria for the determination of corporate location are used. The authors argue that a first-best solution to this interaction is to segregate the two bodies of law by adopting different tests for corporate location—a place of incorporation rule for corporate law and a “real seat” rule for corporate income tax purposes. A second-best solution involves a detailed allocation of substantive law between federal and subnational levels of government. In this respect, the authors draw on the experience in the United States and the European Union to provide illustrative examples of the content of the substantive law governing corporate location, the taxation of corporate migration, and the taxation of foreign-source corporate income.

T.E.

One of the most important components of international income tax systems is the separate-entity/transactional method used to allocate the income of a multinational group among taxing jurisdictions. Under this method, revenue and expense of a multinational group is effectively sourced among taxing jurisdictions on the basis of the residence of corporate group members and the transactions entered into by the members contracting with one another as well as third parties. By adjusting the price charged between contracting group members, application of the arm’s-length principle allows tax authorities to adjust the income allocation that results from an acceptance of the integrity of private-law relationships. An emerging empirical literature now supports what tax practitioners, tax policy makers, and tax administrators have always known anecdotally: that the separate-entity/transactional method of income allocation is vulnerable to a broad range of techniques that permit multinational groups to reduce or eliminate residence-country and source-country taxes. Conventional wisdom holds, however, that adoption of an allocation method based on a specified formula, rather than intragroup transactions, requires a level of political cooperation that is not feasible beyond the subnational governmental level in federal states such as Canada and the United States. Nonetheless, an increasing perception that the separate-entity/transactional method is incapable of generating much-needed revenue continues to make proposals for some form of formulary apportionment method attractive. The current EU project to develop a common consolidated corporate tax base (CCCTB), which would be allocated among member states on the basis of an agreed-upon formula, is arguably the most ambitious attempt yet to jettison the separate-entity/transactional approach.

The first of these two articles provides an important critique of formulary apportionment methods. Roin argues that many of the techniques used to minimize and/or eliminate tax on multinational group income under the separate-entity/transactional approach could be used to realize similar results under a formulary apportionment approach. Much would depend on the choice of the income base, the apportionment factors, and the definition of the business or group subject to apportionment. Even so, Roin manages to illustrate, quite convincingly, how even an ideal apportionment approach could potentially be undermined. Such an approach would consist of a common income tax base, would be applied to a unitary business of a group irrespective of the residence of the relevant group members, and would use sales as the single apportionment factor. Although this approach would eliminate avoidance techniques focused on the use of property and payroll as apportionment factors, as well as familiar transfer-pricing methods that can be used under a “water’s-edge” apportionment approach, it would remain vulnerable to the
use of contract manufacturing and commissionaire arrangements involving independent parties.

Roin begins with a review of the US international income tax system and a relatively general description of common tax-avoidance techniques used by multinational groups under the separate-entity/transactional approach to income allocation. This review is followed by a description of the US experience with formulary apportionment at the state level. The analytical core of the paper focuses on the CCCTB initiative and a recent proposal by two US academics10 as examples of formulary apportionment approaches in an international context. After a careful analysis of implementation issues that either approach would entail, Roin illustrates how they would both be vulnerable to well-known avoidance techniques in a separate-entity/transactional environment. This vulnerability suggests that the perceived benefits associated with formulary apportionment may not exceed the associated costs, and national tax policy makers may more effectively focus on ways to buttress the separate-entity/transactional approach. The only alternative is to rely on tax bases other than income in an international context.

In the second article, Benshalom considers the narrower issue of the taxation of the financial income of multinational groups. He argues that the mobility and fungibility properties of this category of income make it especially difficult to tax in a cross-border context. He then reviews recent developments in thin capitalization legislation, along with the Organisation for Economic Co-operation and Development (OECD) project on the allocation of profits to branches of financial institutions, as examples of incremental adoption of formulary apportionment methods for limited purposes. Benshalom is much more optimistic than Roin regarding the potential of formulary apportionment as a robust method to allocate the income of multinational groups, although he limits his proposal to the income of financial institutions. His conclusions are notable, given that this sector has proved especially difficult to tax in a cross-border context. Benshalom indicates that in a subsequent article, he will attempt to extend his proposal to the financial income of non-financial multinational groups.

Ruth Mason, “Tax Expenditures and Global Labor Mobility”

*New York University Law Review* (forthcoming)

This article examines the provision of personal tax expenditures to individuals who work in a country other than their country of residence. As Mason notes, the tax literature has focused almost exclusively on the mobility of corporate capital and has largely ignored the effect of taxation on labour mobility. She argues that the increasing mobility of labour will place pressure on the existing disjunction between

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the entitlement to tax labour income and the delivery of personal tax expenditures. The former is assigned primarily to the country in which an individual works, while the latter falls to the country of residence. These two countries are, of course, different for those individuals who choose to separate the country in which they work and the country in which they live. Mason’s focus is different, therefore, from the literature examining the “brain drain” phenomenon, whereby individuals migrate to take up labour market opportunities in another country. This literature draws on the Tiebout tax competition model\(^{11}\) and examines the extent to which differences in tax and spending regimes are the cause of the migration decision. Mason’s focus is limited to countries, such as Canada and the United States or the EU member states, that are close to one another geographically and have agreed to provide free movement of labour. In these circumstances, individuals can arrange their labour market participation in a way that splits the tax and spending regimes between two countries.

Mason adopts the standard concept of personal tax expenditures, defined as provisions that deliver benefits through the tax system (that is, exemptions, deductions, or credits) to further social welfare purposes rather than measure income for revenue-raising purposes. She observes that very little effort has been expended by national policy makers in rationalizing the assignment of spending responsibilities in the context of cross-border workers. In contrast, much effort has been devoted to the delineation of taxing rights, with the country of source retaining the primary right to tax the earning of cross-border income. The disjunction between the taxing and spending function that has occurred in the context of cross-border workers has apparently been accepted by national policy makers as an administratively simple means to avoid the claiming of duplicative benefits. Provided that the flow of cross-border workers between two countries is largely symmetrical, the separation of tax revenue and spending responsibilities does not result in a net revenue loss, and it remains an administratively simpler way to avoid claiming of benefits in both countries by cross-border workers.

The principal normative contribution of the article is Mason’s development of “labour export neutrality” and “labour competition neutrality” as analogues in the context of human capital to “capital export neutrality” and “capital import neutrality,” which are well-known welfare benchmarks used to assess international tax rules governing the cross-border flow of financial capital. Mason argues that the exclusive allocation of “the personal tax expenditure obligation” to the residence country is consistent with labour export neutrality in the sense that it does not distort the decision of residents to employ their human capital at home or abroad. On the other hand, shifting the same obligation to the source country would be consistent with labour competition neutrality in the sense that distortion of competition between residents and non-residents for work in a particular jurisdiction would be avoided.

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Mason nonetheless defends the current separation of the obligation to provide tax benefits from the entitlement to tax as “efficient, equitable and administrable, particularly in tax treaties between unrelated, developed states.”

The last part of the article provides an interesting discussion of US and European Court of Justice jurisprudence considering the application of non-discrimination provisions in the US constitution and the EC treaty, respectively, as a basis to overturn the denial of personal tax expenditures to non-residents, even though such denial can be defended as “consistent with international tax practices and principles of good tax policy.” There is also some discussion of the use of refundable tax credits, rather than deductions and non-refundable credits, as a preferable delivery mechanism for cross-border workers.

T.E.


This article reviews the income tax treatment of finance leases in Australia, both under current law and as proposed under the taxation of financial arrangements (TOFA) project. The authors argue that the ability to trade tax depreciation, which is the principal tax advantage of a finance lease, should not be a focus of Australian tax policy makers, given that much the same result can be realized through other structures. The authors do not consider whether these alternative structures should be similarly addressed to eliminate trading of tax depreciation in financing transactions. Canada’s specified leasing rules12 address the use of financing leases for such purposes without defining this category of lease as distinct from an operating lease. An alternative is to follow the financial accounting treatment of finance leases for income tax purposes. That was the proposed approach under the TOFA project; however, it was subsequently abandoned, leaving finance leases as a tax-preferred form of financing for taxpayers who cannot otherwise benefit from the tax depreciation deduction associated with the financed asset.

T.E.

Kim Brooks, “Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?”
Queen’s Law Journal (forthcoming)

Tax sparing is a mechanism by which residence countries attempt to preserve the value of tax preferences in source countries by forgoing their residual right to tax foreign-source income of resident taxpayers. The practice is conventionally implemented through bilateral tax treaties and is commonly limited to developing countries seeking to attract inbound direct investment. The United States, however, has a long history of refusing to include tax-sparing provisions in its treaties. Because

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12 Regulations 1100(1.1) to (1.3) of the Income Tax Regulations and section 16.1 of the Act.
Canada operates an exemption system for active business income sourced in a treaty country (or a country with which Canada has a tax information exchange agreement), tax sparing has not been much of an issue, at least to the extent that provision of exemption is rationalized on policy bases much different from those associated with the provision of tax sparing. When framed in terms of these bases, tax-sparing provisions included in some of Canada’s tax treaties tend to be focused on outbound direct investment undertaken in headquarters-branch rather than parent-subsidiary form.13

This article provides an excellent critique of tax sparing as a developmental finance tool. Much of the critique is grounded in various problems with the design of tax preferences in the capital-importing developing country, which are intended to be preserved by a tax-sparing provision. The policy analysis is preceded by an interesting account of the development of tax sparing from its inception through to the present. The history focuses primarily on the experience in the United Kingdom and the United States, which are the two major capital-exporting countries that have operated a deferral with foreign tax credit system for outbound direct investment. These systems are characterized by the retention of the residual residence-country jurisdiction to tax and therefore require the adoption of tax-sparing provisions in bilateral tax treaties if the value of source-country preferences for inbound direct investment is to be preserved. There is also some discussion of the limited history of tax sparing in Canada, as well as in Australia and at the OECD.

T.E.


To the uninitiated, the European Court of Justice (ECJ) tax jurisprudence appears to be an impenetrable maze. This article, by an academic at the Faculty of Law of the University of Victoria, provides an accessible account and analysis of an important aspect of this jurisprudence: the scope of article 56(1) of the EC treaty,14 guaranteeing the free movement of capital as a fundamental freedom. Readers who are not intimately familiar with the ECJ jurisprudence on this subject will want to read carefully O’Brien’s review of the case law, which delineates the impact of that jurisprudence on the national tax laws of EU member states in an intra-EU context. Readers who

13 Tax sparing is also relevant for dividends paid out of taxable surplus, which are subject to deferral with credit treatment. However, the extent of the Canadian bilateral treaty network means that the category of taxable surplus (active business income earned in non-treaty countries) is quite limited. For an analysis of tax-avoidance opportunities provided by the tax-sparing article in the Canada-Brazil income tax convention, see Deborah Toaze, “Tax Sparing: Good Intentions, Unintended Results” (2001) vol. 49, no. 4 Canadian Tax Journal 879-924.

are familiar with the jurisprudence may want to go straight to O’Brien’s analysis of the nascent case law, which considers the effect on member state tax laws of the same fundamental freedom for movements of capital into the EU from non-member countries.¹⁵

T.E.


This theoretical study develops a model of a foreign subsidiary’s reinvestment or repatriation decision based on expected future tax holidays, where the timing of such holidays remains uncertain. The foreign subsidiary can either repatriate earnings now or reinvest earnings in financial assets until a tax holiday arrives, and then repatriate earnings during the tax holiday. The study derives the theoretical relation between the level of a foreign subsidiary’s permanently reinvested earnings as reported in the income tax footnote and the value of the subsidiary to the parent. The analytical results show that earnings reinvested in financial assets are discounted owing to either the parent jurisdiction tax triggered on their repatriation or the opportunity cost associated with delaying that repatriation. The opportunity cost reflects the excess by which the after-tax risk-free rate exceeds the after-domestic-tax interest rate.

Amin M.


Liabilities for future taxes on earnings of foreign subsidiaries are not required to be disclosed under current US accounting rules if such earnings are considered to be indefinitely reinvested in those subsidiaries. Thus, firms have considerable flexibility in designating earnings as deemed to be permanently reinvested, so that most firms can avoid the reporting of expected repatriation taxes on such earnings. While the efficient market can estimate repatriation taxes of non-disclosing firms when determining share prices, the markets are better able to estimate share prices of firms that do disclose the amount of repatriation taxes. This result is driven by the estimated repatriation tax being downward biased and less accurate for actual repatriation tax effects, relative to firm-disclosed repatriation tax amounts. The authors suggest new disclosure rules to improve the relevance of firms’ estimated repatriation taxes.

Amin M.

¹⁵ The article by O’Brien in this issue of this journal covers many of the same issues as the article in the British Tax Review.

The provision of non-audit services by a firm’s auditors is increasingly restricted, on the grounds that auditor independence should be maintained and seen to be maintained. For example, if the audit firm provides information technology services to a client, it may be difficult for the auditor to question the integrity of the control system by which financial statements are produced. However, whether a firm’s auditors should be restricted from providing tax services has been strongly debated, since the obvious synergy can be of significant benefit to the client.

This study suggests that the provision of tax services by a firm’s auditors can improve the auditor’s knowledge over successive engagements, and that the benefits arising from such knowledge outweigh any impairment of auditor independence. This hypothesis is tested on firms raising debt capital. After controlling for security-level and other firm-level determinants, the authors empirically document that bondholders are willing to lend money at lower yield spreads to firms that pay proportionally more tax fees to their auditor. The results are economically significant. Increasing the proxy for auditor-related tax services by one standard deviation is associated negatively with yield spreads of six basis points. The study further shows that the influence of auditor-related tax services on lowering borrowing costs is stronger for firms that have positive inside information that cannot be credibly communicated.

Amin M.


This study shows the results of a Washington state Department of Revenue field experiment conducted to assess the effects of accountability and heightened sanction awareness on tax compliance. The results show that requiring firms to file an affidavit signed by the party responsible for reviewing tax obligations increases compliance. In addition, provision of information regarding the penalty structure for non-compliance through an educational letter also increases tax compliance, especially for firms with declining revenues. These results contribute to the taxation literature by providing evidence that inexpensive affidavits and mail-based education regarding tax sanctions can be effective.

Amin M.


Statutory anti-avoidance rules and judicial doctrines typically extend to informal “understandings” and “arrangements” that do not approach the level of legally
enforceable agreements. Indeed, the concept of “sham” as a term of art in Canada and other commonwealth countries permits a court to ignore transactions that are inconsistent with the intent of the parties, often because of hidden arrangements or understandings. Raskolnikov uses the label “relational tax planning” to describe the category of tax-planning transactions that are implemented on the basis of understandings or arrangements that do not approach the level of legally enforceable agreements. He argues that, although US tax law has long recognized this type of tax planning, it is difficult to detect, and it has not been targeted with any consistency by US courts and the Internal Revenue Service (IRS).

The article provides a conceptually sophisticated analysis of relational tax planning. Raskolnikov focuses on the risk that a counterparty will not perform his or her obligations (referred to as “counterparty risk”) as a constraint on tax-avoidance behaviour. In this respect, he compares the counterparty risk associated with relational tax planning and traditional anti-avoidance rules and judicial doctrines that use the presence of either “market risk” or “business risk” as indicators that a transaction is not tax-driven and may be respected for income tax purposes. Market risk refers to the retention of a sufficient level of risk of loss and possibility of reward. Business risk refers to the presence of non-tax factors, such as limited or unlimited liability, which indicate that a taxpayer is sufficiently involved in a business. After exploring the efficiency effects of the various forms of risk in the context of risk-based anti-avoidance rules and doctrines, Raskolnikov suggests two broad reform options that could be adopted to more effectively rely on counterparty risk as a constraint on tax-avoidance behaviour. One reform option would be more comprehensive in the sense that it would extend the level of market risk required by various rules for a transaction to be respected, with the effect of forcing taxpayers into relational tax planning that entails a level of counterparty risk that sufficiently constrains the undesirable behaviour. The second reform option is incremental in the sense that it would force US courts and the IRS to distinguish more precisely among various types of environments giving rise to quite different opportunities to engage in relational tax planning. Enforcement resources could then be focused on those environments in which such planning is less likely to be constrained by counterparty risk. As a general proposition, these environments are characterized by thick social norms that make non-performance of informal understandings or arrangements unlikely.

Throughout the article, Raskolnikov draws on a “wash sale” transaction (in the Canadian context, transactions that would be subject to the stop-loss rules in the Act) as a concrete example to illustrate much of the conceptual material. Although he

18 Subsection 13(2.1); subsections 14(12) and (13); subsections 18(13) to (16); subsections 40(3.3) to (3.7); and subparagraph 40(2)(g)(i) and the definition of “superficial loss” in section 54.
does supplement this simple example with various others, he presents no systematic empirical evidence to indicate a level of significance of relational tax planning necessitating the kinds of reform options that he suggests. Inferences on this issue must instead be drawn from a body of anecdotal evidence cited in the article.

T.E.


Taxation and state sovereignty are closely linked. Without the former, the latter is severely weakened. This article attempts to go beyond this trite observation to explore exactly what we mean by state sovereignty in the context of international taxation. After a generalized account of the concept of sovereignty, Ring uses three case studies to better gain a sense of how the concept has been used in international tax. The three case studies are (1) the US approach to international tax competition, (2) the effort of the EU member states to develop coordinated tax systems, including the recent attempt to develop a common consolidated corporate tax base; and (3) the controversy over the US foreign sales corporation/extraterritorial income regime at the World Trade Organization. The article concludes with some general observations on the significance of the concept of sovereignty in international taxation.

T.E.

Andrés E. Bazó, “Do Developing Countries’ Tax Incentives Attract Investment or Create Disaster?” (2008) vol. 52, no. 4 Tax Notes International 299-303

This article explores the arguments for and against tax incentives offered by developing countries. Tax holidays and other incentives for foreign investments may not solve the kind of problems faced by developing countries. Developed countries and international organizations need to help developing countries to avoid the effects of harmful tax competition and erosion of tax bases while attaining development targets.

Amin M.


This study reviews budgeting practices and processes for public investment in low-income and developed countries. It discusses the importance of an appropriate balance between current and capital expenditures. Excessive current budgets without a corresponding capital budget (and vice versa) often result in both failure to meet output goals and a waste of government spending.
The study makes some sound recommendations on how to achieve integration of capital planning and budget management in low-income countries. This study would be useful for development consultants working in low-income countries.

Amin M.


This study examines the decline of corporate tax rates in 32 European countries from 1983 to 2006 to analyze the role of financial openness and tax competition. It finds that openness does not seem to be systematically related to corporate tax rates. As for tax competition, it finds that countries compete over statutory tax rates but not over effective marginal tax rates. The short-run impact of tax competition on corporate tax rates is found to be modest.

Amin M.

Daniel J. Wilson and Charles Notzon, “Tax Credits for Job Creation and Retention: What Can We Learn from the States?” *FRBSF Economic Letter* 2009-08 (San Francisco: Federal Reserve Bank of San Francisco, February 20, 2009), 1-4

The authors of this article argue that a temporary federal tax credit for businesses that create jobs in the United States may be a viable form of fiscal stimulus that is conspicuously missing in the Obama administration’s current stimulus package. While the US government does not have direct experience with administering such a credit, 22 states currently have job creation tax credits, with an average credit of $5,820 per new job. The problem with credits at the state level is that they often end up attracting jobs away from neighbouring states. In the federal context, however, a temporary federal tax credit may be desirable, given the current high level of unemployment and slack in the US labour market.

Amin M.


This 10th annual report describes in significant detail the current state of family and household finances in Canada. The report examines incomes, spending, savings, debt, and net worth across family and household types.

Amin M.
May Luong and Benoît-Paul Hébert, “Age and Earnings”  
(2009) vol. 10, no. 1 Perspectives on Labour and Income 5-11

This article describes the age-earnings profile or the evolution of an individual’s earnings over his or her life cycle. It addresses many of the issues associated with the traditional age-earnings profile, including the interpretation of cross-sectional data, selection problems, bias from voluntary change in number of hours worked, and occupations of working retirees.

Amin M.

Chris Wales, ed., Fair Tax: Towards a Modern Tax System  
(London: Smith Institute, 2008), 95 pages, ISBN 1905370342

Exercises in comprehensive tax reform tend to be initiated by government, usually after a political party has come to power on the promise to undertake such reform. A recent notable exception is the ongoing Mirrlees review in the United Kingdom, a wide-ranging review of the entire UK tax system, chaired by Sir James Mirrlees and sponsored by the Institute for Fiscal Studies.¹⁹

This volume of eight essays appears to have been motivated by the prospect of the Mirrlees review. The broad theme of the essays is an examination of the political philosophy of the UK tax system, with a focus on how it might be modernized or reshaped. With an apparent eye to accessibility, the style of the essays is decidedly non-academic in the sense that they are not heavily footnoted (although many of the contributors are in fact UK tax academics). The subjects covered are (1) issues in personal tax design; (2) business taxation; (3) fairness in the taxation of small businesses; (4) taxation and local government; (5) capital, wealth, and inheritance taxes; (6) environmental and behavioural taxes; (7) user charges; and (8) tax avoidance.

T.E.

¹⁹ The review commenced in September 2006 and thus far has produced a number of conference papers and draft reports on a wide range of topics. For details, see the Institute for Fiscal Studies Web site: http://www.ifs.org.uk/projects/2007.