A Principled Approach to Canadian Taxation of Foreign Income:

A Submission to the Advisory Panel on Canada's System of International Taxation

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1. Introduction

This brief paper is submitted to the Advisory Panel of Canada's System of International Taxation (the "Panel") in response to the request made in the Panel's Consultation Paper published in April 2008, entitled *Enhancing Canada's International Tax Advantage.*[1] It discusses the general approach to tax reform and the specific questions about the "Taxation of Outbound Direct Investment."

The main thesis is that the neutrality theories (capital import neutrality, capital export neutrality, capital ownership neutrality) are not particularly determinative or even that useful in thinking about the reform questions. A principled approach along the lines of fundamental tax principles and tax expenditure analysis should be seriously considered as directing the debate. The ability-to-pay and tax entitlement are fundamental principles underlying the existing outbound tax system. No serious suggestion has been made anywhere that the re-designed system should be fundamentally different. As such, these principles should continue to apply. Situating the exemption system as part of the normative system as opposed to a tax expenditure may redirect the debate to some different questions.

This Paper proceeds first by briefly answering each of the questions stated in Chapter 2 of the Consultation Paper. It then provides the rationale for the principled approach and analysis of the answers.

2. Brief Answer to the Panel's Questions

2.1 Questions on active business income of foreign affiliates

A. *Should Canada's foreign affiliate regime for active business income be retained in its current form, or should changes be introduced to make it a broader exemption system?*

This Submission supports a full exemption system. Such proposed system would not be as a significant policy shift as one might have thought because dividends from foreign affiliates are rarely taxed under the current regime. A full exemption would eliminate the need for detailed rules to "condition" the exemption treatment (such as linking to tax treaties, tracking active business income and its underlying foreign tax, inter-affiliate payments, etc.).

B. *What are the conditions that taxpayers should meet in order to access a broader exemption system?*

The distinction between "foreign direct investment" and "foreign portfolio investment" needs to be retained. As such, the exemption treatment should apply only if the foreign corporation is a "foreign affiliate." There will be no need to limit the exemption to treaty countries.

C. *If the exemption for active business income earned by an affiliate is expanded, is the new TIEA exemption the most appropriate way of achieving this goal? Should the accrual basis of taxation or some credit system apply to active business income earned by a controlled foreign affiliate in a non-Treaty Country that has failed to negotiate a TIEA with Canada?*

This Submission supports unlinking the exemption system from tax treaties, including TIEAs. Under a full exemption system, all dividends from foreign affiliates are exempt from tax at the corporate level. If the exemption treatment is intended to encourage "tax havens" to exchange tax information with Canada, this goal may be achieved through a redesigned FAPI regime. In other words, in stead of a "carrot" (exemption), Canada can use a "stick" (FAPI).

D. *Should Canada exempt the capital gain on the disposition of shares of foreign affiliates? If so, under what conditions?*

Yes, in all cases. The underlying value of the shares is presumably attributable to FAPI or non-FAPI. In the former scenario, FAPI is subject to accrual taxation (assuming that the threshold for FAPI is the same as the threshold for the dividend exemption). Capital gains attributable to FAPI should not be taxed again in Canada. In the latter scenario, the income is subject to territorial taxation. If dividends paid out of such income are exempt, the same treatment should apply to capital gains.

E. If Canada adopts a broader exemption system, are additional rules needed to deal with expenses allocable to exempt foreign income?

Sound expense allocation rules are needed whether the exemption system is expanded. Since the current Income Tax Act (ITA) does not contain such rules, broadening the exemption system may provide the impetus for action. Allocation rules will be crucial in defining "foreign" income and protecting the Canadian tax base. Otherwise, Canadian income would end up "exempt" from Canadian tax.

F. *Should Canada treat other returns (such as interest and royalties) from a foreign affiliate in the same manner as dividends?*

No. There seems to be no obvious tax principle or policy reason to extend the exemption system to interest and royalties.

G. *Should Canada consider providing an exemption for active business income earned through a foreign branch to the same extent as it does for dividends paid from active business income earned through a foreign affiliate?*

Yes. There seems to be no obvious tax principle or policy reason for treating branches differently.

H. *Does the increased significance of tax-exempt entities as outbound investors raise any particular issues regarding Canada's foreign affiliate regime?*

Presumably, tax-exempt entities are not "corporations" and do not benefit from the current partial exemption treatment in respect of their "foreign direct investment". Unless such entities are specifically included in the proposed full exemption system, they will bear the foreign tax burden as they cannot claim any foreign tax credits. However, the exemption system has little impact if tax-exempt entities make foreign portfolio investments.

I. *How can the foreign affiliate rules be amended to reduce the compliance and administrative burden for taxpayers and the CRA while maintaining the tax policy objectives of these rules?*

The proposed full exemption system will be a much simpler regime than the current partial exemption and partial credit system of taxing dividends from foreign affiliates. It should reduce the burden of compliance and administration by eliminating the need for tracking the surplus accounts. In the meantime, it may increase the burden under the proposed FAPI regime. There should be an overall net gain in simplification and administrative efficiency.

J. *Are there other issues or options related to the taxation of active business income earned indirectly through foreign corporations that should be reviewed and considered?*

A fundamental issue to consider is how to rationalize the exemption system. Is it part of a normative system of taxing business income or as a deviation from the norm in order to subsidize Canadian companies in their foreign investment? The answer to this question should help clarify some technical design issues, including interest deductibility.

2.2 Questions on Foreign Accrual Property Income

A. *If Canada adopts a broader exemption system, should the scope of the FAPI rules be changed? For example, should Canada consider changes to the Base Erosion Rules?*

Yes, changes to the FAPI rules are necessary. The base erosion rules can be broadened to capture the use of low-tax jurisdictions for “mobile” business income.

B. *How should the excluded property test be extended to operate appropriately in a broader exemption system?*

The “excluded property” test may be replaced by a test that identifies assets used in earning FAPI. This is particularly relevant if the whole foreign affiliate regime is simplified to include just an FAPI accrual regime and a full exemption regime.

C. *How should passive income earned by non-controlled foreign entities be treated?*

This paper suggests lowering the “control” test to a 10% threshold for the purposes of FAPI accrual rules. If so, there is no need to distinguish between controlled and non-controlled foreign affiliates. However, if the FAPI regime applies to foreign affiliates that are different from the foreign affiliates under the dividend exemption system, it will be unnecessary to deal with the foreign affiliates that are outside the FAPI regime. Presumably, dividends received from such affiliates out of the FAPI should be taxable in Canada, subject to relief for foreign taxes (i.e., similar to the current s.113(1)(b)(c)).

D. Should the Base Erosion rules be reconsidered to accommodate companies that manufacture and source their product from several different jurisdictions?

Not clear. Manufacturing should perhaps be distinguished from purchasing product from foreign jurisdictions. Purchasing activities are more mobile and should, in principle, be subject to FAPI.

E. *Are there other types of transactions to which the Base Erosion Rules should apply?*

Yes. Other types of “mobile” businesses include personal services and e-commerce.

F. *Is there a way to simplify the FAPI rules while maintaining their tax policy objectives?*

FAPI system will be backbone of the redesigned outbound tax system in Canada. The issues are complex. It would be important not to sacrifice substantive policy goals to achieve simplicity. However, unlinking FAPI from the taxation of dividends should simplify the system. Raising the threshold or introducing an exemption (e.g., the 5% of total income suggestion above) should simplify compliance.

G. *Are there other issues or options related to the taxation of passive income of foreign corporations that should be reviewed and considered?*

Sourcing and allocation rules are the key to the operation of the exemption regime and the accrual regime. The redesigned FAPI regime needs to be seamlessly integrated with the FIE regime.

3. Moving Away from the "Battle of Neutralities" [2]

The Consultation Paper states that "the Panel believes it is more appropriate to consider whether Canada should move to a broader or full exemption system."[3] The Consultation Paper identifies the policy framework to include attracting foreign investment, competitiveness, simplicity, and fairness. It recognizes that capital export neutrality (CEN), capital import neutrality (CIN) and capital ownership neutrality (CON) may influence the choice between an exemption system and a foreign tax credit system.[4]

Regarding CEN, CIN and CON as key considerations for international tax policy suffers several shortcomings. First, as recognized by the Panel, "fulfilling the three neutrality standards with a single set of tax rules is impossible".[5] There are disagreements as to what is needed to satisfy CIN or CEN. Traditionally, CEN is considered satisfied by the accrual taxation or deferral with credit system,[6] and CIN is satisfied by the exemption system.[7] Recently, some scholars argue that exclusive source-based taxation (or territorial taxation) "seems to be a theoretically, practically, and politically superior means for achieving CEN."[8] The current international consensus is a compromise of CIN and CEN. As principles of international taxation, CEN and CIN fail to explain the international income tax system that actually exists.[9]

Second, the conflicts between CIN and CEN cannot be reconciled in the absence of harmonization of every country's tax rates. The Carter Commission argues that neutrality requires tax harmonization between nations so that each individual is unaffected, from a tax viewpoint, by citizenship, residence, and the locations of property, business, and employment.[10] Of course, such harmonization is possible only if all countries provide the same public expenditures mix, finance with the same taxes at the same rates, and adjust the taxes simultaneously. Since one of such criteria is unlikely to be met in practice and that therefore international neutrality cannot be achieved. Even if tax harmonization were possible, the Commission notes that ax revenues must still be allocated between source and destination countries, and in a world of other distortions international neutrality may not be a sensible goal.[11]

Third, CEN or CIN can justify almost any proposal of reform: "[E]vry traditional discussion concludes by asserting that whatever policy is being proposed represent a fair balance between those two irreconcilable objectives [CIN and CEN], in every case based largely on the author's preexisting intentions."[12]

The practical implications of CIN and CEN are not as significant as they appear. The apparent difference between deferral with credit system (CEN-based) and the exemption system (CIN based) results in little real difference where foreign business income is not repatriated (that is, if the deferral lasts long enough) because of the time value of money. There is little tax revenue generated from foreign business income whether or not an exemption or a credit system is used.[13] In certain circumstances, the credit system produces tax results that are better than the exemption system.[14]

To the extent that the neutrality theories are helpful at all, their utility is largely limited to the choice between the credit system and exemption system. As far as Canada is concerned, the option of full credit system does not really exist. CIN/CON or CEN rhetoric or theories provide little insight on the debate on the choice of a broader exemption or full exemption, which is the real debate in Canada at the moment.

4. A "Principled" Approach

A more principled approach will take into account the fundamental principles that underlie the apparently complex rules of outbound taxation. Such approach can help policy makers navigate among the various, sometimes conflicting, policy considerations, including the various conflicting neutralities, competitiveness, simplicity, fairness, and practical constraints.[15] It should also help identify the normative and tax expenditure elements of the current system.

4.1 The Principles

There is no simple general principle that applies to all international tax policy issues. However, there are several principles that apply to the current system, the most basic of these principles are arguably the ability-to-pay and tax entitlement.

4.1.1 Ability-to-Pay

The ability-to-pay principle is the foundation of progressive personal income taxation.[16] Since taxes are ultimately borne by individuals, it has been generally considered fair to spread the tax burden among individual taxpayers on the basis of comparative economic well-being, often referred to as ability-to-pay. For example, the Carter Commission regarded equity (or fairness) as a major policy objective.[17] The Carter Commission distinguished between "horizontal equity", which requires that persons "in similar circumstances" bear the same taxes, and "vertical equity", which requires that persons in different circumstances bear "appropriately different" taxes.[18] Both dimensions of equity required that tax be levied in accordance with "ability to pay". Although there are many occasions when ability-to-pay must yield to other policy considerations (such as efficiency, simplicity and competitiveness), it is often given weight in the domestic tax policy process.

The ability-to-pay principle underlies the design of the basic outbound tax rules. The worldwide tax regime required by section 3 of the ITA (i.e., including a resident's foreign income in computing the taxpayer's income) reflects this principle. An income tax based on the ability-to-pay principle is inherently global.[19] The same principle also demands that foreign taxes paid on the foreign income reduces the taxpayer's ability-to-pay and should be allowed to reduce the Canadian tax liability.

The ability-to-pay principle generally applies at an individual level and not to corporations. Corporations and other intermediaries are legal entities used to earn income for the benefit of individuals. Income taxes paid by corporations are generally shifted to shareholders, workers, suppliers, and customers. The residence of a legal fiction (i.e., a corporation) is artificial in many cases, and the income level of a corporation bears little connection with the ability to pay of its shareholders.

4.1.2 Corporations are separate entities

Corporations are "persons" under the ITA. They are generally regarded as taxpayers separate from their shareholders. A corporation is a Canadian resident if it is incorporated in Canada or has its place of central management and control in Canada. Canadian resident corporations are taxable on their foreign income earned directly. However, if foreign income is earned through a foreign corporation, that income is generally not taxable in Canada to the Canadian shareholder.

The "separate entity" principle can effectively cancel the ability-to-pay principle if left unchecked: individuals can choose to earn foreign income through a non-resident corporation. The FAPI rules function as such checks and protect the integrity of the ability-to-pay in Canada.

4.1.3 Tax Entitlement

The tax entitlement principle is an international tax principle. It calls for an equitable sharing of the international tax base between nations in accordance with each nation's tax entitlement.[20] The theoretical foundations for this principle are the economic allegiance theory, ability to pay, and the benefit theory.[21]

A residence country is entitled to tax foreign income on the grounds that: (a) residents owe tax allegiance in return for the rights and privileges that they receive as residents (including those afforded to a corporation by its country of registration); (b) the tax is, in nature, a payment for productivity-enhancing benefits provided by the country of residence to its own factors of production prior to transfer abroad; (c) it is necessary to achieve equitable tax treatment of resident taxpayers by making all income, wherever earned, subject to tax, consistent with the accretion [ability to pay] principle.[22]

A source country is entitled to tax income arising within their borders, including that accruing to foreign investors. A country is permitted "to share in the gains of foreign-owned factors of production operating within its borders, gains that are generated in cooperation with its own inputs, whether they be natural resources, an educated or low-cost workforce, or proximity to a market."[23] In other words, source country's tax entitlements arise from "economic rent" –the source country's tax "may be thought of as a national return to the leasing of these complementary factors to nonresident investors or temporary workers," or a quid pro quo payment for cost-reducing, profit-enhancing services provided by the source country.[24] Source taxation in accordance with the tax entitlement principle has been "the bedrock of most international tax treaties."[25]

Under the tax entitlement principle, Canada is entitled to tax its Canadian residents in respect of their foreign income. However, this entitlement is secondary to the foreign source country's entitlement, which is determined by the nexus or economic connections between that country and the income. The international consensus is tat the source country's taxation of business profit is far significant than investment income. For example, Article 5 of the OECD Model Convention allows the source country unlimited scope of taxation once the threshold of permanent establishment is satisfied. In contrast, the source country's tax jurisdiction over dividends, interest, royalties and capital gains is restricted (Art.10 and Art. 11 of the OECD Model Convention) or totally removed (e.g., Art 12 of the OECD Model convention).

4.1.4 Tax Neutrality

As a general principle, tax policy should be neutral.[26] Canadian outbound tax rules are thus required not to distort Canadian companies' decision to invest at home or abroad. It could also be stretched to mean that Canadian tax rules should not impede Canadian companies' competitiveness by imposing tax costs that are not borne by their competitors from other countries.[27] In international tax debates, this principle of neutrality has been largely discussed in terms of CEN, CIN and recently CON.

4.1.5 Tax expenditures

The ITA contains two general types of provisions: normative or benchmark provisions and tax expenditures. Tax expenditure provisions are generally those that deviate from the norm in order to promote a specific policy objective.[28] An tax expenditure is evaluated on its merits as if it were a separate assistance programme by asking: How much does it cost? Does it fulfil its objectives? Who benefits from it? Because tax expenditure provisions are intended to be non-neutral, it is futile to justify them on ground of neutrality.

4.2 The Current System

4.2.1 Complex Rules

The current outbound tax system contains many complex rules that look at: the character of foreign income, and whether the income is earned directly (e.g., through a branch) or indirectly through a foreign corporation. Income earned directly by resident taxpayers (individuals and corporations alike) is currently taxable, subject to relief for foreign taxes.[29] In the case of foreign income earned through a foreign corporation, more factors affect the design and application of the current rules. These include:

- whether the foreign corporation is a "foreign affiliate" (FA);
- whether the FA is resident in a treaty country,
- whether the foreign income earned by the FA is "foreign accrual property income" (FAPI), active business income, or capital gains;

- whether the FA is "controlled" by a Canadian resident (CFA); and
- whether the Canadian shareholder is a corporation or an individual.

Generally speaking, income earned through a FA is "deferred" from Canadian tax until the FA pays dividends to its Canadian shareholder. If the shareholder is a Canadian corporation, the dividends are taxed differently depending on the character of income and whether the foreign country has a tax treaty with Canada. Dividends are "exempt" if the FA is in a treaty country and the income is derived from active businesses (the "exemption system").[30] Dividends are "taxable" in other cases (the "deferral with credit" system).[31]

The character of the foreign income earned by an FA generally determines the application of the accrual system or the deferral system: FAPI is subject to accrual, non-FAPI is eligible for deferral. Within the deferral system, the character of foreign income as well as the existence or absence of a tax treaty determines whether the dividends are subject to the exemption treatment or the credit treatment.[32]

4.2.2 Active Business Income

An FA's active business income is taxed in Canada as follows: (a) If it is earned directly by a Canadian resident individual (CRI) or Canadian resident corporation (Canco), the income is currently taxed in Canada, subject to foreign tax credit relief; (b) If it is earned indirectly through a foreign corporation that is not a FA, the income is not currently taxed. Dividends received by a CRI or Canco are taxable as foreign non-business income and eligible for foreign tax credit; (c) If it is earned indirectly through a FA resident in a treaty country, the income is not taxable in Canada. Dividends received by Canco are "exempt dividends", although dividends received by CRI are taxable, subject to foreign tax credit; and (d) If it is earned through a foreign affiliate in a non-treaty country, the income is not taxable in Canada when earned, but the dividends received by Canco are taxable ("taxable dividends"), subject to a direct and indirect foreign tax credit. Dividends received by CRI are also taxable and no indirect foreign tax credit is available.

Table 1: Canadian taxation of foreign active business income earned through a foreign corporation (FC)

Status of FC / Canadian investor	FA in treaty country	FA in non-treaty country	Non-FA
CRI - current tax on FC's income? - tax on dividends from FC?	 No, not within s.2(1) or (3) Yes, s.126 relief	 No Yes, s.126 relief	 No Yes, s.126 relief
Canco - current tax on FC's income? - tax on dividends from FC?	 No No, s.113(1)(a)	 No Yes, s.113(1)(b)(c) relief	 No Yes, s.126 relief

In practice, not only exempt dividends are free from Canadian tax, taxable dividends are not actually taxed in Canada after the deduction for direct and indirect foreign tax credit.[33]

4.2.3 FAPI

In the case of FAPI earned through a foreign corporation, Canadian tax rules can be summarized as follows: (a) If earned directly, FAPI is currently taxable to both CRI and Canco, subject to foreign tax credit relief; (b) If earned indirectly through a CFA or FIE of either CRI or Canco, FAPI is taxable when earned, subject to relief for foreign taxes. When dividends are paid out of the pre-taxed FAPI, they are generally tax-free in Canada;[34] (c) If earned indirectly through a foreign corporation that is not a CFA, but a

FA, FAPI is not taxable in Canada when earned. Dividends paid out of FAPI are taxable as taxable dividends to Canco, and eligible for direct and indirect foreign tax credit relief. Same dividends paid to CRI are eligible only for direct foreign tax credit.

Table 2: Canadian taxation of FAPI earned through a foreign corporation (FC)

Status of FC / Canadian investor	CFA	FA but non-CFA	Non-FA
CRI - Accrual tax of FAPI? - dividends from FC taxable?	 Yes, s.91(4) relief Yes, s.126 FTC	 No Yes, s.126 FTC	 No Yes, s.126 FTC
Canco - Accrual tax of FAPI? - dividends from FC taxable?	 Yes, s.91(4) and (5) relief Yes, s.113(1)(b)(c) relief	 No. Yes, s.113(1)(b)(c) relief	 No. Yes, s.126 relief

4.2.4 Basic Scheme

A basic scheme underlying the apparently complex rules contains these elements:

a) Worldwide taxation of residents on foreign income earned directly;
b) Accrual taxation of FAPI earned through a CFA or FIE;
c) Deferral taxation of FAs (other than CFAs in respect of their FAPI);
d) Exempt treatment of dividends from FA's in treaty countries if they are paid out of active business income;
e) Taxable treatment plus credit for foreign taxes (withholding tax as well as underlying foreign corporate tax) of dividends from FAs in other cases.[35]

As mentioned earlier, there is little actual difference between d) and e) in terms of Canada's tax revenue collection. In the absence of empirical evidence to the contrary, it is reasonable to assume that taxable dividends are repatriated only when they carry enough credits to eliminate any Canadian tax payable or when the Canadian corporation is not in a tax-paying position in the first place. Therefore, in effect, dividends from FAs are not taxed at the corporate level.

4.3 A "Principled" Analysis of the Current System

4.3.1 The FAPI Accrual Regime

The FAPI regime applies, in general, income that is mobile or lacks any "intrinsic" or "natural" connection with the source country. It can be earned through the "simple formal expedient of foreign incorporation"[36] in tax friendly jurisdictions. The FAPI rules are thus "anti-avoidance rules" intended to protect the Canadian tax base. The scope of the Canadian tax base is determined normatively by the ability-to-pay principle and tax entitlement principle. The ability-to-pay principle requires taxpayer's income to include foreign income. Because of the inherently mobile nature of FAPI, the foreign source country's tax entitlement over FAPI is limited. Canada, as a residence country of the investor, shares the jurisdiction to tax FAPI. The accrual taxation of FAPI is also consistent with the principle of neutrality as it removes the tax incentives for artificially "sourcing" FAPI to a foreign jurisdiction.[37]

4.3.2 The Deferral Regime

The deferral regime is consistent with the separate entity principle. The foreign source country's tax entitlement to business income takes precedence over Canada's entitlement to tax the Canadian corporation. Canada taxes such income only when it is paid to individual shareholders and applies the ability-to-pay principle at this level. In essence, the exemption system recognizes the foreign country's entitlement to tax the income[38] and Canada's entitlement to tax the individual investors.

The deferral system arguably violates the principle of neutrality as it favors earning foreign income through a foreign subsidiary as opposed to a foreign branch and favors earning foreign income as opposed to Canadian income. In effect, however, such tax bias disappears where the foreign income is taxed in the foreign country at a level equal to the Canadian tax.

4.3.2 Nature of the Exemption system

The current exemption system can be rationalized as a proxy for the deferral with credit system, a tax expenditure, or a normative rule. Under the proxy view,[39] where a foreign country's tax system is comparable to Canada's (this is assessed by the existence of a tax treaty), the credit system will not generate any further tax revenue in Canada. Hence, it is simpler to just "exempt" the dividends from Canadian tax. This view assumes the deferral with credit as the "normative system". Historically, this view is correct.

Under the tax expenditure view,[40] the exemption system is a deliberate violation of tax neutrality in order to enhance the competitiveness of Canadian companies. The recent broadening of the exemption system to countries that have concluded a Tax Information Exchange Agreement (TIEA) with Canada seems to view the exemption system as an "inducement" to encourage tax information exchange with tax haven jurisdictions. The tax expenditure view also assumes that the deferral with credit is the norm. The underlying assumption is that there must be an underlying normative tax system and an expected level of tax in the foreign country in order for that country to become entitled to the cession of Canadian tax. However, the extension of the exemption system to TIEA countries (zero or low-tax jurisdictions) seems to undermine such an assumption.

Can the exemption system be viewed as part of the normative system? If the analysis is focused on the formal rules of the ITA, the answer is “no”: Dividends from a FA are included in income (s.90), which is then reduced by “exempt” dividends. On the other hand, the answer is “yes” if the analysis is focused on the substantive effect of these rules: dividends received by Canadian corporations from their FAs are not actually taxed in Canada (whether or not they are exempt dividends), the exemption system is a *de facto* norm.[41]

In terms of fundamental tax principles, the “normative” view is defendable. As long as the ITA recognizes the general principle of taxing corporations as separate entities, income earned by a corporation is “exempt” from tax at the individual shareholder level until dividends are received. The ability-to-pay principle overrides this separate entity principle only in cases where the corporation is used as a holding vehicle for earning passive income. In general cases, as far as the individual shareholder is concerned, corporate business income is “exempt” from tax, irrespective of whether the income is earned through a foreign corporation.

The exemption system is clearly consistent with the tax entitlement principle. The country in which business activities are conducted has clear and overwhelming claims over the taxation of such income. In addition to providing an enticing business and investment environment, the source country’s resources (natural and labour) and market conditions are perhaps the economic reasons why Canadian corporations carry on business activities in that country.

A "normative" view of the exemption system has other implications, such as interest deductibility. The current paragraph 20(1)(c) of the ITA has been interpreted to allow full deduction of interest on money borrowed to earn effectively "exempt", but formally taxable, dividends. Such interpretation would be difficult to sustain if dividends are actually exempt as part of the normative system. The fungibility of money and interest makes interest expense allocation inherently difficult. Assuming interest can be allocated to earning dividends from FAs, the deductibility of such interest would need to be justified on a "tax subsidy" ground.

4.4 Illuminating Reform Choices

As discussed below, a principled approach can illuminate the reform choices about the structure of the outbound tax regime as well as the technical design questions.

5. Structural Design

5.1 Anything beyond exemption and accrual?

The Consultation Paper is focused on the taxation of Canadian corporations in respect of income earned through foreign affiliates, namely active business income and FAPI. With respect to active business income, the Consultation Paper lists four alternative choices in how the income is taxed in the parent company's country:

- Accrual or worldwide basis of taxation;
- Deferral with credit;
- Partial exemption and partial deferral with credit (the "Canadian system"); and
- Full exemption.

The Consultation Paper suggests moving towards the full exemption system, and acknowledges that "there appears to be little debate that taxing FAPI on an accrual basis is appropriate".[42] The debate is predominantly about the scope of the exemption system. This Submission supports this suggestion. In addition, it recommends the Panel to consider strengthening the FAPI system.

Eliminating deferral with credit system will not violate any tax principles. It would significantly simplify the outbound tax system as it would be unnecessary to compute the surplus accounts and track foreign taxes underlying the dividends. As discussed above, the difference between "partial exemption" and "partial deferral with credit" within the Canadian system is more formal than real. There is little real difference between the current exemption and credit system from the point of tax revenue collected in Canada. There are no clear "principled" justifications for the partial deferral with credit system: the ability-to-pay principle is no more satisfied by the credit than the exemption system; the tax entitlement principle that underlies Canada's cession of tax jurisdiction to the foreign country does not distinguish between treaty or non-treaty countries; and the separate entity principle is applicable outside the FAPI system.

Assuming that both the exemption regime and accrual regime apply to FAs without distinguishing between FAs and CFAs, there is really nothing beyond accrual taxation and exemption. As far as Canadian tax policy is concerned, the key is to define and protect the Canadian tax base.

Policy Concerns

The proposed full exemption system does not represent a major shift in Canada's tax structure or policy for the reasons discussed earlier. Nonetheless, concerns can be raised over the possibility that it will result in further erosion of the Canadian tax base and relocation of domestic operations to the country with lowest taxes.

The concern with relocating investment to foreign low-tax jurisdictions already exists. The current partial exemption system already covers some well-known low-tax jurisdictions, such as Barbados. In fact, Barbados is the 3rd largest recipient of Canadian outflow foreign direct investment (FDI).[43] On the other hand, more than half of Canadian outbound FDI in 2006 was in the United States (42.7%) and United Kingdom (11.3), which are "high-tax" countries. It is difficult to estimate the extent to which a full exemption system would have on the outbound FDI flows. It is unclear about whether the outbound FDI are substitutes or complements for domestic investments. To the extend that Canadian outbound FDI is made for non-tax reasons, such as accessing lower costs, natural resources, or local market, the FDI is arguably not substituting domestic investment. To the extent that FDI substitutes domestic investment and it is driven by Canadian tax reasons, then, the issue is serious. Empirical research is needed.[44]

A related concern is the further loss of the tax base. This Submission was persuaded by the evidence that the current "deferral with credit" (or taxable dividends) regime does not really produce much tax revenue in Canada. So, a move to a full exemption will not further erode the Canadian tax base. That does not mean, however, that the base erosion is not a serious concern. The fact that Barbados is the third largest recipient of Canadian FDI clearly indicates the "tax" motivation behind the initial choice of destination.

6. Design Issues

6.1 Full Exemption

6.1.1 A Simplified System

This Submission argues that a full exemption can be viewed as part of the normative outbound tax system as opposed to a tax expenditure. Under this view, Canada cedes its jurisdiction to tax Canadian corporation's dividends from a FA, but retains jurisdiction to tax individual shareholders of the corporation. Other than the rules defining "foreign affiliate", the rules for tracking the amounts in support of the distinction between "taxable" dividends and "exempt" dividends would become redundant. More importantly, if Canada's cession of tax jurisdiction to the foreign source country is "unconditional" (i.e., irrespective of whether the foreign country has a tax system similar to Canada's), Canadian drafters need to worry only about drawing a boundary between Canada and the rest of the world. What happens between various foreign countries should not, in principle, have much impact on the Canadian tax system. [45]

6.1.2 Eligible Taxpayers

The proposed full exemption system would apply to Canadian resident corporations, not individuals, receiving dividends from a "foreign affiliate". Excluding individuals from the system is necessary under the ability-to-pay principle. Individual shareholders of a resident corporation will be taxable on the dividends paid out of the foreign income earned by the corporation. The "exemption" system is thus limited at the corporate level only.

Non-corporate entities making foreign direct investment, such as tax-exempt entities, can be treated as individuals or corporations. Since tax exempt entities must internalize any foreign tax paid as they are not eligible for foreign tax credits, it seems to make sense to extend the exemption system to such entitles.

6.1.3 Eligible foreign corporations

The definition of "foreign affiliate" can be revised to reflect "genuine" foreign direct investment. A 10% voting rights or value threshold would be consistent with international tax norms and similar to the threshold for distinguishing between direct and portfolio investment in a domestic context (i.e. Part IV of the ITA). This Submission also recommends lowering the threshold for FAPI taxation to 10%. As such, there is a built-in "anti-avoidance" mechanism so that the "FA" status would not be used as a means of avoiding Canadian tax.

6.1.3 Eligible foreign income

The current partial exemption system is limited to active business income earned by a FA in a treaty country. The characterization of income as "active business income" is thus a crucial building block.[46] FAPI is implicitly excluded. So is income that is neither FAPI, nor active business income.

Under a proposed full exemption system, there is no need to define "active business income." From Canadian tax policy perspective, what is important is the accrual taxation of FAPI. Non-FAPI is subject to territorial taxation. However, should the reformed exemption system remain "partial" and some dividends from foreign affiliates remain taxable in Canada, rules similar to the present characterization rules and "surplus" accounting rules would be required.

6.1.4 Branches

The exemption treatment should be extended to non-FAPI income earned by Canadian corporations through a foreign branch. This makes sense where the territorial taxation of business income is accepted as a normative rule and there is no sound policy why this rule should be overruled on ground of ability-to-pay. Including branches in the exemption system is unlikely to erode Canadian tax base. If the business is carried on a country with a comparable tax system, the business income will not attract any Canadian tax because of the foreign tax credit. In the case of business losses, they will not be deducted for Canadian tax purposes.

6.1.5 Unlinking from Tax Treaties

There would be no need to link the exemption system to tax treaties. The issue of low-tax jurisdictions can be addressed through re-designed FAPI.

6.1.6 Other Returns from Foreign Affiliates

This paper suggests that all dividends received by Canadian corporations from their foreign affiliates are exempt from Canadian tax. If the return on equity investment is exempt from tax, a logical question is whether other returns (e.g., royalties and interest) are also exempt from Canadian tax. This question raises a tax neutrality issue: it is biased in favor of equity investment.

On the other hand, the taxation of royalties and interest and non-taxation of dividends in Canada is consistent with the tax entitlement principle. Assuming that the foreign tax law is similar to the ITA, interest and royalty payments are deductible in computing income, thereby not taxed in that country. The Canadian corporate investor has presumably incurred research and development expenses in developing the property licensed to foreign affiliates, Canada is entitled to tax the royalty income. However, in the absence of specific, new, base-protection rules, Canadian developed intangibles can be transferred offshore so that future royalties will be sheltered from Canadian taxation.

6.2 The Accrual Taxation of FAPI

6.2.1 FAPI

The current definition of "FAPI" is intended to capture income that that has no nexus to business activity, is highly mobile and easily shifted to low or no tax jurisdictions. More specifically, FAPI includes:

- passive income from property;
- income from a business that is not really "active", which is determined by either the speculative, isolated nature of the activity, or the main source of income being investment;
- income from "mobile" business activities, such as services[47] and sales or trading;[48]
- income that is actually originated from Canada, but deflected to a foreign jurisdiction.[49]

The FAPI definition also includes, in very simple terms, taxable capital gains on the sale of assets not used in active business and on the sale of shares of affiliates who do not carry on active business. Inter-affiliate payments of investment income do not give rise to FAPI as long as the underlying nature of the income of the group is active (measured by, for example, the deduction of the payment in computing active business income).

The current definition with respect to "mobile" income is generally sound. It can be expanded to include more services and sales income. With respect to capital gains, it is worth considering an alternative that FAPI specifically includes taxable capital gains on the sale of assets that produce FAPI and shares whose value is attributable to appreciation of passive assets.

6.2.2 *Scope of Accrual Taxation*

In addition to defining what foreign income constitutes FAPI, the accrual system needs to define the Canadian shareholders that are subject to accrual taxation. Under the current rules, FAPI of a foreign corporation is taxable to a resident shareholder (individual or corporation) only in cases where the foreign corporation is "controlled" by the resident (i.e., owning sufficient votes, generally 50%, to elect a majority of the board).[50]

In theory, all FAPI should arguably be subject to accrual tax. In practice, if a resident taxpayer cannot compel the foreign corporation to provide sufficient information on the computation of FAPI and the underlying foreign taxes, it would be difficult for the taxpayer to comply with the rules. The "control" test was originally adopted largely to accommodate this practical concern. However, it is questionable whether the "control" test is still necessary at present. Canadian corporations enjoy the exemption treatment in respect of dividends received from their "foreign affiliates". The definition of "foreign affiliate" requires, in general terms, 10% ownership of equity investment. In order to qualify for the exemption, Canadian corporations must compute the surplus amounts of each of the foreign affiliate, which presumably requires a great deal of information. The 10% test does not seem to be a problem. Moreover, the FIE regime imposes accrual tax on income from portfolio investments irrespective of the shareholder's ownership percentage. A lower threshold of 10% or 25% is used[51] or proposed[52] in some other countries.[53]

In order to simplify compliance, the threshold for exemption from the FAPI system can be raised. Another approach might be to exempt a foreign corporation's FAPI from tax if the FAPI is below a defined percentage (say 5%) of its total income.[54]

6.3 Allocation of Expenses and Income Sourcing Rules

6.3.1 Expense Allocation

The need for better allocation rules exists under the current system. A broader exemption system adds more pressure. One of the controversial expenses is interest. In principle, interest expenses incurred to earn taxable income (e.g., FAPI, domestic income, and foreign direct income) are deductible, whereas interest expenses incurred to earn "exempt" income are not. The challenge is how to allocate interest expenses among the different categories of income and whether interest deductible should be used as a tax subsidy to Canadian companies in respect of their foreign investment. There are no simple technical solutions.[55]

6.3.2 Intangibles

In the case of intangibles, where a Canadian company developed an intangible in Canada and then transfers it to a holding entity in a low-tax jurisdiction, which then licenses it to related FAs in other countries, the Canadian tax base can be eroded as a result of:

- deductions of research and development costs;

- no gain on the transfer of the intangible to offshore when the fair market value at that time does not exceed the cost;
- there is no deemed royalty to the Canadian developer after the transfer; and
- the royalty earned offshore is deemed not to be FAPI.

The valuation rules and transfer pricing rules can presumably be applied to address the base-erosion issue. Abolishing the inter-affiliate non-FAPI deeming rule is not a complete solution because part of the royalty is likely earned offshore and should not be taxed in Canada. An alternative solution is a new "income source" rule and expense allocation rule for intangibles. The Canadian developer can be deemed to continue to own the intangibles even when the "legal" title has been transferred to the foreign affiliate.

7. Conclusions

This Submission supports the move to a full exemption system and recommends an enhanced FAPI accrual system to complement it. It suggests that the Panel take a normative, principled approach to analyzing the reform issues. It is hoped that this Submission is somewhat helpful.

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[1] The Consultation paper is available at www.apcsit-gcrcfi.ca.
[2] This term is borrowed from Edward D. Kleinbard, "Throw Territorial Taxation from the Train", *Tax Notes*, February 5, 2007 547-564, at 555.
[3] Consultation Paper, supra note 1, at 2.25.
[4] The CEN generally requires current taxation of foreign income with a full credit for foreign taxes paid. To the extent that foreign taxes are less than domestic tax, the tax base is shared between the source country and the residence country of the shareholder. CIN and CON call for the primary or exclusive taxation of business income in the source country. This is often referred to as the "exemption" system or

territorial system. In practice, no country has adopted a pure credit system or a pure exemption system. The mix of the two systems attempts to balance between CEN and CIN/CON.

[5] Consultation Paper, supra note 1, at 11.

[6] See Peggy B. Musgrave, *United States Taxation of Foreign Investment Income*, at 121 (arguing that only unlimited foreign tax credit system satisfies CEN). Others have defended the "deferral plus credit" (with limitations) on grounds of CEN. See, for example, US Treasury Department, *the Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (2000), 23-26. For a review of this literature, see Fadi Shaheen, "International Tax Neutrality: Reconsiderations" (2007) 27 *Va. Tax Rev.* 203; James R. Hines Jr., *The Case Against Deferral: A Deferential Reconsideration,"* 52 Nat'l Tax J. 385; Mihir A. Desai and James R. Hine Jr., "Evaluating International Tax Reform," 56 *Nat'l Tax J.* 487.

[7] Shaheen, ibid.

[8] Ibid, at 225-8. According to Shaheen, the pure residence-based worldwide taxation system satisfies CEN only when global uniformity with respect to tax systems is achieved.

[9] Michael McIntyre writes: "None of these guidelines [US tax guidelines, including worldwide taxation, source taxation, foreign tax credit, etc.] relies on the so-called principles of capital export neutrality or capital import neutrality, notwithstanding the usual prominence of those principles in discussions of international tax regimes. In my view, capital export neutrality is a secondary goal. Neutral treatment of capital flows cannot be achieved fully without subversion of the income tax through an exemption for capital income. Capital import neutrality is a lobbying position, not a coherent tax policy goal." See "Guidelines for Taxing International Capital Flows: The Legal Perspective" 46 *National Tax J.* 315 (1993), at 318.

[10] Canada, Royal Commission on Taxation (Chair: K. Carter), *Report*, vol. 4 (Ottawa: Queen's Printer, 1966 (hereinafter "Carter Report"), Carter Report, at 491-96.

[11] Ibid.

[12] Kleinbard, supra note 2, at 555.

[13] International Taxation, Report of the Technical Committee on Business Taxation (1997), (the "Technical Committee Report), ch.6. For a review of this report, see Nick Pantaleo and Scott Wilkie, "Taxing Foreign Business Income," (1998) *Corporate Management Conference Report* (Canadian Tax Foundation) 8:1-44.

[14] See, for example, Lawrence Lokken, "Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)" (2006) Vol.59 *S.M.U.L.Rev.* 751-72 (discussing why the credit system often allows US multinational corporations to achieve US tax results more favorable than they could obtain under an exemption system). Lokken attributes such favorable results to the numerous tax minimization techniques used by US corporations, including one technique that is used to separate foreign income taxes from income on which those taxes were imposed through the use of hybrid entity under the check-the-box rules.

[15] "Clearly articulated principles" are called for by Alvin C. Warren, Jr., "Commentary" (Spring 1991), 9 *The American J. of Tax Policy* 145-8, at 147-8.

[16] See *Carter Report*, vol. 4, supra note 10, at 483-84; and Fair Tax Commission (Ontario), *Fair Taxation in a Changing World* (University of Toronto Press, 1993), at 44-48. See also Edwin Seligman, *Essays in Taxation* (The Macmillan Company, 1931), 338 ; and Clifton Fleming, Jr., Robert J. Perioni, and Stephen E. Shay, "Fairness in International Taxation: The Ability-to-pay Case for Taxing Worldwide Income" 5 *Flf. Tax Rev*. 299.

[17] This is the view of the Carter Commission. See *Carter Report*, supra note 10, vol. 1, at 4-5.

[18] *Carter Report*, note 4, above, vol. 1, 4-5. This view is generally shared: Hogg, Magee and Li, *Principles of Canadian Income Tax Law (6th ed)* (Carswell 2006), ch.2.

[19] See Fleming, Jr., et al, supra note 16; Carter Report, *supra* note 10, at 503; McIntyre, supra note 9; David Bradford, *Blueprints for Basic Tax* Reform (2d ed., rev. 1984), at 90; Musgrave, "Sovereignty, Entitlement, and Cooperation in International Taxation" 26 *Brooklyn J. Int'l L.* 1335 (2001), at 1336-7.

[20] The principle of tax entitlement underlies the concept of "inter-nation equity", which was originally developed and advocated by Peggy Musgrave and Richard Musgrave. See Peggy B Musgrave and Richard A. Musgrave, 'Inter-Nation Equity,' in Richard M. Bird and John G. Head, eds., *Modern Fiscal Issues* (Toronto: University of Toronto Press, 1972) 63-85, at 68; Peggy B. Musgrave and Richard A. Musgrave, 'Fiscal Coordination and Competition in an International Setting,' in L. Eden, ed., *Retrospectives on Public Finance* (Durham, NC: Duke University Press, 1991) 61-85, at 65-6; Peggy Musgrave, "Sovereignty, Entitlement, and Cooperation in International Taxation," *Brooklyn J. Int'l L.* 26 (2001) 1335-1356; and Peggy Musgrave, "Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World," in Inge Kaul and Pedro Conceicao, ed. *The New Public Finance Responding to Global Challenges* (Oxford University Press 2006) 167. Other scholars and their work include: Nancy Kaufman, 'Fairness and the Taxation of International Income,' *Law and Policy in International Business* 29 (1998):145-203; Klaus Vogel, 'World-wide vs. Source Taxation of income – A Review and Reevaluation of Arguments,' in *Influence of Tax Differentials on International Competitiveness: Proceedings of the VIIIth Munich Symposium on International Taxation* (Deventer, Boston: Kluwer Law and Taxation Publishers 1991), 160-61; Jinyan Li, *Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto, Canadian Tax Foundation, 2003), ch.12.

[21] Kaufman, ibid, at 188 (suggesting that Musgrave's entitlement principles need a foundation in a theory of justice and that "economic allegiance" should be the foundation of a nation's competence in taxation and inter-nation equity).

[22] See, e.g., Peggy Musgrave, "Combining Fiscal Sovereignty and Coordination" (2006), supra note 20, at 168.

[23] Ibid.

[24] Ibid.

[25] Ibid., at 172.

[26] The Carter Commission argued, and many experts agree, that the tax system should be "neutral". What is meant by a neutral system is one that is "designed to bring about a minimum change in the allocation of resources within the private sector of the economy": *Carter Report*, supra note 10, vol. 2, 8.

[27] Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," *Corporate Management Report* (Canadian Tax Foundation, 1993), 2:1-72 (noting that a basic issue in outbound taxation is whether "whether it is important to try to ensure that Canadians conducting foreign commercial operations through foreign corporations are not impeded by business costs, in the form of Canadian taxes, that their competitors do not face".

[28]Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973) and Surrey and McDaniel, *Tax Expenditures* (1985) are the seminal works on the topic.

[29] S.2(1), s.3 and s.126 of the ITA.

[30] S.90 and s.113(1)(a) of the ITA.

[31] S.90 and s.113(1)(b)(c) of the ITA.

[32] S.113(1)(b)(c) of the ITA.

[33] According to some practitioners, why would anyone bring back taxable dividends if they end up being taxed in Canada. The Consultation Paper indicates (at 14) that there is no reliable data showing the amount of Canadian tax actually collected on taxable dividends.

[34] S.91(5) and s.113(1)(b)(c) of ITA.

[35] For an overview, see Li, Cockfield and Wilkie, *International Taxation in Canada* (2006), chapters 11 and 13. For some insights on the historical background of the current rules, see Alan Short, "Conference on the Report of the Royal Commission on Taxation (Canadian Tax Foundation) 1967, 329; and Alan Short, "International Tax Provisions," *Twenty-Second Tax Conference (*1970) 171.

[36] An exempt surplus account also includes inter-affiliate dividends traced to exempt surplus, tax-free portion of capital gains, as well as taxable capital gains from the disposition of "excluded property" (largely assets used in carrying on active business activities).

[37] This has been typically phrased as promoting CEN. See Wilkie at al, supra note 27 at 2:27.
[38] Ibid., at 2:10.
[39] Brian J. Arnold, ""Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal" (2002) vol.50, no.1 *Canadian Tax J.* 607-29; Wilke et al, supra note 27, 2:27 (referring to Department of Finance justification for the partial exemption system. Whether the foreign country has a treaty with the home country is suggested as a way of "limiting" the exemption system in Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations" (2001) Vo.54 *National Tax J.* 771.
[40] See, for example, Angelo Nikolakakis, "Exempt Surplus: What's the Problem? A Reply to Brian Arnold" (2002) vol.50, no.4 *Canadian Tax J.* 1354-77.
[41] Wilke et al, supra note 27; Wilke and Pantaleo, supra note 13.
[42] Consultation Paper, supra note 1, at 2.43.
[43] **Canadian Foreign Direct Investment Abroad, by Top-10 Destinations, 2006** (Billions CAD): United States (42.7%), UK (11.3), Barbados (7.3%), Ireland (4.7%), France (3.2%), Bermuda (3%), Netherlands (2.3%), Hungary (1.9%), Australia (1.8) and Germany (1.8%). Source: Statistics Canada, International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by country, annual (dollars), CANSIM Table 376-0051. This data is reproduced in Competition Policy Review Panel, Consultation Paper, "Sharpenning Canada's Competitive Edge", (2008) "http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/en/00013e.html.
[44] This is an empirical question that is beyond the scope of this Submission. There is some research indicating the U.S. outbound FDI complements domestic investment and employment.See R. Glenn Hubbard, "Tax Policy and International Competitiveness", *The Tax Magazine,* Vol. 82, No.3, March 2004.
[45] Canada can work through the OECD or collaboratively with foreign countries to curtail international tax evasion or abusive avoidance transactions.
[46] Exempt surplus account also includes inter-affiliate dividends traced to exempt surplus, tax-free portion of capital gains, as well as taxable capital gains from the disposition of "excluded property" (largely assets used in carrying on active business activities).
[47] S.95(2)(b) of ITA.
[48] S.95(2)(a.1) of ITA.
[49] S.95(2)(a.2), (a.3) and (a.4) of ITA.
[50] "Controlled foreign affiliate" is defined under s.95(1) of the ITA. "Control" means "de jure" control: See, eg., *Duha Printers (Western) Ltd. V. M.N.R.,* [1998] 3 C.T.C. 303, 98 D.T.C. 6334 (S.C.C.).
[51] For example, France.
[52] 10% was discussed in the UK HM Treasury Report, "Taxation of Companies' Foreign Profits: Discussion Document" (2007), at 4.16. 25% is mentioned in the New Zealand's International Tax Review: A Direction for Change: A Government Discussion Document" (2006), at 5.26.
[53] For more discussion, see Brian J. Arnold, "Controlled Foreign Corporation Rules, Harmful Tax Competition, and International Taxation," in *2000 World Tax Conference Report*, Report of the Proceedings of the First World Tax Conference: Taxes without Borders (Toronto: Canadian Tax Foundation, 2000) 17:1-26 at 7.
[54] This is the rule in Australia, and proposed in the New Zealand Report, 5.11.
[55] There has been a great deal of debate on interest deductibility in Canada. For some recent literature, see Sandra Slaats, "Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries," (2007) vol.55, No.3 *Canadian Tax J.* 676; Tamaki, P.K. 2004. "Policy Forum: Thoughts on the Deductibility of Interest and Other Expenses." (2004) col.52 *Canadian Tax J.* 1121. For some international literature, see Shaviro, D. 2001. "Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals." 54 *Tax L. Rev.* 353.