From the Editor:

Is Canada Ahead of the United States on Tax Reform?

By Jeremy Scott — jscott@tax.org

The United States needs to reform its tax system. That seems to be a common refrain from the government, business, liberals, and conservatives. The U.S. system is antiquated, fails to raise enough revenue to support necessary government spending, encourages business to relocate overseas, and is overly burdensome to all taxpayers. Of course, all of those things cannot realistically be true at the same time, which highlights why tax reform will be so difficult to achieve — it means different things to different people. But tax reform is not impossible. If the United States needs proof of that, it need only look to its northern neighbor.

Over the last decade, coinciding with the resurgence of the Canadian Conservative Party under Stephen Harper, Canada has implemented a gradual but successful tax reform agenda, according to Caroline Harris. In the early 1990s, Canada was facing rising deficits, government debt of 70 percent of GDP, and interest payments on public debt that totaled 35 percent of total government receipts. However, Canada today has succeeded in lowering its unemployment rate, halving its debt-to-GDP ratio, and maintaining a 3 percent growth rate, which is higher than the U.S. rate, Harris writes. She points to reductions in the Canadian corporate tax rate as a major factor in the country's prosperity. By 2012 Canada's corporate tax rate will have fallen from 42.6 percent to 25 percent. The reduced corporate tax rate has increased corporate profits by 10 percent, Harris argues, adding that this will lead to increased investment and more jobs. Harris also notes that Canada has increased its oil and natural gas production by opening up access. If the United States would follow suit, it could create 530,000 new jobs and deliver more than $150 billion in new taxes, royalties, and revenue to the federal government, Harris writes. She concludes that although the Canadian tax system isn't perfect, the direction of its reforms should be followed by the United States. (For Harris's article, see p. 837.)

There are few opponents of a reduction in corporate tax rates. The difference of opinion usually occurs when offsets are discussed. Business and conservatives would prefer that a corporate tax rate not be paid for, which would follow the model of corporate tax reform in Canada and most of Europe. President Obama and Democrats would like to curtail tax preferences (particularly those for the oil and gas industry) in exchange for a reduction in the corporate tax rate. Although American wage earners should be reluctant to support further reductions in the taxation of capital (because that lost revenue will have to come from somewhere), a lower corporate tax rate might be inevitable. It will be hard for the United States to remain an outlier if Canada, the United Kingdom, and Japan all significantly reform their corporate tax systems. In that sense, the United States probably is lagging behind its neighbor on tax reform, although it shouldn't necessarily be so quick to follow Canada's example without noting the differences in scale.

Corporate Tax Burdens

Many economists now argue that the burdens of the corporate tax are not really borne by shareholders or capital. Some believe that a high percentage of the tax (possibly even 80 percent) burdens labor instead. Republican presidential candidate Mitt Romney clearly agrees. In a well-publicized gaffe in Iowa, Romney dismissed the idea of raising taxes on corporations, telling his Midwestern audience that corporations were people. Lee Sheppard characterizes Romney's remark as typical of the type of politicians who allow corporations to keep their taxes opaque and low. Reporting on a recent meeting of the International Institute of Public Finance, Sheppard discusses how the various models measuring the impact of the corporate tax are flawed. She points out that if 80 percent or more of the corporate tax was really borne by labor, corporate managers wouldn't fight so hard to keep their tax rate low. The U.S. corporate tax is primarily paid by large, publicly traded corporations that earn excess rates of return and high rates of profit, Sheppard concludes. Because the models don't address excess rates of return, they are hopelessly out of date, she says. (For Sheppard's analysis, see p. 775.)

Commentary

The Supreme Court's *Culbertson* decision provides the general standard for determining whether a partnership will be respected for federal tax purposes. The *Culbertson* Court wrote that a partnership's validity depends on all the facts and the good-faith business purpose of the parties involved. However, in *Castle Harbour* the taxpayer's counsel argued that *Culbertson* was irrelevant for capital-intensive partnerships in the wake of section 704(e)(1). This argument, however, misunderstands the role of section 704(e)(1), according to Karen Burke and Grayson McCouch (p. 813). They write that the argument in *Castle Harbour* is significant because it represents a concerted litigation strategy to roll back *Culbertson* and challenge antiabuse rules in tax shelter cases. Burke and McCouch argue that a more modest reading of section 704(e)(1) is appropriate and that legislative history makes it clear that the section was not intended to overrule long-established case law.

On July 15 the Large Business and International Division issued an internal directive with guidelines to help IRS agents apply the codified economic substance doctrine and the strict liability penalty. Although the directive provides a welcome framework for avoiding haphazard assertions of the doctrine and penalty, it is not public guidance on which taxpayers can rely, write Robert Chase, Carol Tello, Ken Jones, and R. Zeb Kelley (p. 828). In fact, the directive raises transparency issues, and it is not clear that local counsel will consistently apply it, the authors write. They explore the positive and negative aspects of the directive and highlight important questions that remain. They conclude that public guidance is needed or else taxpayers will have little direction on how to approach the codified doctrine.

A recent private letter ruling permits the use of a consent dividend election during liquidations and provides flexibility to REITs that do not have sufficient funds to meet distribution requirements, according to Abraham Leitner (p. 825). He reviews the letter ruling and finds that the IRS has begun to loosen up these requirements. Leitner summarizes some of the distribution requirements that REITs are subject to and explains how the IRS's increased flexibility can be used by this class of taxpayer.

The European Union plans to tax airlines that fly into EU airspace based on their total emissions. The program is designed to raise revenues and reduce carbon emissions. The tax would primarily affect non-European carriers. Because the tax is based on total miles flown and not just miles flown within the EU, it would cost a taxpayer more to fly to London from San Francisco than from New York, despite traveling an equivalent amount of miles in Europe, writes Diana Furchtgott-Roth (p. 833). She notes that the Europeans are calling this an emissions trading scheme rather than a tax and discusses how airlines are allowed to trade their total emissions in order to avoid being taxed. The EU also allows some countries to be exempt from the tax if they take equivalent measures to reduce emissions, writes Furchtgott-Roth. Calling the tax "an unprecedented power grab," she argues that the United States should oppose it and commends a House bill that would prohibit U.S. airlines from paying the tax. Europe might have the right to charge an emissions tax within its own borders, but it should not be able to tax emissions generated in international airspace or the airspace of other countries, Furchtgott-Roth concludes.

California's budget crisis has caused its tax agency to interact with practitioners and taxpayers much more often than in the past. Because the California system only selectively conforms with federal tax law, it can be challenging for out-of-state practitioners to deal with, writes Robert Wood (p. 839). Wood updates his January 2010 article on California's tax trenches with developments over the last 18 months, providing additional tips for practitioners. He also calls attention to the basic differences between California and federal tax law.

Despite mixed support in Congress and almost no support from the White House, the idea of a repatriation holiday continues to fascinate academics and many businesses. The billions of dollars in permanently reinvested earnings overseas might seem enticing to those seeking to reinvigorate the economy or improve a company's bottom line. But the lessons of the first repatriation holiday should give policymakers pause. M. Mendel Pinson and Melanie Shanley argue that a longer-term perspective might have a more lasting effect and meet the basic goals of the first holiday (p. 845). They argue that Congress should enact a new tax rate on foreign earnings to level the playing field and remove the incentives for permanently reinvested earnings. A competitive tax rate would create greater value for shareholders, encourage smarter investment by firms, and lead to new revenue for the government, they conclude. ■