Benjamin Alarie and Edward M. Iacobucci, "Tax Policy, Capital Structure, and Income Trusts" (2007) vol. 45, no. 1 *Canadian Business Law Journal* 1-19

With the two quite different sets of legislation introduced on November 23, 2005 and October 31, 2006, respectively, the Department of Finance appears to have finally laid the income trust structure to rest.[2] The apparent death of this substitute for a conventional corporate structure tends to support the claims of some commentators that the income trust phenomenon was predominantly tax-driven, with little in the way of efficiency gains. Alarie and Iacobucci draw on capital structure theory to argue that the reasons for the popularity of the income trust structure are more complicated than this and can only be explained by the interaction of tax and non-tax considerations.

Conventional wisdom holds that the income trust was created—in substantial part, at least—to avoid the double taxation of equity income distributed as dividends by public corporations. The double taxation occurred because of the partial integration of corporate and shareholder taxation under the Income Tax Act.[3] By substituting high-yield subordinated junk debt for shares, the income trust structure avoided the corporate-level tax by distributing income to investors as deductible interest expense, which was taxable to the investors as interest income. Under standard capital structure theory, corporations are assumed to issue debt in this kind of a tax environment to the point that the benefits of avoidance of the corporate-level tax are offset by increasing levels of bankruptcy and agency costs.

As the authors correctly emphasize, the income trust structure avoided these non-tax costs by ensuring that debt and equity of a public corporation carrying on a business were held proportionally by investors through the intermediary trust. The authors also observe that the income trust may have resulted in efficiency gains attributable to a stronger commitment to distribute cash, although they acknowledge that this stronger commitment depends on the relative tax advantage of debt over equity. They recognize that the proportional holding of debt and equity by investors in an income trust structure was the unique feature that avoided the standard bankruptcy and agency costs that must normally be incurred to access the relative tax advantage of debt. They do not acknowledge, however, that such proportional holding means that the high-yield subordinated junk debt functions as tax-deductible preferred shares and, as such, is used as a near-perfect tax substitute for this form of equity. It was simply not obvious why the income trust structure should have been maintained as this particular tax-preferred form of equity. Fundamental tax reform intended to equalize the tax treatment of income trusts and conventional corporate

2 Canada, Department of Finance, *News Release* 2006-061, October 31, 2006; and Canada, Department of Finance, *News Release* 2005-082, November 23, 2005.

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

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structures was the obvious policy response to this tax-driven product of financial innovation, and it took far too long for the Department of Finance to recognize this policy prescription.

T.E.

Ian Cooper and Kjell G. Nyborg, "Valuing the Debt Tax Shield"
(2007) vol. 19, no. 2 *Journal of Applied Corporate Finance* 50-59

This easy-to-read article reviews many current issues that arise in valuing the debt tax shield. The authors consider different valuation approaches, including incorporation of the shareholder's and debtholder's personal marginal tax rates. They explore issues such as whether the value of the debt tax shield should be based on the corporate marginal tax rate or on a lower rate, and whether the value should depend on how favourably dividends are taxed in the regime. Accurate valuation of the debt tax shield can give buyers a competitive advantage when they buy assets. The authors point out the importance of using internally consistent assumptions when valuing the increasingly material debt tax shield.

Amin M.

Reuven S. Avi-Yonah, "The Three Goals of Taxation"
(2006) vol. 60, no. 1 *Tax Law Review* 1-28

This article complements an earlier one in which Avi-Yonah makes the case for the adoption of a value-added tax (VAT) in the United States—not as a replacement for the income tax, but as an additional source of revenue.[4] In doing so, he challenges directly the US academic literature that trumpets endlessly the superiority of a consumption tax as a replacement for the income tax. Avi-Yonah suggests that three goals of taxation—generation of revenue for governmental functions, redistribution of income and wealth, and regulation of economic activity—all require a combination of an income tax and a consumption tax. Realization of these three goals is seen to answer the question why virtually all developed countries employ both income and consumption taxes, and why the United States moved from taxing primarily consumption to taxing primarily income in the early 20th century. Avi-Yonah believes that unsustainable budget deficits in the United States will ultimately require the adoption of a VAT as the preferable form of consumption tax to raise sufficient revenue to support a growing public sector. The income tax will continue to be maintained as a means of redistributing a portion of unconsumed wealth (that is, savings).

T.E.

4 Reuven Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT" (2004) vol. 105, no. 13 *Tax Notes* 1651-66.

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