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Poor Lord Conrad Black of Crossharbour. He is at war with the United States government. Just as his spirits were lifted by the judiciary - the United States Supreme Court narrowed the scope of the "honest services" doctrine so it would not apply to individuals in his circumstances - resulting in his being granted bail pending further appeals, the executive branch kicked him in the shins with a US\$71-million income tax assessment for unpaid taxes and penalties. Meanwhile, the Securities and Exchange Commission is lurking in the background with its civil charges.

Lord Black Case Highlights U.S. Tax Law Issues

Date: August 11, 2010

Vern Krishna

Poor Lord Conrad Black of Crossharbour. He is at war with the United States government. Just as his spirits were lifted by the judiciary—the United States Supreme Court narrowed the scope of the “honest services” doctrine so it would not apply to individuals in his circumstances—resulting in his being granted bail pending further appeals, the executive branch kicked him in the shins with a US\$71-million income tax assessment for unpaid taxes and penalties. Meanwhile, the Securities and Exchange Commission is lurking in the background with its civil charges.

Lord Black repudiates the tax assessments, saying he is not liable for taxes as he is neither a resident nor citizen of the United States. If only tax law were that simple. Like Canada, the United States bases its jurisdiction to tax on the relationship between the taxpayer and his or her residence in the country. Residence-based systems tax persons on their worldwide income.

Countries use economic and social nexus with the country to determine residence status. For example, one may determine residence by factual criteria: physical and financial connections with the country, a job, home family, bank accounts and social connections.

Factually based tests, however, are necessarily uncertain. Hence, some countries supplement such criteria with more precise bright-line tests.

Canada, for example, deems a taxpayer to be a resident if she or he resides in Canada for 183 days or more in the year. The United States uses a more complex weighted average formula that looks at an individual's presence in the country over the past three years. Under the formula, an individual who is in the country for more than 121 days a year in each of the past three years is deemed a U.S. resident.

To be sure, these arbitrary numbers. Nevertheless, they provide some certainty in determining residence for tax purposes. However, they also create the potential for double taxation where one country claims jurisdiction over a taxpayer based on his factual connection with the country and another country claims jurisdiction over the taxpayer based on a mechanical rule. Tax treaties attempt to resolve double tax claims.

Most countries do not use nationality as a basis for taxation. The notable exception is the United State of America, which taxes its citizens, regardless where they live. U.S. citizens must file tax returns even if they live abroad. However, the United States exempts a substantial portion of a nonresident citizen's foreign earnings from tax.

There is, however, a third basis for taxation: source of income. The theory of source-based taxation is that the country where the income originates should be entitled to tax foreign investors who use the country's economic and political resources to produce the income. For example, regardless of residence or citizenship, a country may tax a foreign investor who derives investment or employment income in the country.

We justify source-based taxation on the theory that imported capital should bear the same tax burden as domestic economic activities. It is also justifiable on the benefit principle—the taxpayer benefits from his legal, political and economic affiliation with the country in which it derives its income. Thus, non-resident taxpayers who benefit should pay the source country taxes to compensate for the benefit. The difficulty with source-based taxation is proper characterization of income and identifying the source of different types of income. The law reports are full of inconsistent claims by countries.

Lord Black must surely, as many ordinary Canadians do, rue the day he ever got involved with tax law. His problems started innocently enough with an unusual Canadian court decision that exempted—since changed by statute—“non-compete” payments from taxation. Following the decision, owner-managers began adding a non-compete clause to every share sale of a business. Like Winnieth-Pooh, Lord Black savoured the honey and got stuck. Zealous U.S. prosecutors, eager to establish their careers, saw the matter differently. Lord Black ends up in a Florida prison teaching American history to eager later learners.

As Lord Black will no doubt discover, the tax collector is far more brutal and subject to fewer judicial restraints than the criminal justice system. The tax case will likely endure longer than the war in Afghanistan. Interest will accumulate steadily on any amount ultimately payable. Win, lose or draw, Lord Black could, like many Canadians, be poorer for his entanglement with the tax system.

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