An Evaluation of Some Financial Instrument Tax Reform Proposals

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First, I would like to thank Neil Brooks, the new editor, for inviting me to comment on Tim Edgar’s excellent book *The Income Tax Treatment of Financial Instruments: Theory and Practice*.¹ I would also like to congratulate Tim Edgar on winning the Douglas J. Sherbaniuk Distinguished Writing Award for his article “Some Lessons from the Saga of Weak-Currency Borrowings,”² which offers a condensed version of the main themes of his book. Both the article and the book deal, of course, with the issue of the taxation of financial instruments, particularly financial tax arbitrage.

In the book Edgar surveys recent trends in derivative taxation, focusing on the United States, Australia, and New Zealand, countries that have undertaken major tax reforms. It is easy to see why he needed five years, including a sabbatical, to tackle this subject in 645 pages, almost half of which are taken up by detailed end-notes. Although I come to different conclusions from Edgar, at least in terms of what may be relevant to Canada, his book is an invaluable research resource.

Edgar’s proposed model, conceived in the United States, is called “expected-return taxation,” and I would like to evaluate its merits within the following four constraints that may limit its use:

1. The economic definition of profit can conflict with national tax policy objectives and has practical problems. To his credit, Edgar has tried to develop an approach that minimizes disruption and maintains the realization principle (in the non-financial sector). Contrary to some economic theories, however, he proposes the repeal of favourable capital gains tax rates and the imputation of interest under “modern portfolio theory” concepts (in some surprising places, as we will see) in order to better achieve the objectives of the next two points.

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2. Edgar submits that the primary goal of tax reform should be tax neutrality or the equivalent taxation of equivalent financial transactions. However, the “linchpin” of his proposed model, the distinction between debt and equity, remains a problem. Although he identifies a number of alternatives, such as making interest non-deductible or dividends fully deductible, each appears to have significant costs for the affected parties, whether in the public or the private sector.

3. The concern expressed in his book and the literature regarding tax arbitrage, or the exploitation of tax asymmetries, may be overstated if the effects of arbitrage are measured in financial terms and compared with, say, government-sponsored tax preferences. In some cases, tax arbitrage could be viewed as a means of reducing double taxes or of utilizing unused tax preferences. This concern may also overlook the primary driver of financial innovation—risk management—and may not be resolved by his or any other proposed solutions in the international context.

4. A more immediate problem for Canada may be that of enforcing the intent of its own laws through prescriptive legislation and the general anti-avoidance rule (GAAR). In my view, the government should review the legislative framework and approach and use more “purposive” legislation, albeit sparingly, in combination with some accounting measurement rules that would minimize tax deferrals and distortions.

**ECONOMIC PROFIT**

The US author David Weisbach has stated:

The Haig-Simons definition of income tax is often cited as the most important income tax principle. Under the Haig-Simons definition, income is the sum of consumption plus the change in wealth during a taxable period. Implementing it would require taxpayers to value their assets at the end of each taxable period and include in income any increase in value and deduct from income any decrease in value. The Haig-Simons definition does not offer guidance for line drawing. . . .

Most lines in the tax law are inconsistent with the Haig-Simons definition.³

Edgar describes the concept as follows:

Indeed, many writers have concluded that the best way to eliminate tax-avoidance opportunities in capital markets would be to adopt a benchmark income tax system, modelled on the Haig-Simons ideal, that incorporated three fundamental principles for the taxation of all financial instruments, including shares:

1) recognition of changes in value by marking to market all financial instruments (“accretion taxation”),

2) elimination of the corporate income tax and its replacement with a tax at the investor level on changes in the value of all financial instruments, and

3) inclusion and deduction of the full amount of all gains and losses.⁴
However, Edgar recognizes the potential problems with this economic ideal “benchmark,” including valuations and liquidity issues, that mandate some form of “second-best” approach. All of the difficulties begin here, though, because only some of the practical problems or competing issues are typically addressed in most of the literature.

It should be noted that there is no universal agreement on the benchmark scenario: some tax theories would dispense entirely with income taxation, and under a replacement consumption tax model income from capital would be taxed at a preferred rate, such as nil.5 As Edgar says, “[p]rovided that the level of private savings increases and that an increase in private investment is desirable, the increased return will result in efficiency gains.”6 This line of theory implies, however, that there may be efficiency gains from the preferential treatment of income from capital, even under an income tax regime. Edgar says, “[t]he economic evidence on this point is ambiguous.”7 However, before one can legitimately recommend the repeal of favourable capital gains tax rates (as opposed to the elimination of income tax in favour of a consumption tax, which would be a far greater political challenge), one would likely have to demonstrate that it is not a significant benefit to capital markets. This is because the repeal of favourable capital gains tax rates would cause, through higher taxation of returns, a significant transfer of wealth from invested capital in the economy to somewhere else and is not a step to be taken lightly, particularly if the evidence for or against its effect is ambiguous. Some would argue that it would be a political “non-starter.”

Edgar sees the principle benefit of his proposals in terms of minimizing financial tax asymmetries and related arbitrage opportunities. However, there can be seen to be other national tax objectives or constraints that may be of equal or greater importance. My perception of the ranking of governmental priorities in this area is as follows:

1. tax preferences and international competitiveness,
2. tax leakage and revenue concerns, and
3. tax arbitrage.

For instance, Canada has a relatively small economy that has to compete internationally and is financially weaker than its largest trading partner, the United States. This has led to a whole series of tax incentives for Canadian corporate finance and investment, such as:

- the lower capital gains tax inclusion rate, recently reduced to 50 percent.8 (the United States has recently reduced its top rate for individuals from 20 to 18 percent);
- provisions related to small business corporation shares, such as the capital gains exemption9 and recent rollover10 rules;
- Canadian dividend tax credits;11
tax deferrals on Canadian stock options;12
labour-sponsored venture capital corporation tax credits;13
a guaranteed capital gains tax rate on Canadian securities;\textsuperscript{14}
flowthrough share tax benefits for Canadian exploration and development;\textsuperscript{15}
and
foreign property restrictions for tax-deferred plans.\textsuperscript{16}

The government seems implicitly to be in favour of the tax asymmetries caused by tax incentives, and it would likely face a great political challenge if it repealed capital gains tax benefits and, potentially at least, reduced our international competitiveness in the capital markets.

Weisbach says:

The most efficient tax system is the tax that raises the necessary revenue with the lowest dead weight loss. A tax system will have the lowest dead weight loss if and only if the change in dead weight loss from a change in the tax on a commodity (the marginal dead weight loss) is equal for all commodities. . . .

This [paper] shows that efficiency analysis can be done by policymakers. While the analysis is not simple and while it requires information, it should be well within the reach of tax policymakers.\textsuperscript{17}

Weisbach concludes that there is currently insufficient empirical evidence to make appropriate decisions about “line drawing,” including drawing the line between debt and equity. However, he also points out that, “as a general matter, taxes that raise more revenue will have a higher dead weight cost,” and

[t]his is a general problem with applying the models to real decisions. The decision to move a line will often raise or lower tax revenues, and we do not know what offsetting tax law change will be made to keep total revenues constant. For example, changing the border between debt and equity would change the size of the corporate tax base.\textsuperscript{18}

In short, not only does the evidence concerning the total financial impact of Edgar’s proposal to eliminate the favourable capital gains tax rate seem insufficient, but the tax system appears to be strongly biased against it.

FINANCIAL TAX EQUIVALENCE

Edgar’s central argument is that, “[f]or reasons of fairness, the tax system should ensure that all equivalent financial transactions are taxed equivalently.”\textsuperscript{19} Most calls for reform suggest a two-pronged approach to achieving this objective:\textsuperscript{20} (1) elimination of favourable capital gains tax rates and (2) mark-to-market (“accretion”) taxation on all traded instruments. Recognizing that not all financial instruments are publicly traded, Edgar proposes a second-best approach, expected-return taxation, which would limit the use of mark-to-market taxation and make the following changes:

- eliminate the distinction between ordinary income and capital amounts;
- extend accrual recognition to the expected return attributable to the embedded debt in options and prepaid forward and swap contracts;
extend accrual recognition to the expected return associated with the fixed-payment debt element in all contingent-payment debt instruments with embedded derivatives; and

apply accretion recognition to unexpected gains and losses on certain instruments that give rise to the problem of “selective realization.”

It should be noted, however, that when governments, like those of the United States and Canada, have capital gains tax preferences and the realization principle for their investors, then financial tax equivalence and economic substance appear to become largely irrelevant. The simplest example from Edgar’s book is a common share investment that can be viewed as a sale of corporate assets to the corporation’s creditors (if any) and a purchase of a call option by the shareholders. In tax systems with a realization principle, one cannot distinguish between a sale and a loan on economic as opposed to legal grounds: “The Haig-Simons definition [of economic profit] offers no guidance for this problem.” An economic substance approach, if taken to its logical limits, has no meaning here because there is no unique benchmark. Legal form becomes the “primary driver” in traditional tax systems and so the drafting principles become critical, as discussed below.

Edgar’s second-best approach also does not solve the complex issue of debt-equity distinction, and unless this is solved, there can be little progress toward the stated objective of financial tax equivalence.

Edgar lists four alternative models for dealing with this issue:

1. Eliminate the corporate income tax, or what is referred to in the United States as the “shareholder allocation” model. However, the practical issues with this approach appear to make it a non-starter from the government’s perspective, including audits and potential reassessments of corporate income at the shareholder level (for example, in the extreme, reassessing not hundreds but millions of persons), flowthrough of business losses of failed businesses, and the resulting tax revenue losses to the government. Edgar agrees that this approach is flawed but does not choose from the following alternatives either.

2. Treat interest like dividends—that is, make interest non-deductible but provide an imputation tax credit on interest for lenders. However, uncertainty about how tax-exempt entities or non-residents would be kept tax-neutral (as shareholders for instance in companies that pay more tax) and the “hit” on corporate earnings from the additional corporate taxes seem to make this alternative a non-starter as well, this time from a private sector (capital markets) perspective.

3. The third alternative is the same as the second but with no tax on investors instead of a credit. This approach, referred to as the comprehensive business income tax (CBIT) in the United States, appears to be a non-starter for the same reasons as the second alternative.
4. Make dividends deductible like interest or impute a deductible cost of equity capital. However, corporations cannot flow out tax losses to their shareholders (see the first alternative), so this approach of effectively treating companies as 100 percent leveraged would potentially leave many with unusable tax losses. In addition, it seems unlikely that the government would choose to make dividends deductible when they may be received by tax-exempt entities, because there could be an overall tax revenue cost to the fisc.

It is easy to see why none of these alternatives has been adopted and why Edgar did not select one for a more refined analysis of his proposals. However, this issue is critical to his proposals. If the debt-equity distinction continues to be based on legal form (with modifications for preferred shares in Canada, as discussed below, or with a dividend imputation system like Australia), then the existence of tax-exempt entities and non-residents eliminates the possibility of financial tax symmetry. As Edgar notes:

Admittedly, this system does not adequately address avoidance opportunities that arise because of rate differences among taxable corporations, loss corporations, and tax-preferred holders of financial instruments such as pension plans. Only a system that taxes all financial returns identically in all respects can eliminate opportunities of this kind.28

Under the present tax system, the introduction of expected-return taxation would probably cost the government significant tax revenues, even if dividends were not deductible by issuers, by imputing interest deductions to corporations and interest income to tax-exempt entities or non-residents. This may well be why the United States has not adopted expected-return taxation and has not extended its “bifurcation” rules beyond limited circumstances.29

Edgar’s proposal to impute interest on standard derivatives such as put and call options could also, because of their time-value-of-money component, cause liquidity problems for investors, although many of these derivatives are short-term securities and the issue would pertain more to complexity and compliance than to tax significance. However, his analysis of the embedded-loan element of shares is more important, as discussed below.

Weisbach estimates that the US original issue discount (OID) rules, which impute an interest deduction and inclusion on zero-coupon debts to issuers and holders, cost the US treasury over US$70 billion per year.30 However, he ignores the probable concentration of such instruments in the tax-exempt sector, which may mean the real cost is well over US$100 billion per year.31 Canada effectively (perhaps unintentionally) penalizes corporations for issuing OID debt, because compound interest is deductible only on a paid basis under paragraph 20(1)(d) of the Act:32

Revenue Canada is prepared to allow amortization on only the simple-compound method, and even then only where the taxpayer can clearly establish that the discount is interest. This treatment has destroyed any incentive for taxable borrowers to make use of zero coupon bonds since borrowing costs are increased.33
As I argue below, this tax asymmetry could be eliminated, without cost to the
government, by the addition of an accrual rule to the Act (there would be no tax
 cost since Canadian borrowers use ordinary debt). However, the point is that
whenever interest imputation (as opposed to accrual) is introduced to corporate
borrowers, tax revenue is likely to be lost where investors are subject to low or zero tax.

Hence, Weisbach concludes, “We should not impose the OID rules on options.
Doing so will lose revenues and be inefficient.” Nevertheless, expected-return
taxation would accrue imputed interest, as discussed below.

It is difficult to analyze expected-return taxation in the abstract, and Edgar does
not spell out the details because he did not choose a debt-equity model. However,
the US author of the idea, Robert Scarborough, proposed to introduce it into the
existing US tax system as follows:

I propose that all the derivatives that are not subject to mark-to-market taxation be
subject to expected value taxation in order to prevent anticipated deferral. The
proposed system would apply to any derivative that requires an up-front payment by
one party. . . .

An interest return would be imputed on the unrecovered balance of the up-front
payment (i.e., the amount of the up-front payment allocated to contingent payments
that have not yet been fixed) at a rate equal to the risk-free rate of return, and the
amount of the imputed return would be includable in income by the payor and
deductible by the recipient of the up-front payment.35

Scarborough would not, it appears, extend his expected-return taxation to syn-
thetics, which are combinations of positions in different instruments that replicate
another instrument. For example, he would not accrue interest on a synthetic debt
that was constructed from a stock plus a long put and a short call.36 This approach,
which seems to contradict the tax-symmetry objective, is actually quite a skilful
way of preventing interest deductions to equity issuers under his proposal, since the
interest might accrue to tax-exempt entities. However, further analysis is required
beyond Edgar's book and Scarborough's article to determine whether government
tax revenues could be adequately protected. The government is the body, at least in
the first instance, that would have to be convinced of the merits of the proposal. If
the government chose only to accrue income to investors with no deduction to
issuers, this would just create another type of tax asymmetry and defeat the overall
objective.

It appears, though, that Edgar would not be so constrained, because he pursues
tax-neutrality issues over tax-revenue concerns. For instance, his expected-return
taxation apparently would be broader than Scarborough's:

As described [in an earlier chapter] . . . the functional similarity of debt and equity is
supported by option-pricing theory. . . . The embedded option in a share, however,
also has an expected time-value return that gives rise to expected gain or loss in the
same manner as options generally. In effect, the embedded-debt element in an option
is also embedded in a share as the equivalent of an option. A system of expected-
return taxation requires accrual recognition of this expected gain or loss, with realization-based recognition limited to unexpected gain or loss arising on maturity.

The use of option-pricing theory is problematic. The calculation of imputed interest on a share, at the “risk-free rate,” is based on arbitrage theory from the Black-Scholes option-pricing model. In reality, there is no assurance that the stock will earn a risk-free return. Edgar may go too far in extending the concept of accrued interest to the imputation of interest using modern portfolio theory. As John Hull states:

It is important to appreciate that risk-neutral valuation (or the assumption that all investors are risk neutral) is merely an artificial device for obtaining solutions to the Black-Scholes differential equation.

We all know that returns on stocks can be negative, and it may be small comfort to investors that there is a theoretical interest element that may reduce the overall negative return but still cause advance taxation of the imputed interest under the expected-return model. This treatment of imputed interest raises liquidity issues for taxpayer-investors and may provide an incentive for the “selective realization” of losses. Edgar says that there would need to be “loss-limitation” rules in a realization system but he does not spell them out, and no matter what form they take, they could cause liquidity problems when the overall return is negative (that is, paying tax on “phantom income”).

It is also not clear for what period Edgar would impute interest on the hypothetical option embedded in a share. His example noted earlier overgeneralizes in stating that a share can be viewed as a sale of assets to debt holders and as a purchase of an option by shareholders with the same term. For instance, if a company had no debt, option-pricing theory would not apply. In Edgar’s world, then, but not Scarborough’s, shareholders would presumably be obliged to impute some average annual government interest rate on a hypothetical call option computed by formula for each investor and their valuators, based on some sort of average market value of a company’s assets and debts, assuming that the financial data were available, but this would not apply to companies with no debts. I suspect it would take taxpayer-voters a lot of convincing to accept this as any sort of rational model, with imputed interest arising from their equity investments.

While theorists conceptualize such “unbundling,” it seems difficult to justify imputing interest based on an expected-return model and not on legal rights. Again, option-pricing theory is not based on expected returns; the risk-free rate is an arbitrage-pricing mechanism that mathematically avoids the need to determine expected returns, as explained by Hull. It is also not a guaranteed return nor the return that investors demand when making risky investments. I believe Scarborough was right in excluding equity from his model on theoretical grounds. However, his model could also lose on tax revenue grounds, as discussed below.

As noted above, equity can be combined with options to create synthetic debt for which Scarborough would not accrue interest. This seems to make it clear that
Scarborough, the “expected-return” author, is primarily concerned with tax deferrals and government revenue losses and not financial tax equivalence per se. Although Edgar’s concerns are broader than Scarborough’s because he proposes reforming the whole system, including the repeal of capital gains tax breaks, he does not have or choose a realistic solution to the debt-equity distinction, at least not in the short term.

Another US author’s proposals would also narrowly limit the use of expected-return taxation system. In 1996 David Hariton recommended that the US Treasury department should (among other things)

   (b) stop finding loans embedded within the terms of equity swaps, commodity swaps and similar derivative contracts (although it should continue to find them in interest rate swaps, where the underlying payments under the swaps are generally equivalent to payments on fixed or floating-rate debt instruments); and
   (c) likewise drop the proposed project to accrue interest on forward contracts and deep-in-the-money options.41

Although the issue of embedded loans and imputed interest under modern portfolio theory is interesting, I would argue that imputing interest is not the key to the derivative tax-deferral reporting problem. If an option holder on income account (in Edgar’s world that would be everyone, but realistically it would exclude most individuals and anyone using capital treatment) accrues interest on the time value of money implied in an option, the overall return could still be negative if, for example, the option expires “out of the money” to the investor. Presumably, Edgar would argue that this is just an unfortunate tradeoff of accruing expected returns and deferring unexpected returns for practical reasons (such as the problem of valuing non-traded securities). However, a potentially better approach than expected-return taxation is the accounting “accrual” approach, under which income, whatever its theoretical components, is accrued as it is earned. As noted above, the “risk-free” return is really not the “expected” return.

The Canadian government may have addressed its major concerns about income deferral with its new foreign investment entity rules, but other, simpler areas could also be remedied by an accrual concept instead of the legal concepts of “paid” or “payable” and “received” or “receivable,” as discussed further below.

FINANCIAL TAX ARBITRAGE

Significance

Every country has its own set of tax preferences to serve as economic incentives, to meet equity (fairness) objectives, or for political, competitive, or other reasons. Canada’s tax breaks include, in addition to the preferential capital gains tax rate, the principal residence capital gains exemption, personal tax brackets, and tax-deductible contributions to tax-deferred plans such as pension plans and registered education savings plans. These tax preferences cost the government a great deal in terms of forgone tax revenues, but not as much as they might. The amount of unused
carryforward contribution room for registered retirement savings plans (RRSPs), for example, is reportedly over $300 billion.42

One significant tax preference in the corporate sector for financial instruments is the deductibility of interest expense on debt financings. In this context Edgar quotes a theory of equilibrium tax optimization that may not exist. The Modigliani-Miller theory referred to by Edgar43 postulated that companies should issue debt until the tax savings on interest deductions are offset by bankruptcy costs. This theory was later revised by Miller to suggest that companies may appear to be underleveraged from a tax viewpoint, as a result of the tradeoff between tax savings on interest deductions on one hand and increased taxes on interest to investors holding debts on the other, in market equilibrium. However, empirical studies appear to have disproved this theory44 and, as with RRSPs, this tax preference appears to be underutilized, likely because of higher priorities such as liquidity. Finally, on the basis of tax costs alone, companies should not pay dividends and are subsidizing the government to the extent that their shareholders are taxable. (The 25 percent Canadian dividend gross-up and tax credit for individuals do not offset public company tax rates, which are typically in the 40 percent range.)

Hence, it is not clear that one of the largest tax preferences in the economy is in any way optimized from a tax viewpoint. It then becomes difficult to anticipate significant economic distortions from incremental tax arbitrage in a strictly domestic market, since international tax arbitrage is not subject to the analysis.45 (On a global basis, a corporate group’s income may be excluded from any tax as a result of divergent tax systems between countries.) Edgar’s criticism of the tax biases favouring debt over equity does not appear to recognize that national debt-equity ratios may be understated (that is, underutilized from a tax viewpoint) and that dividends create potential double tax that, arguably, should be reduced by arbitrage on efficiency grounds. Although arbitrage may seem inefficient compared with a model where all corporate distributions are either deductible or nondeductible, with minimal tax asymmetries, neither of these alternatives appears to be viable, as discussed earlier. Edgar might agree, but he did not contemplate a “third-best” approach, which may be necessary. Such an approach would accept all government-provided tax preferences as “givens” and maintain a legal-based distinction between debt and equity. It would simply expand the accrual principle, as discussed below.

Let’s look at a particular type of derivative transaction, an “equity monetization” transaction. An investor with unrealized gains on a stock portfolio might enter into a monetization transaction46 whereby a creditor (for example, a financial institution) lends funds on a zero-coupon note against the portfolio. The investor can use these funds to diversify his investments and enter a forward sale agreement to pay off the loan, locking in the current value of the portfolio. An equivalent transaction would be a prepaid forward contract, where the investor receives advance payment and reinvests it. If the government imputed an interest deduction to the investor-vendor under the prepaid forward alternative, he would be taxed neutrally to the two-part borrowing-forward sale transaction. However, the government would gain little or
nothing from the legislative changes required and would only lose if the creditor-purchaser were a tax-exempt entity.

Some may argue that this example is a deemed disposition issue in a system with a realization principle. But the United States, which does have a “constructive sale” rule, would also permit this hedging transaction within certain (qualitative) parameters. As one US author explains:

Some zealots instead will accuse Congress of timidity in making an exception for market risk hedges and argue that §246(c)(4)(C) and other risk-based rules should be tightened up to cover portfolio risk-reduction strategies. Putting aside the vast administrative difficulties of generally implementing such an approach, such an approach would lead inevitably to either massive dead weight losses (that is, requiring taxpayers to shoulder far more risk than is efficient by holding undiversified portfolios) or to a tax system that essentially marks assets to market (that is, if the taxpayers “persist” in holding diversified portfolios of assets).47

Financial Innovation

Although Edgar is right that tax and regulatory rules generate arbitrage activity, the point can also be overstated. Edgar says: “An admittedly casual empiricism indicates that a sizable element of innovation along the boundary between debt and equity is driven by tax and regulatory arbitrage.”48

Again, everything is relative. These types of arbitrage are significant (and in some cases appropriate in reducing double taxes or utilizing unused tax preferences), but financial innovation is primarily driven by risk management such as hedging.

For instance, stock index guaranteed investment certificates (GICs) issued by banks permit investors to obtain some of the benefits of equity markets and protect their capital. Banks issue many varieties of GICs to suit many tastes, but in fact they are tax-disadvantaged because the Canada Customs and Revenue Agency (CCRA) says that the returns are fully taxable on income account and not on capital.49

A better sense of what the financial revolution is all about can be gleaned from one of the many risk-management books on the market, most of which have no reference to tax or tax arbitrage at all (the arbitrage referred to below is pricing):

Derivatives, securitization, and disintermediation have wrought significant changes and greater efficiency for [the] markets. Arbitrage, facilitated by derivative trading, has increased market efficiency. Derivatives also help institutional investors fine-tune the risks in their portfolios through hedges and through a broader set of investment choices.50

Finally, many of the innovative domestic products are designed to exploit not tax but accounting arbitrage opportunities, particularly in response to Canada’s unique rule, established in 1994, that permits legal debt to be booked as equity if the issuer has the option of settling the debt with its own shares.51 In contrast to the accounting, the issuer can deduct interest expense on its legal debt for tax purposes, that is, the best of both worlds.
In summary, it is not at all clear that tax asymmetries are a primary driver of financial innovation. The evidence is against it, in fact, so no one should draw a false inference. (I don’t believe Edgar intended to, but his book is about tax, so one can expect a tax focus.) International tax symmetries are, however, another story.

**Cross-Border Tax Arbitrage**

Cross-border tax arbitrage is seldom discussed in the literature on derivative tax reforms because of the problem of tax asymmetries between countries as they pursue their own national interests. However, one form of tax arbitrage has to do with non-resident withholding taxes, an area that Edgar touches on, including the following comments:

A curious issue with synthetics is the failure of tax-policy makers to respond to opportunities for the avoidance of non-resident withholding tax. The general approach to synthetics applied in a domestic context in the conversion transaction and constructive sale legislation in the United States has not been applied to address erosion of the withholding tax base.52

Again using “financial equivalence” as his benchmark, Edgar expresses the following frustration:

The cash flows associated with these synthetics replicate, however, to a considerable extent, the cash flows associated with the ownership of shares or a debt instrument that would otherwise be subject to non-resident withholding tax. The important tax-policy issue is whether the differences in the legal attributes of substitutable positions are sufficient to justify different tax treatment. For the most part, it is difficult to see why the differences should have any relevance for tax purposes. . . .

Even so, there appears to be a lack of commitment to withholding taxes by many governments. This fact is reflected in the extension of exemptions for interest on portfolio debt and maintenance of the exempt status of payments on derivatives. Moreover, many countries are moving to lower their withholding tax rates on dividends and even eliminate them through the provision of limited imputation tax credits to non-resident shareholders. In that context, there seems to be little political will to shore up the withholding tax base.53

I believe the secret to this mystery has got to do with the weighing of concerns about international competitiveness and tax leakage—two primary drivers not significantly addressed by Edgar. These are the objectives I ranked higher than tax arbitrage concerns earlier, based on observations of government actions over time.

For instance, the United States repealed its withholding taxes on much of its (arm’s-length) debts owing to non-residents on this premise. The following is from an article published in 1984:

Another major change is the exempting of foreigners from U.S. withholding tax (set at 30% unless reduced by a U.S. tax treaty) on interest on many new issues of U.S. debt securities. This new exemption will make it easier for both the U.S. government
and U.S. corporations to sell bonds abroad, thus helping to finance the U.S.’s heavy merchandise trade deficit.\textsuperscript{54}

This proposal became the US “portfolio interest exemption” that Edgar refers to, which excludes, however, certain contingent-payment debts. This approach was extended in the new US-UK tax treaty:

Under the new treaty, where the interest in question is determined by reference to:
- receipts, sales, income, profit or other cash flow of the debtor or a related person;
- any change in the value of any property of the debtor or a related person, or to any dividend, partnership distribution or similar payment made by the debtor to a related person,
then the jurisdiction in which the interest arises may withhold tax from that payment.\textsuperscript{55}

One can see in this approach an attempt by the two countries to balance concerns about international competitiveness (in this case, the withholding tax exemption for most types of ordinary interest) with concerns about undue or excessive tax leakage. That is, the tax deduction for potentially very large participating interest in the borrower’s country will be subject to 15 percent withholding tax under the new US-UK treaty. Therefore, while withholding taxes may address tax leakage concerns, they do not appear to be a tool for addressing cross-border tax arbitrage.

**Legislative Approaches**

The issue of “weak-currency borrowings” has received a tremendous amount of attention in Canada in the past few years as the Shell Canada case\textsuperscript{56} worked its way through the courts under the old rules before the GAAR and now as the Canadian Pacific (CP) case\textsuperscript{57} is being appealed under the GAAR. In the meantime, however, the federal government was not prepared to wait for the courts to resolve this matter and introduced amending legislation in the February 2000 budget in the form of a specific anti-avoidance rule. Two articles in a recent issue of the journal analyzed these rules and their economic effects in some detail.\textsuperscript{58} These rules will affect only weak-currency borrowings and will have no impact beyond that. It remains to be seen whether the GAAR will have any effect on the CP case under appeal, but there is no evidence so far that it will.

In interpreting the GAAR, the Tax Court of Canada stated: “No transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series.”\textsuperscript{59} One commentator interpreted this as follows:

It, therefore, remains unclear whether the judgement supports the principle that each step of the series must have its own bona fide non-tax purpose, which purpose was (in Canadian Pacific’s situation) the same as the overall purpose of the borrowing (i.e., to obtain the required borrowed funds at an attractive all-in cost), or whether it is based
on a finding that because the overall series has a bona fide non-tax purpose, each step must be considered within the umbrella of this purpose.\textsuperscript{60}

If the second view is sustained on appeal, then Canada will have nothing resembling a “step transaction doctrine,” such as those under common law principles in the United States and United Kingdom\textsuperscript{61} In that case, Canada might consider introducing a statutory rule that would empower the minister to combine a series of transactions if certain conditions are met. Until the CP case is resolved, however, such a rule may be premature, unless one sees in the Citibank decision\textsuperscript{62} another sign for the government that its drafting approach is flawed.

In Citibank the Tax Court had to decide whether the minimum conversion ratio in the terms of some BC Gas Inc. shares constituted a “guarantee” under the term preferred share rules that would make the dividends non-deductible to Citibank. In effect, the prescriptive legislative approach prevented the minister from applying a purposive approach and the government lost:

Mogan J. criticized the term preferred share definition as “prolix in the extreme,” and noted that the extremely detailed drafting merely invited equally detailed counter-drafting on the part of sophisticated taxpayers attempting to escape the language. The Minister’s argument that the Court would be contradicting the object and purpose of the provision by permitting the Shares to escape term preferred share treatment was defeated by the definition itself:

> It is so detailed; so particularized; so long and tedious and excessive in its use of language. The Respondent has put forward the object and purpose argument to show that the subject shares go against the spirit of the legislation. When the definition is drafted with such care, why can the Appellant not argue that it is flowing with (and not against) the spirit of the legislation when it has, with equal care, drafted the terms and conditions of the share which is outside the forbidden area of the definition?

Judge Mogan suggested that the legislative intent might better have been served by denying dividend deductions to any share “that may reasonably be regarded as” a debt instrument. Having chosen, rather, to adopt an extremely detailed definition, Parliament threw down the gauntlet and challenged taxpayers to a “drafting duel.” In this case, the taxpayer won [emphasis added].\textsuperscript{63}

The judge’s suggested solution emphasized above is simplistic and would not have achieved all the government’s objectives over the long period during which the term preferred share rules were being developed through patchwork legislation. For instance, there have been a number of ongoing exemptions\textsuperscript{64} for after-tax financing in the corporate sector, in order to permit financial institutions to finance corporations on a more tax-effective basis in certain situations (for example, where the borrower has tax losses and cannot use interest deductions). As noted earlier, making all corporate distributions deductible would likely increase the amount of unusable tax losses (which a flowthrough system would overuse with failed business losses flowing out to investors), and making all corporate distributions non-
deductible and non-taxable would prejudice corporations’ operating results and benefit only some (taxable) investors. However, I take the judge’s point as a clue that drafting more “purposive” legislation can be much more efficient than drafting results-oriented legislation when dealing with anti-avoidance concerns. The new weak-currency legislation65 is a case in point: it restricts taxpayers’ actions with detailed rules and quantitative guidelines, no matter what the motivations or changing economic environment may be. This means that the government has to rely on the completeness of its prescription and, if the Tax Court’s approach is sustained, not look to the GAAR to rectify loopholes where tax-motivated transactions occur.

Meanwhile, more complex legislation proliferates under the government’s results-oriented approach, such as the new foreign investment entity rules,66 of which some commentators have said “portions of [them] are totally incomprehensible”67 and “we’ve reached new heights of complexity in drafting style—which is extraordinary—and in concept and reach.”68

Another kind of legislation, distinct from the anti-avoidance rules, are measurement rules. Edgar suggests that the legislatures do not want to rely on the dictates of accountants,69 but he does not distinguish measurement from characterization rules. While it would be a mistake to rely on characterization rules,70 accounting measurement rules, with their accrual concepts, generally reflect economic reality better than legal principles, at least under generally accepted accounting principles (GAAP).

For instance, there are a variety of tax provisions that modify the general computation-of-profit rule in section 9 of the Act. Paragraphs 12(1)(a) and (b), for example, modify income recognition for the computation of amounts received or receivable, and numerous prescriptive provisions modify the deduction for expenses, such as paragraph 20(1)(c), which modifies the calculation of interest expense to allow that which is only paid or payable. This use of legal terms (in the sense of legal rights or obligations) for defining measurement can frustrate business transactions, as noted above with respect to compound-interest debts, and can also create opportunities to defer tax on income earned but not legally received or receivable. The accrual concept under GAAP is less precise and harder to define because it does not rely on legal results and the rights of taxpayers, but a definition could be added to subsection 248(1) of the Act along the following lines:

**Accrual method of reporting**—The method of recording transactions by which revenues and expenses are reflected in the determination of results for the period in which they are considered to have been earned and incurred, respectively, whether or not such transactions have been settled finally by the receipt or payment of cash or its equivalent.71

Some judgment would be required in the interpretation of this definition, of course, but only for the sake of more relevant measurement. The CCRA habitually refers to the appropriateness of GAAP72 where no specific provision applies and so it should appreciate this proposal. Paragraphs 12(1)(a) and (b) could be repealed
in favour of a rule that refers to the “accrual method of reporting income from a property or business.” Similarly, for interest expense, paragraphs 20(1)(c) and (d) could be amended to refer to accrued interest under the “accrual method of reporting” in addition to the “paid” alternative. A Canadian company would then be able to deduct compound interest and issue a zero-coupon obligation, as US companies can, and not be tax-disadvantaged. Numerous other provisions related to expenses in subdivision b of the Act could also refer to the accrual method instead of paid or payable methods. This proposal might look like it creates an advantage for taxpayers, but artificial rules create tax asymmetries, and the government might have won some matching principle cases like Canderel if such a concept had been in place. It is likely that better matching of income and expenses in accordance with GAAP would result in more tax symmetries between counterparties, and could be achieved without having to wait for a significant reform of the Act with respect to the taxation of financial transactions.

CONCLUSIONS

In summary, Edgar has done some great work in raising the debate concerning the taxation of financial instruments to a very high level. Although his proposals may have merit under certain ideals, I believe that it would take a very conclusive economic study, not yet undertaken, to persuade most governments considering the issue of financial tax asymmetry, that a world without tax preferences, at least in the capital markets, would be a more desirable world, both economically and politically, and this is not likely to happen until the issue of cross-border tax asymmetries is better addressed. However, one of the advantages of his book is that he shows how far a country would have to go to significantly address the problem.

Some comments made by Edgar in his review of the Australian Tax Office’s (ATO) discussion paper for reform in 1997 seem applicable here as well, with respect to both his book and his article:

Readers who are interested in the cross-border tax issues presented by financial instruments will be somewhat disappointed by the issues paper, which focuses principally on the domestic aspects. Although more fully developed than the discussion in the consultative document, the proposals in the issues paper regarding cross-border problems remain fairly conventional and tentative. In defence of the ATO, this result reflects a realistic view that the domestic aspects of financial arrangements are within the control of the Australian government and can be addressed unilaterally. Effective resolution of cross-border issues requires a level of international cooperation that is still extremely problematic.

Although Edgar continues in this review and in his book to comment on the practical problems with Australia’s purposive approach and suggests that the alternative of an “unquestioning acceptance of financial accounting standards” is equally inappropriate, I have argued that a selective use of both a purposive approach and GAAP would significantly improve the Canadian tax system, as opposed to a wholesale
adoption of either approach. Interested readers can judge for themselves whether my proposals would be worth pursuing. Of course, having the government do nothing is another option, but it seems unlikely in the long term.

In my 1995 article on this subject,76 I suggested that with relatively minor amendments to the Act the issue of derivative tax arbitrage could be adequately addressed, given competing constraints (as noted above), provided that the CCRA expanded its administration of the Act to handle modern financial transactions, including hedging. I am pleased to see that the CCRA is doing just that, as in its recent interpretation77 that a shorting transaction can be on capital account if it is a hedging transaction. This is an expansion of its isolated comment in a 1981 interpretation78 that all shorts were considered to be on income account. We should hope that this trend of embracing hedging theory (at least) will continue, and potentially avoid the need for a radical redrafting of the Act—that is, unless an entirely new and better drafting technique is developed.

NOTES

4 Edgar, supra note 1, at 75.
6 Edgar, supra note 1, at 78.
7 Ibid., at 432, note 44.
8 Section 38 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
9 Section 110.6.
10 Section 44.1.
11 Section 121.
12 Subsections 7(1.1) and 7(8).
13 Part X.3 of the Act.
14 Subsection 39(4).
15 Subsection 66(12.6) and related provisions.
16 Section 206.
17 Weisbach, supra note 3, at 37 and 63.
18 Ibid., at 48.
19 Edgar, supra note 1, at 33.
20 Ibid., at 71.
21 Ibid.
And their publicly traded or prospectused funds, which are mutual funds referred to in subsection 39(5) of the Act.

Edgar, supra note 1, at 95.

In a mark-to-market system, the distinction is irrelevant.

Weisbach, supra note 3, at 24.

Edgar, supra note 2, at 27-28. See also Edgar, supra note 1, at 116.


Edgar, supra note 1, at 117.


It should be noted that the United States did not introduce the OID rules to lose money (tax revenue). Borrowers on the accrual method were apparently already able to deduct the interest accrual and the rules were introduced to pick up cash-basis investors. However, this does not change the fact that deductions for corporate distributions cost governments tax revenues because some investors are tax-exempt and there is a lack of tax symmetry.

As discussed below, the Act uses legal terms like “paid” or “payable”—that is, terms with legal certainty—instead of accounting accrual rules. Many of the deduction provisions in subdivision b of the Act require payment, even though section 9 will respect accounting accrual rules for regular (non-capital) expenses. In my view, the goal of certainty in drafting is self-defeating for the government because the absence of a legal matching principle will create tax asymmetries that can always be exploited. Although paragraph 20(1)(d) was introduced, I believe, to accommodate the deduction of compound interest, the standard drafting style simply does not reflect economic reality, so zero-coupon debts are uneconomical more by accident than by intention.


Weisbach, supra note 30, at 47.


Ibid., at 1048.

Edgar, supra note 1, at 574, note 253.


Edgar, supra note 1, at 363, for example.

Hull, supra note 38.


“Canadians can ‘carry forward’ indefinitely unused contribution room into the future. A mountain of unused room has been building since 1991, and reached a cumulative $248.4-billion by 2000. New room based on earned income in 2001 is $58.1 billion, which makes the current unused contribution room $306.3-billion, said Statistics Canada client services officer Danielle Lessard.” Jonathan Chevreau, The Financial Post, November 30, 2001. He points out that total contributions are only about 10 percent of the available tax limits.
43 Edgar, supra note 1, at 97.
45 Except for Edgar’s brief analysis of withholding taxes, discussed below.
48 Edgar, supra note 1, at 310.
49 CCRA document no. 9406155, “T5 Reporting.”
52 Edgar, supra note 1, at 359.
53 Ibid., at 359-60.
54 Robert Brown, “U.S. Tax Law Causes Canadian Unease,” *The Financial Post*, May 11, 1984. It is interesting that the US government, presumably in the spirit of competition and a “level playing field,” applies basically the same withholding tax rules to its debts as the private sector, whereas the Canadian government only comprehensively exempts all of its and other governmental debts from withholding taxes. The exemptions in part XIII of the Act for the private sector are very narrow and are not eliminated in any treaty that Canada has signed. It appears that our government likes to play on a “tilted playing field,” while it quenches its thirst for deficit financing.
56 *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669 (SCC).
57 *Canadian Pacific Limited v. The Queen*, 2000 DTC 2428 (TCC).
59 Supra note 57, at paragraph 15.

See regulation 6201 and section 15.1 of the Act.

New section 20.3.

Draft amendments to section 94 and related provisions.


Robert Couzin, ibid.

Edgar, supra note 1, at 133.

For many reasons, including potential revenue loss to the government. For instance, if compound (convertible) debts were bifurcated as required under the Canadian accounting rules, interest expense would be created that may be payable to a tax-exempt entity (see May, supra note 61, at 542).


Canderel Limited v. The Queen, 98 DTC 6100 (SCC).


Ibid.

May, supra note 29.
