Further Reflections on Derivative Taxation

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PRÉCIS

Dans un récent article publié dans la présente revue, Tom Clearwater, faisait état du traitement fiscal disparate réservé à des opérations économiquement équivalentes portant sur des instruments financiers et citait l'arrêt de 1998 de la Cour d'appel fédérale, *The Queen v. Shell Canada Limited*. Il laissait entendre que la cour avait erré en appliquant des notions de théorie économique sans fondement législatif. La Cour suprême du Canada a récemment infirmé ce jugement. Les motifs n'ont pas encore été publiés.

Le présent article porte sur les conclusions de Clearwater selon qui la question de la substance économique est pertinente dans une perspective de politique fiscale, la règle générale anti-évitement ne réussira pas à contrecarrer des opérations comme celles effectuées par Shell Canada et le Parlement devrait envisager certaines modifications législatives précises, jusqu'à présent non identifiées ou non divulguées.

Par contraste, l'auteur fait valoir ici que l'accent mis sur la substance économique est déplacé et que les règles anti-évitement constituent en réalité l'outil le plus approprié pour le gouvernement (comme on l'a démontré, par exemple, au Royaume-Uni) dans la mesure où les principaux instruments financiers (par opposition aux instruments dérivés) sont imposés différemment selon les régimes fiscaux interne et étranger. L'auteur conclut, conformément à d'autres articles, que bien que certains changements d'ordre législatif limités soient justifiables—des changements de forme plutôt que des changements de fond, toutefois—dans un contexte général (par opposition aux circonstances particulières de *Shell Canada*), il n'existe à l'interne aucune solution globale et cohérente au problème autre que l'harmonisation internationale.

ABSTRACT

In a recent article for this journal, Tom Clearwater compared the disparate tax treatment of purportedly economically equivalent financial instrument transactions, focusing on the 1998 Federal Court of Appeal decision in *The Queen v. Shell Canada Limited*. Clearwater suggested

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that the court erred in applying economic substance criteria without statutory authority. The Supreme Court of Canada has recently overturned that decision, with reasons forthcoming.

This article examines Clearwater's conclusions that the issue of economic substance is relevant from a tax policy viewpoint, that the general anti-avoidance rule will be ineffective in thwarting transactions like the one in *Shell Canada*, and that some precise, but as yet unidentified or undisclosed, legislative amendments should be considered by Parliament.

Here, in contrast, it is argued that the focus on economic substance is misplaced and that anti-avoidance concepts are actually the more appropriate tool for the government (as demonstrated, for instance, in the United Kingdom), as long as primary financial instruments (as opposed to derivatives) are taxed differently under both domestic and international tax regimes. It is concluded here, in agreement with some other articles, that while certain limited legislative changes may be in order—though these would be more in the nature of improved drafting style than of substance—there is no comprehensive, internally consistent solution to the problem in general (as opposed to narrow circumstances like those in *Shell Canada*), other than through international harmonization.

In "The Judicial Role in Derivative Taxation: The Queen v. Shell Canada Limited and Financial Contract Economics,"[1] Tom Clearwater suggests that, owing to the absence of statutory direction, the Federal Court of Appeal (FCA)[2] overstepped its authority in employing economic theory to recharacterize Shell's transaction as effectively one composite transaction instead of two. The Supreme Court of Canada (SCC) is presumably in agreement since it has recently reversed that decision, with reasons forthcoming.[3] Clearwater further suggests that the general anti-avoidance rule (GAAR)[4] will be ineffective and that Parliament should become active in developing solutions to the taxation of derivatives through legislative reforms. However, in reaching his conclusions, he may have confused the issues of economic substance and anti-avoidance. In addition, he appears to be advocating a formulaic (or "prescriptive") approach to derivative taxation through legislative changes, although, after reviewing various alternative models, he did not propose any particular approach. I believe

[1] Tom Clearwater, "The Judicial Role in Derivative Taxation: The Queen v. Shell Canada Limited and Financial Contract Economics" (1998), vol. 46, no. 6 *Canadian Tax Journal* 1212-44.

[2] *The Queen v. Shell Canada Limited*, 98 DTC 6177 (FCA).

[3] *Shell Canada Limited v. The Queen*, June 14, 1999 (SCC).

[4] Section 245 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.

that this omission was for good reasons, and I would like to briefly respond to his two premises, drawing on some other current literature. I will argue, contrary to Clearwater, that less specific and not more specific legislation would enable the courts to do their job, at least in the context of transactions undertaken since GAAR was introduced.

To recap the facts of the *Shell Canada* case, Shell borrowed, under the issuance of five-year debentures, the equivalent of US $100 million in a so-called weak currency (New Zealand dollars at the time). The loan carried a high-risk premium on its interest rates, giving Shell a high annual (stated) interest cost. However, Shell immediately entered into a foreign currency forward contract to lock in a foreign exchange gain on maturity, which it reported on a deferred capital gains basis in year 5 for tax purposes. The FCA struck down the plan in its 1998 decision, using "financial integration" theory, and allowed Shell an interest deduction at only 9.1 percent (based on US borrowing rates) and not the 15.4 percent rate claimed. As noted, the SCC has reversed the decision, and perhaps this will help put an end to the use of economic substance criteria by the courts. However, it is Clearwater's comments on GAAR and his call for parliamentary action that I would like to address.

Clearwater puts forward the intriguing proposition that had Shell simply borrowed in the weak currency and not entered into the hedge contract, "interest-rate parity" would have left it neutral over time. He states that the forward contract "merely provides a measure of certainty to the borrower by allocating the risk of a misguided guess concerning future market movements to the lender-contractor."[5] This premise appears to be central to Clearwater's argument that

- the issue to be decided, as stated by the FCA, is inherently one of economic substance; and
- the FCA did not recognize that an ordinary weak currency borrowing with "spot" exchange-rate conversions was a legitimate economic alternative, and it was therefore in error to view a strong currency borrowing as the only "proper" choice.

Clearwater's disagreement appears to centre on the court's comment that "[t]he foreign exchange contracts were a necessary component of the plan to secure US $ funding at a commercial rate."[6] I suggest that this observation was correct, for two reasons:

1) A forward contract creates absolute certainty (subject to counterparty credit risk) of (in this case) locking in a predetermined foreign exchange gain.

2) The interest-rate parity theorem is used to set foreign currency contract rates but has little power to forecast a particular exchange rate on a

[5] Clearwater, supra footnote 1, at 1219, footnote 18. Again, at 1240, he states that the forward "agreement is unnecessary to making a weak currency hedge work." If this were true, it would mean that large sums of money are being misspent by corporate treasurers.

[6] Supra footnote 2, at 6187.

particular date (since forward rates can change daily). This theorem is based on a simple formula,[7] similar to all forward contracts, founded on arbitrage principles[8] and not forecasts.

Once one recognizes that Shell could not simply borrow in a weak currency and convert at spot rates and be risk neutral, the proper analysis (at least beginning with GAAR) should then be one involving anti-avoidance principles and not economic substance, as explained below.

Clearwater correctly describes derivatives as contracts that (are designed to) allocate risk between counterparties. However, in *Shell Canada*, this was found not to be the purpose of the transaction; in the court's view, the purpose was to save taxes. There was no real counterparty risk sharing in *Shell Canada* at all. Shell entered into a transaction that created risk and then eliminated the risk simultaneously by entering into a forward contract. The funds Shell borrowed were not to be used in any New Zealand operation—a use that would have potentially left Shell in a "self-hedged" situation—but instead were to be converted and used in the United States.

One might expect this creation of fictitious or unnecessary risk to be dealt with using broad interpretative principles.[9] There is good precedence for that approach in the United Kingdom. The difficulties of using precise legislation, as called for by Clearwater, will be discussed later on. The 1995 UK court decision in *Uniholdings Ltd.*[10] at least shows it is possible for a court to apply "the composite transaction approach." Like *Shell Canada*, this case involved a corporation borrowing in a foreign currency and simultaneously entering into a forward contract to eliminate currency risk. However, in *Uniholdings Ltd.* the company was offered a lower interest rate by borrowing in a strong currency (US dollars) instead of British pounds. This was not a tax-motivated transaction, and in fact the company would be potentially worse off if the borrowing and hedging

[7] See any derivatives textbook, such as John C. Hull, *Options, Futures, and Other Derivatives*, 3d ed. (Englewood Cliffs, NJ: Prentice-Hall, 1997), referred to in Clearwater, supra footnote 1, at 1218, footnote 14.

[8] Arbitrageurs can "long" and "short" equivalent financial positions to ensure that any dichotomies in pricing between derivative positions and underlying positions are quickly exploited. Hedge pricing permits the pricing of forward contracts to be based on today's underlying values without forecasting values. This is not the case for all derivatives; for instance, there is no "closed form" solution to pricing North American options. (That is, there is no compact formula comparable to the interest-rate parity formula, and numerical procedures are required such as using a modified Black-Scholes formula with a Taylor series expansion.) See, for example, Hull, supra footnote 7.

[9] The court, by overlooking this point and turning its attention to economic substance and financial integration, created a "straw man" that Clearwater was able to "knock down." As he says, supra footnote 1, at 1240, "[t]he court's integration test will therefore create asymmetrical tax results, as it did in *Shell Canada*, wherever multiple parties transact on one side of a composed hedge transaction" (composite?).

[10] *Whittles (HMIT) v. Uniholdings Ltd. (No. 3)*, 1995 BTC 119 (Ch. D.), analyzed by David Wentzell, "Taking the Composite Transaction Approach to the Taxation of Derivatives," Current Cases feature (1996), vol. 44, no. 1 *Canadian Tax Journal* 153-56.

were treated as separate transactions. This was the position taken by the Inland Revenue (the opposite of the FCA's position in *Shell Canada* for obvious reasons), which on reassessment "characterized the loss on the repayment of the loan (which was an amount equal to the gain on the forward contract) as a loss on a borrowing and thus not available under UK tax law for offset against the gain on the forward contract."[11] In commenting on the *Uniholdings Ltd.* decision, David Wentzell explains:

> The court then applied the approach taken by the House of Lords in the *Ramsay* decision. Simply put, that approach "establishes that for fiscal purposes a composite transaction must be regarded as a whole, the court not being bound to consider individually each separate step." When *Ramsay* was applied to the Uniholdings situation, the legal result was that there was no gain or loss when the forward contract matured and the loan was finally discharged.[12]

In the 1997 Conference Report, Scott Wilkie and Heather Kerr survey the anti-avoidance doctrine in a number of countries, including the United Kingdom.[13] They describe the UK criteria, in the landmark *Ramsay* decision,[14] for the composite transaction approach as

> (1) a preordained series of transactions or a composite transaction and (2) the insertion of steps having no commercial (business) purpose apart from the avoidance of liability to tax. Under the *Ramsay* principle, if these two requirements were satisfied, the inserted steps could be disregarded for fiscal purposes.[15]

Although the *Uniholdings Ltd.* decision was reversed on appeal in 1996 in a two out of three majority decision,[16] on the basis of the subtleties of the interpretation of "composite transaction,"[17] one can imagine the relevance

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[11] Ibid., at 154.

[12] Ibid., at 155.

[13] J. Scott Wilkie and Heather Kerr, "Common Links Among Jurisdictions: Informing the GAAR Through Comparative Analysis," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 34:1-30.

[14] *W.T. Ramsay v. Inland Revenue Comrs.*, [1982] AC 300 (HL).

[15] Supra footnote 13, at 34:10.

[16] *Whittles (HMIT) v. Uniholdings Ltd. (No. 3)*, [1996] BTC 399 (CA).

[17] The crucial issue appears to have been that the court felt it could not override or ignore clear statutory provisions "which provide that only losses 'accruing on a disposal of an asset' shall be allowable." Ibid., at 415. This may be a part of the SCC's rationale in overturning the FCA's decision in *Shell Canada* as well, where we have a specific legislative rule for interest deductibility in paragraph 20(1)(c). In this case, the government may want to take another look at the 1990 recommendations to make interest deductibility a more general rule under section 9: see report of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, "Submission to the Minister of Finance on the Issue of Deductibility of Interest," in *Canadian Tax Reports*, Special Report no. 964, extra ed. (Don Mills, Ont.: CCH Canadian, August 1990). This approach of having more general rules and subjecting them to anti-avoidance rules (or "non-qualifying" exclusions) is the opposite of Clearwater's recommendation of continuing to pursue (the inevitable ongoing patchwork of) specific legislative amendments.
(The footnote is continued on the next page.)

of such a concept in an anti-avoidance situation. In any event, the *Ramsay* decision was apparently further clarified by the House of Lords in the 1997 *McGuckian* decision.[18] Wilkie and Kerr comment:

> It was in the *McGuckian* case that Lord Brown-Wilkinson coined the expression "real transaction." He used the expression to refer to the transaction that could be said to have taken place once the *artificial steps were stripped out* [emphasis added].[19]

Wilkie and Kerr also note the views of a UK author that may be relevant to Canada:

> Edward Nugee observes that the principles of statutory interpretation set out in *McGuckian*, coupled with the avoidance/mitigation distinction in *Willoughby*, produce a test for avoidance in the United Kingdom that is not very different in some respects from the Australian "dominant purpose" test or the US "no business purpose" test and, he proposes, may be used to interpret the "misuse or abuse" test in the Canadian GAAR.[20]

Further, Wilkie and Kerr note the following critical point:

> The *Willoughby* case also confirms that, in the United Kingdom, a determination of the "real" transaction *does not* involve the identification of a transaction that achieves an economically equivalent result [emphasis added].[21]

Therefore Clearwater appears to be correct in suggesting that the FCA improperly applied economic analysis in *Shell Canada* to arrive at a "proper result."[22] However, he may be incorrect in criticizing, as he does, a 1995 article by Scott Wilkie in which Wilkie recommends a "more activist interpretive"[23] approach. Once we recognize that Shell needed a forward contract because a straight borrowing in a weaker currency (with periodic "spot" conversions) was not, in fact, an "economic equivalent" to a strong currency borrowing, the force of Clearwater's argument that a

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17 Continued . . .
Moreover, as the Mintz report noted, "[t]he use of a detailed drafting style can also lead to situations in which the underlying purpose of tax legislation is not clear." Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 10.7.

18 *IR Commrs. v. McGuckian*, [1997] BTC 346 (HL).

19 Wilkie and Kerr, supra footnote 13, at 34:10.

20 Ibid., at 34:12.

21 Ibid., at 34:13, discussing the decision in *IR Commrs. v. Willoughby*, [1997] BTC 393 (HL).

22 This approach is not new for this court. In the 1992 income-splitting case of *The Queen v. Kieboom*, 92 DTC 6382, the FCA adopted the concept of "economic interest" in arriving at its decision. That decision still stands and is quoted with affection by Revenue Canada from time to time (see, for example, Revenue Canada document no. 9828555, January 14, 1999). However, the recent case of *Shepp v. The Queen*, 99 DTC 510 (TCC), may help put an end to this approach, as well as the SCC's overturning of *Shell Canada*.

23 J. Scott Wilkie, "Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1144-66, at 1166.

legislative fix is required to deal with economic substance is significantly weakened. It is not at all clear that economic substance was the real issue in the *Shell Canada* "avoidance" transaction. Even if GAAR proves ineffective in such circumstances, the argument here is simply that a more specific anti-avoidance rule could easily do the trick[24] without having to deal with issues of substance—an area potentially even beyond the scope of Parliament, for reasons discussed below.

Clearwater does explore a number of alternative taxation models for derivatives (mark-to-market, bifurcation, etc.), but this is a whole other subject that is far beyond the issues arising from Shell's transactions. He also identifies problems with each alternative model he reviews and hence falls short of recommending anything other than that Parliament should "begin resolving the uncertain matter of derivative taxation."[25] This is much easier said than done because—as has been pointed out elsewhere[26]—as long as we maintain certain fundamental tax principles, such as realization, and distinctions between capital and non-capital and between debt and equity, a consistent model for derivative taxation is not possible.

Fortunately, in the next issue of this journal following the publication of Clearwater's article, Richard Wood tackles the broader issue of alternative economic models for derivative taxation and even makes some concrete recommendations.[27] He also quotes a comment by a US tax commentator, that "the current differential treatment of stocks and bonds precludes consistent treatment of all financial contracts"[28]—an observation similar to the above remarks. Wood is under no illusions that this situation is about to change. He states:

> In what follows it is assumed that an international consensus on this issue will not emerge in the near future and that the tax treatments of debt and equity are broadly fixed, particularly for smaller capital-importing countries.[29]

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[24] For instance, along the lines of the UK "composite transaction" concept whereby unnecessary artificial steps are "stripped out" of a series of transactions. The *Shell Canada* type of transaction might also require a change in the interest deductibility rules (as I mentioned in footnote 7, supra) to a less specific (or narrow) basis. However, as explained in footnote 41, infra, the *Shell Canada* transaction is just a minor example of tax asymmetry between domestic capital gains and interest deduction rules. The real action is with cross-border tax asymmetries, for which no real answer appears to be on the horizon.

[25] Clearwater, supra footnote 1, at 1244.

[26] See Glenn L.E. May, "Overview of Financial, Tax, and Accounting Principles for Derivative Financial Instruments," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 29:1-27, at 29:2, for the Canadian context; and Bradford L. Ferguson, "The Rationales for the Rules: How To Think About Derivatives in the Tax World" (December 1994), 72 *Taxes: The Tax Magazine* 995-1026, at 1026, for the US context.

[27] Richard Wood, "The Taxation of Debt, Equity, and Hybrid Arrangements" (1999), vol. 47, no. 1 *Canadian Tax Journal* 49-80.

[28] Ibid., at 60, footnote 26.

[29] Ibid., at 57.

Returning to Clearwater's analysis, he fully reveals his desire for a formulaic (prescriptive legislative) approach in his criticism of the SCC's decision in *Canadian Deposit Insurance Corp. v. Canadian Commercial Bank (CDIC)*,[30] where the court was forced to make an "either/or" choice between debt and equity.[31] However, it is difficult to see how he would draft remedial legislation to avoid the court's choice based on the "predominant" features. As I noted in my 1995 article, the more specific the legislation, the easier it is to "fall outside" it, as demonstrated in the United States.[32]

Richard Wood also illustrates this issue in his footnotes when, for instance, he describes the ill-fated attempt of the US Internal Revenue Service to prescribe rules "to determine whether an interest in a corporation is to be treated as debt or equity. . . . While regulations were issued in 1980, they were so controversial that they were subsequently withdrawn."[33] He also quotes a US tax commentator's statement that "it is not possible to characterize an instrument as equity or debt by reference to a checklist of abstract attributes."[34] Clearly, after a long history of analysis, the United States has decided that such issues of (legal) substance should be left to the courts, quite the opposite of Clearwater's suggestion. Characterization issues are involved in a variety of areas in Canadian income tax law, such as capital versus non-capital items and property versus business income. Presumably Clearwater would be more comfortable with a mathematical approach to all such areas instead of human judgment.[35] There are pros and cons, but singling out debt-equity distinctions tends to ignore the bigger picture, which would entail a more comprehensive debate. In addition, "debt-like shares" in Canada are already typically captured

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[30] *Canadian Deposit Insurance Corp. v. Canadian Commercial Bank (CDIC)* (1992), 97 DLR (4th) 385 (SCC).

[31] Clearwater, supra footnote 1, at 1225.

[32] May, supra footnote 26, at 29:26.

[33] Wood, supra footnote 27, at 59, footnote 23.

[34] Ibid., at 59, footnote 25, quoting David P. Hariton, "Distinguishing Between Debt and Equity in the New Financial Environment" (Spring 1994), 49 *Tax Law Review* 499-524, at 522.

[35] In the recent case of *Speciality Manufacturing Ltd. v. The Queen*, 99 DTC 5222 (FCA), the court held that a debt-equity ratio of over 100,000:1 did not indicate an "arm's length" relationship. Presumably Clearwater would find this to be "judicial interference" and would prefer an all-encompassing statutory definition of "non-arm's-length," including some prescribed debt-equity ratio that was clearly not "commercial" (such as 20:1?). The problem with this approach is that there are no suitable all-encompassing definitions. (For example, is equity to be measured at book value or at fair market value? And what about the infinite array of other potential indicia?) The statutory prescriptive approach simply substitutes the judgment of one group (government officials) for that of another (the judiciary) without deference to appropriate weighting in the particular circumstances. While it is agreed that Parliament must set the guidelines (the basic rules of the game), human judgment is inevitable. See supra footnote 34 and accompanying text on the particular problem of defining debt and equity.

under some form of preferred share legislation[36] with very intricate rules. Clearwater's approach would have to be integrated with these rules or else wait for their repeal, neither of which appears very promising.

Readers can decide for themselves whether or not Wood's proposed economic model is worth pursuing. It would involve a type of "legislative activism" that Clearwater says we need. It is interesting to note, however, in light of the above-noted constraints (that is, an ongoing debt-equity distinction and definitional problems), that Wood's recommended approach was a bifurcation approach (he calls it "dual bifurcation") of debt-equity attributes. The most obvious candidate for bifurcation is convertible debt, as is now required for accounting purposes in many cases.[37] However, in the United States, such instruments are exempt from the US bifurcation tax rules.[38] It seems that governments are loath to apply complex bifurcation rules to instruments that may cost them tax revenues in the process.[39]

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[36] Such as "term preferred shares" and "taxable preferred shares" (both defined in subsection 248(1) and some unnamed variations in section 112). The accounting now treats many such shares as debt (see infra footnote 37), and in many cases they would be debt in the United States. However, our policy makers may have been more clever (perhaps less fair for those looking for "tax symmetry"), since dividends on such "debt-like" shares are not deductible to issuers (that is, they are still treated as equity distributions) but are ultimately taxable to investors (even if passing through corporate investors and tax-exempts and ultimately to the "true" Canadian taxpayers, individuals). While some tax credits may be attached, the 25 percent dividend gross-up and credit usually does not offset the typical 40 percent or higher corporate tax rate. Tax revenue considerations tend to drive tax policy; see infra footnote 39 and accompanying text.

[37] Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), section 3860.

[38] See, for instance, May, supra footnote 26, at 29:10, for a discussion.

[39] Bifurcation of an equity component from a compound debt instrument for tax purposes would, by following the accounting approach, increase deductible interest expense to the issuer and the investor may be a tax-exempt. See May, supra footnote 26, for further elaboration. In 1990, Tim Edgar made an unusual (unrealistic?) recommendation to treat all hybrid securities, such as convertible or participatory debts, the same as "taxable preferred shares" (see supra footnote 36). Tim Edgar, "The Classification of Corporate Securities for Income Tax Purposes" (1990), vol. 38, no. 5 *Canadian Tax Journal* 1141-88, at 1175. This approach might address the revenue concerns of the government (to a limited degree) but is hardly palatable to the corporate sector. Tax asymmetries would be reduced in a narrow sense (that is, many types of hybrids would be taxed equally) but increased in a broader sense. First, there would be a net increase in tax, since dividend tax credits for individuals do not generally offset underlying corporate taxes and are meaningless to tax-exempts. Second, corporate effective tax rates would increase for what is considered to be an expense for accounting purposes—that is, interest expense on debt, such as the debt component of a convertible—but would be non-deductible; thus, the tax and accounting treatments would be polar opposites, even for simple interest. It would seem naive to believe that such negative results would not affect behaviour in such a way that the government would come out a loser again. For instance, companies might react by avoiding the issuance of convertible debt with low interest and switch to high "coupon" straight debt with warrants. The related option premiums are tax-exempt unless they expire under subsection 49(2), and the government would be out of pocket to the extent that investors were tax neutral (for example, tax-exempts). The government also has to be sensitive to the

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In any event, Wood's "legislative approach" is subject to the caveat that his recommendations are not of great value unless a large group of countries adopt the same rules.[40] This is because the "real action" is on the cross-border front.[41]

In summary, it appears that the issues raised in *Shell Canada* are more of an anti-avoidance, rather than an economic substance, nature. Although certain technical amendments appear to be appropriate,[42] it is not apparent that a major legislative overhaul is relevant, unless a group of countries wish to get together and start by agreeing on debt-equity definitions, if that were possible as opposed to just wishful thinking.[43]

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39 Continued . . .
international competitiveness of Canadian companies, which might be impaired, for instance, if only Canadian companies were punished for issuing convertible debt and other hybrids (via non-deductible interest). The various bifurcation proposals then would generally cause either revenue loss for the government or a significant tax cost to corporations, depending on the choices made. Consequently, it is small wonder that nothing has happened along these lines.

40 See Wood, supra footnote 27, at 77.

41 There is lucrative and active trading in cross-border financial instruments by tax arbitrageurs. Academic articles, such as Alvin C. Warren Jr., "Financial Contract Innovation and Income Tax Policy" (December 1993), 107 *Harvard Law Review* 460-92 (referred to in Clearwater's article, supra footnote 1, at 1215, footnote 7, as his "primary" source), which refer to US domestic derivative models in isolation of the rest of the world, tend to overlook this point. For instance, if dividends on a preferred share are deductible to a US corporate payer under the US "in-substance" debt classifications and are tax-free dividends to a Canadian company under Canada's foreign affiliate rules, where does the solution lie? Neither country can claim to be "right" (or, alternatively, both can!); they are two different conceptual models and are simply asymmetrical with each other. However, such amounts of corporate earnings can be free from worldwide taxation. Derivatives linked to such instruments can also be treated asymmetrically for tax purposes. (There are some fascinating examples of these in the marketplace.) The examples go well beyond financial instruments and include entity status (limited liability companies, unlimited liability companies, etc.), leasing (capital versus operating), and securitizations (on or off balance sheet)—all discussed in past Canadian Tax Foundation articles and papers. Tax arbitrage will likely continue as long as sovereign states independently pursue their own tax policies. This is the critical point, referred to again in footnote 43, infra.

42 See supra footnote 17 and also some recommendations made in May, supra footnote 26, at 29:27.

43 In a broader context, John Helliwell (commenting on the Mintz report) notes, "Many of the perceived pressures on the domestic tax system are due to differences in tax status or rates in other jurisdictions. The most effective way of dealing with international discrepancies is harmonization." John Helliwell in Stanley Winer, rapporteur, "The Report of the Technical Committee on Business Taxation (the Mintz Report): A Panel Discussion by Michael P. Devereux, Roger Gordon, and John Helliwell, with a Comment by Jack Mintz" (1998), vol. 46, no. 6 *Canadian Tax Journal* 1245-77, at 1268.