Some Lessons from the Saga of Weak-Currency Borrowings

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PRÉCIS

L'auteur soutient qu'il y a deux grandes leçons générales à tirer de la saga entourant les emprunts en devises faibles, sujet qui a fait l'objet des affaires *Shell Canada Limitée c. La Reine* et *Canadien Pacifique Limitée c. La Reine*, pour l'élaboration d'une méthode cohérente de traitement fiscal des instruments financiers. La première leçon porte sur le besoin d'imposer de façon uniforme les flux de trésorerie équivalents. Le traitement fiscal uniforme, bien qu'il puisse facilement constituer un objectif politique de nature générale, est difficile à instaurer en ce sens que ceux qui élaborent les politiques fiscales doivent définir des flux de trésorerie équivalents, tels qu'ils ressortent de certaines parités d'évaluation et de rapports qui sous-tendent l'évaluation par arbitrage des instruments financiers. Les emprunts en devises faibles ne mettent en lumière qu'un seul exemple particulier d'un manque d'uniformité dans le traitement fiscal des flux de trésorerie équivalents, tel qu'ils ressortent de la parité de taux d'intérêt. Pour les besoins de l'imposition uniforme des titres de créance en monnaie nationale et en devises, les émetteurs et les porteurs de titres doivent comptabiliser les gains et pertes de change prévus. Le fait qu'un titre de créance soit considéré ou non comme un instrument de couverture n'est pas pertinent pour l'établissement d'une solution législative destinée à parvenir à ce résultat.

La seconde leçon concerne les limites du pouvoir judiciaire en tant qu'acteur important dans l'élaboration d'une méthode d'imposition des instruments financiers fondée sur des principes. En effet, l'auteur ajoute que l'adoption d'un régime de lois complet est le moyen le plus efficace d'éliminer le manque d'uniformité, qui constitue une source de complications et qui va bien au-delà de la parité de taux d'intérêt et des emprunts en devises faibles. Un régime pratique et théoriquement défendable ne suppose rien de plus que l'extension logique de

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certaines caractéristiques des régimes fiscaux existants. Plus particulièrement, une distinction entre les gains et pertes prévus et non prévus constitue un fondement valable pour l'établissement d'un régime efficace de second choix dans le contexte d'un impôt sur le revenu fondé sur la réalisation. Cette distinction, qui est au cœur d'un régime de comptabilisation global, n'est que partiellement établie en vertu des régimes fiscaux existants. La saga entourant les emprunts en devises faibles n'est qu'un exemple de l'échec général d'accepter toutes les implications de cette distinction comme fondement pour l'élaboration d'une méthode raisonnable d'imposition des instruments financiers.

Bien qu'un régime de comptabilisation global puisse faire disparaître, dans bien des cas, le manque d'uniformité dans le traitement fiscal, diverses contraintes pratiques font appel à des compromis qui donnent lieu à des discontinuités ennuyeuses dans le traitement fiscal, en raison desquelles des changements mineurs dans la composition des flux de trésorerie entraînent des résultats fiscaux dont les écarts sont disproportionnés. L'auteur indique que les tribunaux peuvent jouer un rôle utile en traçant des règles régissant les limites qui donnent lieu à des discontinuités et à des occasions de planification fiscale. En voulant forcer les tribunaux à se décharger de cette responsabilité dans le contexte d'un régime de comptabilisation global, ceux qui élaborent des politiques fiscales peuvent s'en remettre à une combinaison de dispositions anti-évitement précises et à une approche fondée sur des facteurs pour qualifier des instruments particuliers de titres d'emprunt, de titres de participation ou d'instruments dérivés.

ABSTRACT

The author of this article argues that the saga of weak-currency borrowings, as played out in *Shell Canada Limited v. The Queen* and *Canadian Pacific Limited v. The Queen*, provides two important general lessons for the development of a coherent approach to the income tax treatment of financial instruments. The first lesson concerns the need for consistent taxation of equivalent cash flows. Although easy to state as a general policy goal, consistent taxation is difficult to implement in the sense that tax policy makers must identify equivalent cash flows as revealed by certain pricing parities and relationships that underlie the arbitrage pricing of financial instruments. Weak-currency borrowings highlight only one particular instance of an inconsistency in the tax treatment of equivalent cash flows as revealed by interest-rate parity. Consistent taxation of domestic-currency and foreign-currency debt requires the accrual recognition of expected exchange gains and losses by issuers and holders. The status of a debt instrument as hedged or not is entirely irrelevant to the design of a legislative approach intended to realize this result.

The second lesson concerns the limitations of reliance on the judiciary as a significant policy actor in the development of a principled approach to the taxation of financial instruments. Indeed, the author argues that adoption of a

comprehensive legislative regime is the most effective means to eliminate troublesome inconsistencies that go beyond interest-rate parity and weak-currency borrowings. A workable and theoretically defensible regime involves nothing more than the logical extension of certain features of existing income tax systems. In particular, a distinction between expected and unexpected gains and losses provides a defensible basis for the design of an effective "second-best" regime in the context of a realization-based income tax. This distinction, which lies at the core of a comprehensive accrual regime, is only partially developed under existing income tax systems. The saga of weak-currency borrowings is just one example of a general failure to accept the full implications of this distinction as the basis for the development of a sensible approach to the taxation of financial instruments.

Although a comprehensive accrual regime can suppress many inconsistencies in tax treatment, various practical constraints require compromises that create troublesome "discontinuities" in tax treatment, whereby small changes in the pattern of cash flows result in disproportionately different tax results. The author argues that the courts can play a useful role in "policing" the boundary lines that give rise to discontinuities and tax-planning opportunities. In an effort to force the courts to discharge this responsibility in the context of a comprehensive accrual regime, tax policy makers can rely on a combination of specific anti-avoidance rules and a "factors approach" to the characterization of particular instruments as debt, equity, or derivatives.

INCONSISTENCIES, DISCONTINUITIES, AND THE CUBBYHOLE APPROACH TO THE TAXATION OF FINANCIAL INSTRUMENTS

This article reviews the saga of weak-currency borrowings as played out in *Shell Canada Limited v. The Queen*[1] and *Canadian Pacific Limited v. The Queen*.[2]

1 99 DTC 5669; [1999] 4 CTC 313 (SCC), rev'g. 98 DTC 6177; [1998] 2 CTC 207 (FCA), rev'g. 97 DTC 395; [1997] 2 CTC 2023 (TCC).

2 99 DTC 5132; [1999] 2 CTC 193 (FCA), aff'g. 98 DTC 2021; [1998] 4 CTC 2023 (TCC). The Federal Court of Appeal granted leave to appeal to the Supreme Court of Canada under section 37.1 of the Supreme Court Act. On November 10, 1999, the Supreme Court of Canada referred the matter back to the Federal Court of Appeal to be addressed in accordance with the reasons in *Shell*, supra footnote 1. See Roger Taylor, "Kiwi GAAR Hearing Delayed?" (December 28, 1999), vol. 7, no. 12 *Canadian Tax Highlights* 89-96, at 91. In a judgment delivered from the bench on February 17, 2000, the Federal Court of Appeal decided to remit the case back to the Tax Court of Canada (Bonner TCCJ) for findings of fact and a decision on whether the general anti-avoidance rule (the GAAR) is applicable to one of the two borrowings of the taxpayer at issue. The minister of national revenue conceded that the decision of the Supreme Court in *Shell* was determinative of the treatment of the other

The decisions in these two cases highlight some important conceptual points that are significant not only in the relatively narrow areas of foreign-currency debt and exchange gains and losses, but also for the income tax treatment of financial instruments generally.[3] Perhaps most important, the decisions support the argument for a limited reliance on the judiciary as a significant policy actor in the taxation of financial instruments. In short, the approach of the courts to the treatment of weak-currency borrowings under the Income Tax Act[4] illustrates all too clearly the need for legislative responses.[5] The important policy question concerns the apparent limitations of past legislative practice, which consists of a series of ad hoc responses designed to address particular instruments and categories of financing charges. Consideration of the viability of this legislative practice necessarily requires an assessment of the design features of more comprehensive legislative solutions.

The approach to the treatment of financial instruments currently reflected in the Act has been referred to as "the tax cubbyhole system." Under this approach, every financial instrument must be classified and its associated cash flow slotted within an accepted cubbyhole that attracts one of a defined set of different tax treatments. The tax cubbyholes are defined by certain features incorporated into the Act that result in differences in tax treatment associated with

- ordinary income versus capital amounts,
- dividends versus interest, and
- realization versus accrual recognition of gains and losses.

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borrowing in the case. The Federal Court of Appeal remitted this latter matter back to the minister for reassessment in accordance with the reasons of Supreme Court in *Shell*. See Federal Court of Appeal, docket: A-480-98, February 17, 2000. The substantive issues associated with the two borrowing in *Canadian Pacific* are discussed infra footnotes 23 to 28 and accompanying text.

3 Many of these ideas were discussed in a paper presented by the author at the Canadian Tax Foundation's 1997 Corporate Management Tax Conference: Tim Edgar, "The Tax Treatment of Interest and Financing Charges in a World of Financial Innovation: Where Should We Be Going?" in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 10:1-57. This article updates the earlier paper to account for judicial and legislative developments following the Tax Court of Canada decision in *Shell*, supra footnote 1.

4 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.

5 On this point, see also 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, arguing for legislative responses; and Glenn L.E. May, "Further Reflections on Derivative Taxation" (1999), vol. 47, no. 3 *Canadian Tax Journal* 534-43, doubting the need for further legislation in the absence of reform that eliminates fundamental asymmetries.

Capital gain and loss treatment is available for investors who hold instruments on capital account and not as traders; dividend treatment is available for instruments that are considered shares; interest treatment is limited to debt financing charges within the restrictive legal definition of interest; gain or loss (other than interest) is recognized when realized; and specific rules for the taxation of option premiums are limited to forward-based contracts that are properly characterized as call and put options.

These distinctions are artificial in the sense that they are irrelevant in capital markets, which recognize basic equivalences that underlie the arbitrage pricing of financial instruments. Although an oversimplification, it is probably correct to say that all cash flows, whatever their form, must be valued for capital market purposes, and differences in attributes affect the valuation exercise only.[6] Arbitrage pricing identifies equivalent cash flows and ensures that they are priced equivalently. Under the recognized tax cubbyholes, slight changes in the form of financial instruments can produce significant differences in tax treatment that contrast with financial theory and its recognition of certain basic equivalences. The differences in tax treatment permit the replication of cash flows associated with conventional instruments in unconventional forms that attract different tax consequences[7] and create opportunities for tax avoidance. In addition, the need to classify new instruments for the purposes of specified tax treatments generates substantial uncertainty that can discourage the use of particular instruments for non-tax purposes.

In essence, a tension exists between the reality of financial equivalences recognized by capital markets and the specified differences in tax treatment for certain conventional instruments embodied in the existing income tax system. The tension manifests itself in tax-avoidance opportunities centred on "inconsistencies" and "discontinuities" under the tax cubbyhole system.[8] "Inconsistencies" arise when equivalent cash flows associated with different financial instruments are taxed differently. "Discontinuities" arise when small changes in the pattern of cash flows produce disproportionately different tax results. In this respect, two aspects of the process of financial innovation are critical for tax policy purposes:

- First, all financial instruments are composites of a set of basic building block instruments (forwards, futures, swaps, options, and credit-extension [debt]

6 Lewis R. Steinberg, "Commentary" (Summer 1995), 50 *Tax Law Review* 725-29, at 725.

7 Alvin C. Warren Jr., "Financial Contract Innovation and Income Tax Policy" (December 1993), 107 *Harvard Law Review* 460-92.

8 Jeff Strnad, "Taxing New Financial Products: A Conceptual Framework" (May 1994), 46 *Stanford Law Review* 569-605.

instruments) that provide a single payoff on the occurrence of a single contingency, resulting in expected time-value returns and/or unexpected gains and losses attributable to the resolution of a bet.[9] "Hybrid instruments" consist of the combination of two or more separate instruments in one legally distinct instrument.[10] "Synthetic instruments" consist of the combination of two or more legally distinct instruments to replicate the cash flow pattern associated with another legally distinct instrument.[11]

- Second, basic parities or financial equivalences (interest-rate parity, futures parity, put-call parity, and option pricing) underlie the arbitrage pricing of the building block instruments.

The tax cubbyhole approach reflected in the Act fails to recognize in any systematic sense these fundamental aspects of the process of financial innovation. As noted above, it is based on specified tax treatments for a limited range of conventional instruments. These specified treatments are often inconsistent in their treatment of expected gains and losses; they also require the articulation of boundary lines that are the source of discontinuities.

Some commentators have suggested that maintenance of the traditional tax cubbyholes is untenable in a world of financial innovation. However, many of these same commentators consider the problems presented by financial innovation to be intractable for any income tax system that falls short of the "accretion ideal" (that is, recognition of the full amount of gains and losses as they arise with changes in the value of financial instruments).[12] It is argued here that radical reform of the Canadian income tax system is unnecessary.[13] The challenges presented by the latest wave of financial innovation are no different, in principle, from some of the more limited challenges of the past, and the fundamental features of past responses require only some limited modifications to

9 Reed H. Shuldiner, "A General Approach to the Taxation of Financial Instruments" (December 1992), 71 *Texas Law Review* 243-350.

10 David A. Weisbach, "Tax Responses to Financial Contract Innovation" (Summer 1995), 50 *Tax Law Review* 491-544.

11 Ibid.

12 The term "accretion taxation" is used here to avoid confusion with the term "accrual taxation" in its more limited sense of a requirement to spread expected gains and losses over the term of a financial instrument for the purpose of recognizing such amounts as they are expected to arise (that is, "accrue").

13 See also May, supra footnote 5; and 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.

provide a workable and theoretically defensible system.[14] The more limited responses to the prior challenges of financial innovation are fundamentally sound and provide a defensible paradigm for a modified approach that is described in certain of the US tax literature[15] and is reflected, in part, in the mark-to-market legislation in sections 142.2 to 142.6 of the Act. Moreover, a comprehensive version of this legislation applied to a broad range of taxpayers and financial instruments has been implemented in New Zealand[16] and is about to be adopted in Australia.[17] As a second-best alternative to accretion taxation, this legislative approach (referred to here as "a comprehensive accrual regime") minimizes, to the greatest extent possible, the inconsistencies and discontinuities that plague the traditional tax cubbyhole system.

The next section of the article reviews the decisions in *Shell* and *Canadian Pacific* in an effort to emphasize some arguments in support of a comprehensive accrual regime. I discuss the failure of the courts to achieve consistent treatment of domestic-currency and foreign-currency debt, and outline the legislative approach in New Zealand as a possible corrective measure. In this respect, it is notable that the Department of Finance, in the February 28, 2000 budget, has proposed the adoption of a limited version of the New Zealand approach as a legislative response to weak-currency borrowings.

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14 The types of limited modifications that constitute the modest legislative agenda described here are suggested by Daniel Halperin, "Saving the Income Tax: An Agenda for Research" (November 24, 1997), 77 *Tax Notes* 967-77.

15 David P. Hariton, "The Taxation of Complex Financial Instruments" (Summer 1988), 43 *Tax Law Review* 731-88; Stephen B. Land, "Contingent Payments and the Time Value of Money" (Winter 1987), 40 *The Tax Lawyer* 237-306; Nöel B. Cunningham and Deborah H. Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership" (Summer 1992), 47 *Tax Law Review* 725-814; Robert H. Scarborough, "Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives" (December 1994), 72 *Taxes: The Tax Magazine* 1031-49; and Shuldiner, supra footnote 9.

16 Income Tax Act, 1994 (New Zealand), as amended, subpart H of part E, sections EH A1 to EH 18 (division 1 applicable generally to financial arrangements entered into on or after October 23, 1986 and before May 20, 1999); and sections EH 19 to EH 59 (division 2 applicable generally to financial arrangements entered into on or after May 20, 1999).

17 Australia, *Taxation of Financial Arrangements: A Consultative Document* (Canberra: Australian Government Publishing Services, December 1993); Australia, *Taxation of Financial Arrangements: An Issues Paper* (Canberra: Australian Government Publishing Services, December 1996); Australia, Review of Business Taxation, *A Platform for Consultation—Building on a Strong Foundation: Overview of the Taxation of Investments*, Discussion Paper 2, vol. 1 (Canberra: Australian Government Publishing Services, February 1999), chapters 5-7; Australia, Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (Canberra: Australian Government Publishing Services, July 1999), chapter 9; and Australia, *Draft Legislation: A New Tax System (Income Tax Assessment) Bill 1999* (Canberra: Australian Government Publishing Services, July 1999).

I draw two general lessons from the saga of weak-currency borrowings. The first lesson is the importance of consistency as a policy goal in the taxation of financial instruments. Although that goal is easy to state, it is difficult to attain. It must be defined in a manner that accurately accounts for the pricing parities and other relationships that underlie the arbitrage pricing of financial instruments.

The second lesson of the saga of weak-currency borrowings is the need for a comprehensive and coherent legislative scheme to minimize troublesome inconsistencies and discontinuities. Specific anti-avoidance rules, along with a "factors approach" to the classification of particular financial instruments, can be used to control tax avoidance focused on discontinuities along boundary lines that necessarily remain because of constraints in the design of comprehensive legislation. The courts can potentially perform a useful, but limited, role in interpreting and applying these rules and maintaining the distinction between debt and derivatives, and debt and equity. Inconsistencies in tax treatment should be resolved to the greatest extent possible by the core elements of a legislative regime applicable to financial instruments.

The article concludes with an outline of the principal elements of a modest agenda for legislative reform. The details of these proposals and their related policy rationales are developed in detail in a forthcoming monograph to be published by the Canadian Tax Foundation.[18]

APPLICATION OF THE TAX CUBBYHOLES TO WEAK-CURRENCY BORROWINGS

Weak-currency borrowings are a financing technique used by some Canadian corporations in the late 1980s and early 1990s. The tax benefit associated with such borrowings is well known; it is based on a tax-avoidance opportunity presented by inconsistency in the tax cubbyhole treatment under the Act for such borrowings[19] and the underlying economics reflected in a particular financial equivalence, "interest-rate parity." As explained in any textbook on corporate finance or financial markets,[20] interest-rate parity describes a basic relationship between interest rates and forward currency exchange rates that reflects

18 Tim Edgar, *Income Tax Treatment of Financial Instruments: Theory and Practice* (Toronto: Canadian Tax Foundation, forthcoming).

19 For an extensive discussion of the cubbyhole treatment of weak-currency borrowings under the Act, see Stephen S. Ruby, "Recent Financing Techniques," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 27:1-46, at 27:2-33.

20 See, for example, Charles W. Smithson, *Managing Financial Risk: A Guide to Derivative Products, Financial Engineering, and Value Maximization*, 3d ed. (New York: McGraw Hill, 1998), 60-67.

arbitrage-pricing conditions.[21] Under those conditions, forward currency exchange rates do not reflect the market's best guess about the future strength of specific currencies but are a function of the difference in interest rates for borrowings in different currencies. More particularly, the difference between the forward and spot exchange rates for two currencies must equal the difference between interest rates for borrowings in the same currencies. This equivalence ensures that an investment in a weak currency yields the same expected return as an equivalent investment in a stronger currency. In the absence of such an equivalence, an opportunity to realize riskless profits would arise, and arbitrage traders would enter the market to seize the opportunity in a way that would quickly equate the rates of return in the two currencies and restore price equilibrium.

The financial equivalence expressed by interest-rate parity means that a portion of the higher interest rates associated with a weak currency compensates lenders for the expected loss in value of their loan principal on repayment. For borrowers in such currencies, a portion of the nominal interest payments represents a repayment of principal. Forward-exchange agreements covering future interest payments and repayments of loan principal can be used to lock in the amount of the expected loss in value of the weaker currency. Where a taxpayer fully hedges foreign-currency debt with forward-exchange agreements, the debt is converted into a synthetic domestic-currency borrowing.

The two cubbyholes under the Act relevant for weak-currency borrowings are those for interest expense, which is recognized generally on an annual accrual basis, and foreign exchange gains, which are recognized on realization at a preferential three-quarters rate where they are capital in nature for the particular taxpayer. With a weak-currency borrowing, the borrower can deduct the full amount of nominal interest expense on an annual accrual basis while deferring the inclusion of an offsetting exchange gain until the repayment of the loan principal, even though the amount of that gain is fixed from the outset of the borrowing under a forward-exchange agreement.[22] Such treatment is non-neutral as compared to an equivalent borrowing in Canadian dollars and flies in

21 Interest-rate parity is expressed as $Ef/Es = (1 + ir)/(1 + id)$ where Es is the spot exchange rate for two currencies; Ef is the forward exchange rate; ir is the interest rate for the foreign currency; and id is the interest rate for the domestic currency. Multiplying both sides of the equation by Es reveals the relationship between spot and forward exchange rates: that is, $Ef = (1 + ir)/(1 + id) \times Es$. The significance of the relationships expressed by interest-rate parity for income tax purposes and, in particular, for the treatment of foreign exchange gains and losses is explained in David G. Broadhurst, "Income Tax Treatment of Forward Exchange Contracts, Swaps, and Other Hedging Transactions," in the 1989 Conference Report, supra footnote 19, 26:1-32, at 26:22-32.

22 This point is illustrated in considerable detail in Ruby, supra footnote 19, at 27:2-33.

the face of the financial equivalence expressed by interest-rate parity. Taxpayers are able to lower their after-tax cost of financing by altering the form of their borrowings to take advantage of the tax cubbyholes that provide different tax treatment for equivalent cash flows.

Subject to some slight differences in the details, the taxpayers in *Shell* and *Canadian Pacific* implemented the same basic structures to take advantage of the tax-avoidance opportunity provided by the tax cubbyhole treatment of weak-currency borrowings under the Act. On May 10, 1988, Shell Canada Limited ("Shell") entered into a weak-currency ("Kiwi") loan whereby it borrowed NZ $150 million for five years from a syndicate of lenders at an annual interest rate of 15.4 percent. Shell also entered into a master forward agreement with Sumitomo Bank ("Sumitomo") under which Shell agreed to (1) sell NZ $151.987 million for US $102.014438, (2) deliver to Sumitomo on the interest payment dates an amount of US dollars equivalent to the amount of interest payments in NZ dollars, and (3) deliver to Sumitomo on the maturity of the loan an amount of US dollars equivalent to the NZ $150 million loan principal.[23] In return, Sumitomo agreed to deliver the amount of the NZ dollar interest payments to Shell on the interest payment dates, as well as NZ $150 million on maturity of the loan. Each of these amounts was determined on the basis of forward exchange rates for the US dollar/NZ dollar. Shell had no need for NZ dollars in its business and wanted to borrow an amount of US dollars equal to the amount of the NZ dollar borrowing (converted at the spot exchange rate), which it accomplished pursuant to the master forward agreement with Sumitomo.

Canadian Pacific Limited ("Canadian Pacific") implemented two separate weak-currency borrowings: (1) a NZ dollar borrowing; and (2) an "Aussie/yen" borrowing. The former was arranged by Goldman Sachs and involved the issue on December 1, 1987 of NZ $125 million debentures with a seven-year term and a nominal interest rate of 16.8 percent per annum. The NZ dollars were immediately swapped into Canadian dollars, and Canadian Pacific entered into a series of forward contracts under a master forward agreement with Sumitomo to purchase the required NZ dollar cash flows. The Aussie/yen borrowing was arranged by RBC Dominion Securities and involved the issue on April 21, 1989 of A $260 million debentures with a five-year term and a nominal interest rate of 16.125 percent per annum. The Australian dollars were immediately swapped into Japanese yen, which were used to purchase Canadian dollars at the prevailing spot rate. This time Canadian Pacific entered into a series of forward contracts under a master swap agreement with Morgan Guaranty Trust to purchase the

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23 The NZ $1.987 million difference between the amount of the loan principal and the amount advanced to Shell represented a premium received for entering into the loan.

required yen cash flows. Yen were interposed between the Australian dollar borrowing and the acquisition of Canadian dollars to achieve much the same effect as the NZ dollar/US dollar exchange in *Shell*; that is, the interposition of a stronger currency between the Australian dollar borrowing and the acquisition of Canadian dollars provided a larger expected exchange gain attributable to the larger spread in interest rates between the Australian dollar and the yen. The principal difference was, of course, the fact that Canadian Pacific had no use for yen. Shell at least had a need for US dollars in its business.

The conclusions of the various courts in *Shell* and *Canadian Pacific* are relatively straightforward. The difficulty lies in the fact that the conceptual bases underlying those conclusions are irreconcilable. To qualify as deductible interest under paragraph 20(1)(c), the nominal interest payments in a weaker foreign currency must be properly characterized as interest within the restrictive legal definition.[24] In addition, the amounts must be considered reasonable, and the borrowed funds must be used for a qualifying income-earning purpose. In *Shell*, both the Tax Court of Canada and the Supreme Court accepted the taxpayer's arguments that the nominal interest payments expressed in NZ dollars should be fully deductible under paragraph 20(1)(c). The interest rate was a market rate that both courts found to be reasonable for the purposes of paragraph 20(1)(c). Moreover, the courts found that the interest payments satisfied the restrictive legal definition of interest and were used for a qualifying income-earning purpose as traced through to the use of the US dollars in Shell's business. The foreign-currency gain was properly recognized on realization when the NZ dollar borrowing was repaid. The Tax Court and the Supreme Court characterized this gain as a capital amount, because it arose in connection with a long-term borrowing by Shell.

At the Federal Court of Appeal, Mr. Justice Linden (speaking for the majority) concluded that the portions of the NZ dollar interest payments that compensated the lender for expected declines in the value of the NZ dollar principal were, in fact, payments of principal. Accordingly, these particular portions of the NZ dollar interest payments were not compensation for the use of borrowed money as required by the legal definition of interest. Furthermore, the majority considered the full amount of the nominal interest payments to be unreasonable to the

24 Under the legal definition of interest developed by the courts, an amount is characterized as interest only if (1) it represents compensation for the use of money, (2) it is calculated with reference to an outstanding principal amount, and (3) it accrues on a daily basis. For a discussion of the judicial development of this concept and its application under the Act, see Tim Edgar, "The Concept of Interest Under the Income Tax Act" (1996), vol. 44, no. 2 *Canadian Tax Journal* 277-347.

extent that it compensated the lenders for expected declines in the value of the NZ dollar. Mr. Justice Linden also characterized the purpose of the NZ dollar borrowing as tax-motivated and a non-qualifying use that could be severed from the qualifying use of the US dollars. To the extent that the compensating foreign currency gain was accounted for in a reduction of the nominal interest payments, Mr. Justice Linden recognized that the relevant tax cubbyhole for such amounts should not apply, since the gains were effectively accounted for on an accrual basis as ordinary income amounts.

At least in terms of substantive principles, the only significant distinguishing feature of *Canadian Pacific* is the possible application of the general anti-avoidance rule (the GAAR) in section 245 of the Act. The NZ dollar borrowings in *Shell* and *Canadian Pacific* were implemented before the application date of the GAAR. However, Canadian Pacific's Aussie/yen borrowing was implemented after that date, and the minister of national revenue assessed, in the alternative, on the basis of the GAAR. Although Bonner TCCJ had considerable sympathy for the conclusions reached by his colleague Christie TCCJ in *Shell*,[25] he considered himself bound to follow the decision of Mr. Justice Linden, which was released during the hearing of *Canadian Pacific*. The possible application of the GAAR to the Aussie/yen borrowing by Canadian Pacific was not an issue and was not considered. In very brief reasons, the Federal Court of Appeal initially affirmed this result and the reasoning of the Tax Court in *Canadian Pacific*.

The reversal of Mr. Justice Linden's decision by the Supreme Court of Canada brings the GAAR back into play for weak-currency borrowings implemented after the application date of the GAAR (including, in particular, the Aussie/yen borrowing in *Canadian Pacific*). Revenue Canada (now the Canada Customs and Revenue Agency) has stated that it will consider the application of the GAAR to such borrowings if the relevant funds are not needed in the business of the borrower.[26] Whether the courts will uphold this position remains to be seen.

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25 Bonner TCCJ spent considerable time articulating his reasoning in the event that he was free to decide the case unconstrained by the decision of the Federal Court of Appeal in *Shell*, supra footnote 1. Largely for the same reasons as those provided by the Tax Court in *Shell*, Bonner TCCJ preferred to permit the deduction of the full amount of nominal interest expense expressed in the weak currency. However, he would have characterized the foreign exchange gain on the forward agreements as ordinary income amounts.

26 Revenue Canada document no. 982994, November 19, 1998. May, supra footnote 5, at 539-40, suggests that an appropriate legislative response would be a specific anti-avoidance rule targeted to weak-currency borrowings in which the borrower has no use for funds in the relevant currency. This suggested approach is reflected to a large extent in the legislative response recently proposed by the Department of Finance. See infra footnotes 50 to 52 and accompanying text.

Taxpayers have two principal arguments supporting the inapplicability of the GAAR.[27] The first argument is one that makes the GAAR difficult to apply in any financing transaction. Taxpayers are almost always able to point to a need for borrowed funds in their businesses, and thus can rely on the exception from the definition of an avoidance transaction for those transactions that can reasonably be considered to be undertaken primarily for a non-tax purpose. With weak-currency borrowings, the success of this argument depends on the adoption of an approach that looks broadly to the borrowing transaction in the currency that is required in the business of a taxpayer. A narrower focus on the need for the particular foreign currency can lead to the conclusion that the funds were borrowed for the tax-avoidance opportunity presented by the existing tax cubbyholes in the Act. Even if considered tax-avoidance transactions, weak-currency borrowings may not be subject to the GAAR on the basis that they do not constitute a misuse of a particular provision or do not result in an abuse of the provisions of the Act read as a whole.[28] It may be very difficult for a court to conclude that the deduction of the full amount of nominal interest payments in a foreign currency based on a market rate constitutes a misuse of paragraph 20(1)(c) or an abuse of the tax cubbyhole system read as a whole.

As noted above, the primary difficulty for the courts and for taxpayers highlighted by *Shell* and *Canadian Pacific* arises from the fact that the different conclusions depend on which of two irreconcilable approaches is applied to characterize the relevant transactions. The possible application of the GAAR would not seem to affect this basic problem in any way. In particular, application of the tax cubbyholes under the Act to hedged weak-currency borrowings depends on the characterization of the component parts of the borrowings either as a single composite transaction that should be treated as a synthetic domestic-currency borrowing or as separate transactions that should be taxed independently. At a general level of principle, the approach to this characterization issue involves the standard arguments about the need to respect transactions that are "commercially real" and not artificial or abnormal because they are consistent with some perception of "normal business practice."[29] The Supreme Court of

27 Richard B. Thomas, "Shellshocked!" Current Cases feature (1998), vol. 46, no. 2 *Canadian Tax Journal* 357-65. Although the application of the GAAR was not at issue in *Shell*, supra footnote 1, these arguments were alluded to by the Supreme Court with apparent approval in the context of former section 245, which prohibited the deduction of expenses that could be considered "artificial" or "undue."

28 Subsection 245(4).

29 See, for example, Brian J. Arnold, "Canadian Tax Court Approves Kiwi Loans" (April 28, 1997), 14 *Tax Notes International* 1367-68; and Richard B. Thomas, "Tax Avoidance with a Little Help from Downunder," Current Cases feature (1997), vol. 45, no. 2 *Canadian Tax Journal* 295-301.

Canada decision in *Shell* is just the latest in a line of avoidance cases that cite "commercial reality" as a supposed basis for respecting the legal form adopted by taxpayers for tax-planning purposes.

The alternative to this approach characterizes transactions based on perceptions of economic substance and applies the relevant provisions of the Act to that perceived substance. It is probably accurate to say that a lack of well-defined criteria for the application of a characterization approach based on economic substance underlies a distaste of Canadian tax practitioners and many judges for this approach.[30] However, the content of "commercial reality" and "legal substance" is also elusive. In a sense, the debate over "legal form versus economic substance" as a basis for the characterization of transactions is no more than a thinly veiled cloak for various unarticulated reasons that are assumed to justify a boundary between abusive and acceptable tax avoidance. Indeed, the basic tension in *Shell* and *Canadian Pacific* is one that runs through a long line of tax-avoidance cases. In most instances, the effectiveness of a tax-avoidance transaction depends on the significance of the legal form of the relevant arrangements necessary to attract a tax treatment that is inconsistent with the underlying economics.[31] With tax-avoidance arrangements, taxpayers inevitably rely on the paramountcy of legal form as a means of realizing the particular tax benefits. The Canada Customs and Revenue Agency is left arguing that the legal form should be ignored in favour of a perceived economic substance, which should provide the basis of taxation.

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30 For a review and discussion of the approach of Canadian courts to the characterization of transactions based on notions of economic substance, see Brian A. Felesky and Sandra E. Jack, "Is There Substance to 'Substance Over Form' in Canada?" in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 50:1-63. US courts have been much more willing to ignore legal form and characterize transactions on the basis of their perceived economic substance. For an excellent discussion of the scope of this approach, see David P. Hariton, "Sorting Out the Tangle of Economic Substance" (Winter 1999), 52 *The Tax Lawyer* 235-73. As a response to sophisticated "corporate tax shelters," the US Treasury department has recently proposed a statutory economic substance test to replace the judicial doctrine. See United States, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (Washington, DC: US Treasury Department, July 1999).

31 Canadian courts and tax practitioners tend to use the term "legal form" in a more restrictive sense to describe an approach to the characterization of transactions that accepts the label used by taxpayers. See *Shell*, supra footnote 1, at 5676; 328: "Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect." This sense of the term is so narrow that it is virtually useless in the analysis of tax-avoidance transactions. To accept the label used by taxpayers as determinative for tax purposes is tantamount to a taxpayer-elective system, which is obviously intolerable. The general issue in tax-avoidance transactions is the extent to which the courts are bound to accept the private law form of transactions that have independent legal significance. This

Whatever the verbal formulas invoked by taxpayers, the courts, and tax administrators, the fundamental question is the same from a tax-avoidance perspective: when should the legal form be respected in preference to the substantive economics? In the context of the existing tax cubbyhole system governing the income taxation of financial instruments, the answer to this question is not at all clear. It is argued below that responsibility for some kind of sensible answer lies with the Department of Finance. In particular, the department should consider the adoption of a comprehensive accrual regime to address troublesome inconsistencies more completely.

LESSON ONE: CONSISTENCY AND THE TREATMENT OF FOREIGN-CURRENCY DEBT

For tax policy makers, the debate over legal form or economic substance as the basis for the design of a tax system is irrelevant. Any sensible and coherent system of taxation designed to finance the provision of public goods and redistribute wealth should take appropriate account of the economic results of particular transactions.[32] The task of tax policy makers is to explore the extent to which tax legislation is constrained by a need to tax on the basis of legal form and/or the use of alternative approaches to implement taxation on the basis of economic substance. Viewed from this perspective, tax-avoidance cases, such as the weak-currency borrowings in *Shell* and *Canadian Pacific*, are interesting only because they highlight weaknesses in the underlying structure of an income tax system based on legal form and variations in that form as proxies for economic income and changes in economic income.[33] The tax treatment of

wider sense of "legal form" is often referred to as "legal substance." See, for example, 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. The term "legal form" in its wider sense is used here to describe an approach to the characterization of transactions that is based on an uncritical acceptance of the relevant private law relationships.

32 See, for example, *A Tax System Redesigned*, supra footnote 17, at 15: "A major motivation of the reforms to the taxation of financial arrangements was to ensure that different forms of financial instruments are taxed according to their economic substance rather than their legal form."

33 Neil Brooks, "The Responsibility of Judges in Interpreting Tax Legislation," in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997), 93-129, at 94-95. This general point is emphasized in a comment on the decision of the Australian High Court in *FC of T v. Spotless Services Limited & Anor*, 96 ATC 5201, considering the application of the general anti-avoidance rule in part IVA of the Income Tax Assessment Act, 1936, as amended. See Richard Krever, "The Ghost of the Duke of Westminster Laid to Rest in Australia?" Current Cases feature (1997), vol. 45, no. 1 *Canadian Tax Journal* 122-30. See also *A Tax System Redesigned*, supra footnote 17, at 242-45, emphasizing the need for structural reform as the principal response to tax-avoidance transactions.

financial instruments is one area in which a dependence on legal form may be severely strained. Weak-currency borrowings and the decisions in *Shell* and *Canadian Pacific* are significant for their provision of yet another illustration of the weaknesses of the tax cubbyhole approach and its reliance on legal form as a means of categorizing cash flows for purposes of the Act.

The consistent taxation of equivalent cash flows should be a minimal requirement of any sensible legislative regime. Otherwise, there are opportunities for "pure tax avoidance" in the sense that a tax-preferred legal form can be substituted for another form without compromising important non-tax considerations.[34] These instances of pure avoidance entail small, or no, efficiency losses, yet the revenue losses can be significant. In the narrow context of weak-currency borrowings, it is difficult to conceive of any compelling policy reason that justifies the attendant revenue loss and mandates preferential treatment as compared to that accorded an equivalent domestic-currency borrowing. Viewed from this broader policy perspective, Mr. Justice Linden's judgment is defensible in its realization of consistent treatment of domestic-currency borrowings and hedged foreign-currency borrowings. However, his reasoning is arguably limited to tax-driven weak-currency borrowings and does not clearly extend to hedged strong-currency borrowings, even though the associated foreign exchange loss is the equivalent of an additional amount of interest that equates the return with that in a weaker currency.[35] In fact, Revenue Canada confirmed its position that the foreign exchange loss on such a borrowing is not interest within the restrictive legal definition and can be recognized only on realization (that is, repayment of the borrowing) generally as a capital loss.[36] Although the Tax Court and Supreme Court decisions in *Shell* result in the inconsistent treatment of all hedged foreign-currency borrowings and Canadian dollar borrowings, they at least realize consistent treatment of borrowings in a foreign currency, whether that currency is weaker or stronger than the Canadian dollar. The common weakness of all the judgments is the focus on the integration of a foreign-currency loan or borrowing with related hedging transactions as determinative in the attempt to realize

34 Michael Brooks and John Head, "Tax Avoidance: In Economics, Law and Public Choice," in *Tax Avoidance and the Rule of Law*, supra footnote 33, 53-91, at 54-78; and Myron S. Scholes and Mark Wolfson, *Taxes and Business Strategy* (Englewood Cliffs, NJ: Prentice Hall, 1992), chapters 6 and 7.

35 In *Whittles (HMIT) v. Uniholdings Ltd. (No. 3)*, [1995] BTC 119, the UK Chancery Division accepted an integrated approach to the characterization of a fully hedged strong-currency borrowing, with the effect that the foreign-currency loss was treated as additional interest expense. The decision was overturned on appeal by the UK Court of Appeal, [1996] BTC 399. The foreign-currency loss was characterized as a capital amount that was non-deductible because it did not arise on the disposal of an asset as required by the capital gains tax legislation.

36 Revenue Canada document no. 9219187, November 17, 1994.

consistency of tax treatment. Indeed, the policy implications of interest-rate parity are not in any way limited to hedged foreign-currency debt (whether in a weaker or stronger currency).[37]

Over the long term, differences in exchange rates reflect differences in the inflation rates of countries that are, in turn, reflected in different interest rates. Although currency exchange rates and interest rates tend to be closely correlated, spot exchange rates are not exact reflections of differences in interest rates, and movements in the former are unpredictable in the short term. In other words, the relationship between spot exchange and interest rates is not a causal one, and gains and losses arising because of movements in spot rates are entirely unexpected in the short term.

To the extent that foreign exchange gains and losses are attributable to movements in spot rates, and hence are entirely unexpected, they are equivalent to unexpected gains and losses that arise on domestic-currency debt with changes in interest rates. Moreover, because the amounts are entirely unexpected, an accrual method of accounting is inappropriate. The inappropriateness of accrual recognition applies equally to unexpected exchange gains and losses associated with foreign-currency debt, the physical holding of foreign currency, or the assumption of a derivative position in a forward, futures, or swap contract written on foreign currency. The financial equivalence expressed in interest-rate parity means only that expected movements in exchange rates should be accounted for on an accrual basis, in the same manner as the expected gain and loss in the form of interest is recognized on a domestic-currency obligation. To the extent that expected gains and losses on foreign-currency debt are attributable to expected exchange rates, but are not recognized on an accrual basis, the expected cash flows are ignored and the associated amounts are excepted from accrual recognition. Foreign-currency debt is taxed inconsistently with domestic-currency debt otherwise subject to the accrual recognition of all expected returns associated with all expected cash flows. Lenders have an incentive to invest in stronger currencies with expected gains that are understated for tax purposes.[38] Borrowers have an incentive to borrow in weaker currencies with expected losses that are overstated for tax purposes.[39]

37 But see May, supra footnote 5, at 539-40, where the author argues that an unhedged weak-currency borrowing is not, in fact, the equivalent of a borrowing in a stronger currency. May's proposition appears to be based on the fact that an unhedged borrowing exposes the issuer to unexpected gains and losses attributable to movements in the spot exchange rate. The problems with this narrow view of equivalency are discussed infra, footnotes 38 to 41 and 45 to 48 and accompanying text.

38 See New Zealand Inland Revenue, *Taxation of Financial Arrangements: A Discussion Document* (Wellington, NZ: New Zealand Inland Revenue, Policy Advice Division, December 1997), 47-49.

39 Ibid., at 44.

The significance of interest-rate parity therefore lies in the fact that, from a strictly ex ante perspective, all foreign-currency debt (whether hedged or not) is the equivalent of debt denominated in the domestic currency of a taxpayer. Consistent treatment of both types of instruments requires the application of a yield-to-maturity calculation that treats expected exchange gains and losses as interest income and expense subject to accrual recognition.[40] Unexpected exchange gains and losses can be treated as ordinary income or capital amounts subject to realization-based recognition. This result is achieved, for example, under the New Zealand accrual regime,[41] which equates the expected yield on foreign-currency debt with that on a domestic-currency instrument and requires the same amount to be spread on a yield-to-maturity basis. Unexpected gains and losses attributable to movements in the spot exchange rate are recognized in full on realization as non-capital amounts, as are unexpected gains and losses attributable to movements in the market rate of interest. Expected gain or loss is measured by using forward exchange rates[42] to determine the expected NZ dollar value of all future cash flows, which are spread on a yield-to-maturity basis over the term of the relevant foreign-currency instrument. Realized amounts are converted to the NZ dollar equivalent at the prevailing spot rate, which gives rise to unexpected exchange gains or losses.

As an alternative to an "expected-return" approach, the "retranslation basis" modifies the tax cubbyholes applicable to foreign-currency debt by requiring the recognition of (1) nominal interest income or expense over the term of a loan at the relevant spot exchange rate, and (2) changes in the value of the loan principal

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40 Ibid., at 43. In principle, the characterization of expected exchange gains and losses as additional amounts of interest income or expense should apply for non-resident withholding tax purposes. With weak-currency borrowings, the amount of nominal interest expense would be reduced by the expected exchange gain. With strong-currency borrowings, the amount of the nominal interest expense would be increased by the expected exchange loss. See Julian S. Alworth, "Taxation and Integrated Financial Markets: The Challenges of Derivatives and Other Financial Innovations" (1998), vol. 5, no. 4 *International Tax and Public Finance* 507-34, at 517, where the author suggests that non-resident withholding tax be applied to the embedded interest element of foreign-currency debt, calculated as the difference between the spot exchange rate on issue and forward exchange rates corresponding to the series of expected cash flows.

41 New Zealand Inland Revenue, *Determination* G9B, "Financial Arrangements That Are Denominated in a Currency Other than New Zealand Dollars: An Expected-Value Approach," May 1998.

42 *Taxation of Financial Arrangements*, supra footnote 38, at 45: "the best objective measure we have of expected exchange rate movements is the set of forward exchange rates"; and at 44: "We believe that advances in financial markets and information technology mean this [the lack of quoted forward rates] is no longer a constraint. Quoted forward rates are now more accessible, and where a rate is not quoted, ready access to spreadsheet software makes their calculation from interest rate information reasonably straightforward."

based on movement in the spot exchange rate from the beginning to the end of a taxation year.[43] This approach is based on an assumption that the close correlation between currency exchange rates and interest rates means there is an interest element in exchange gains and losses that should be subject to accrual recognition.[44] The retranslation basis, however, produces inconsistent results in all cases of domestic-currency and foreign-currency debt, largely because it requires the recognition of unexpected exchange gains and losses before realization. The same assumption is not applied to changes in the value of domestic-currency debt caused by movements in interest rates, which are generally recognized only on realization. There appears to be no obvious tax policy reason for the inconsistent treatment of comparable unexpected exchange gains and losses on foreign-currency debt. As suggested below, the application of accretion taxation to all gains and losses on financial instruments can be justified under a realization-based income tax as the most effective means to address the selective realization of unexpected losses. That justification applies most obviously where financial instruments can be traded at low transaction costs. Nothing about the nature of foreign-currency debt suggests that it should always fall within this justification, while domestic-currency debt does not. To address tax-avoidance opportunities and eliminate distortions in debt capital markets, foreign-currency debt that cannot be traded at low transaction costs should be taxed consistently with comparable domestic-currency debt. Such treatment requires adoption of the expected-return approach reflected in the New Zealand legislation and its limitation of accrual recognition to expected exchange gains and losses. Accretion taxation can be applied equally to traded foreign-currency and domestic-currency debt instruments that present problems of selective realization.

Another alternative to expected-return taxation is reflected in the US Internal Revenue Code and is largely consistent with the approach applied by Mr. Justice Linden in *Shell*.[45] Under this approach, accrual recognition of expected exchange gains and losses is limited to "fully hedged" foreign-currency debt, which

43 See, for example, paragraphs 142.3(1)(a) and (b) of the Act and draft regulations 9101(1)(c), and 9101(2)(b), and 9104(1), governing the recognition of foreign exchange adjustments on non-traded debt held by a financial institution. The retranslation basis was the original method adopted under the New Zealand accrual legislation for foreign-currency borrowings and loans. See New Zealand Inland Revenue, former *Determination* G9A, "Financial Arrangements That Are Denominated in a Currency or Commodity Other than New Zealand Dollars," December 4, 1989.

44 See, for example, Susan Glazebrook and Robin Oliver, *The New Zealand Accrual Regime: A Practical Guide* (Auckland: CCH New Zealand, 1989), 130-31, where this assumption underlies the authors' case for the adoption of the retranslation basis.

45 In *Canadian Pacific*, supra footnote 2, at 2022-23; 2026 (TCC), Bonner TCCJ accepted that this approach was consistent with the financial accounting treatment.

is integrated with offsetting derivative positions and accounted for as a synthetic domestic-currency instrument.[46] Application of this "integration" approach is based on a recognition that the cash flows associated with a domestic-currency debt instrument are replicated by the combination of cash flows associated with a foreign-currency borrowing or loan and forward-exchange agreements entered into to cover future payments of interest and principal. In effect, by entering into offsetting positions in derivative instruments written on the foreign currency, a borrower or a lender can ensure that the amount of any exchange gain or loss equals the expected amount reflected in forward exchange rates. This result occurs because an unexpected gain or loss on the series of interest and principal cash flows attributable to movements in the spot exchange rate is offset by a corresponding loss or gain on the related derivative.

Unlike the retranslation basis, an integration approach achieves some consistency in taxation of foreign-currency and domestic-currency debt by treating fully hedged foreign-currency debt as a synthetic domestic-currency instrument. However, consistent taxation of foreign-currency and domestic-currency debt is achieved only where an instrument is considered fully hedged within the relevant legislative concept. With an unhedged (or "partially hedged") instrument, expected exchange gains and losses reflected in forward rates are not treated as interest equivalents and are recognized on realization, as are unexpected gains and losses attributable to movements in the spot exchange rate.[47] This significant difference in tax treatment creates an important discontinuity where small changes in the risk associated with a foreign-currency borrowing or loan can result in disproportionate changes in treatment associated with its status as hedged or unhedged.

By treating all foreign-currency debt as the equivalent of a domestic-currency obligation, an expected-return approach such as that adopted in New Zealand eliminates this discontinuity and the need to define a hedged instrument subject to treatment as a synthetic.[48] Forward-exchange agreements covering future

46 See Internal Revenue Code of 1986, as amended (herein referred to as "IRC"), section 988(d) and reg. section 1.988-5(a)(9)(ii), which together treat a hedged foreign-currency borrowing or loan as if it were entered into as a single US dollar instrument.

47 In effect, no attempt is made to bifurcate exchange gains and losses into expected amounts equivalent to interest and unexpected amounts attributable to other factors that determine movements in exchange rates. However, some measure of character matching is realized under the US rules by the treatment of all foreign exchange gains and losses as ordinary income amounts recognized on realization. See IRC section 988(d) and reg. section 1.988-5.

48 IRC section 988(d)(2)(A) defines a qualifying "section 988 hedge transaction" as a transaction entered into (1) "to reduce risk of currency fluctuations with respect to property which is held or to be held by the taxpayer," or (2) "to reduce risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred by the taxpayer."

interest payments and repayments of principal simply reduce or eliminate the amount of unexpected gain or loss that will arise with movements in the spot rate. As a result, the hedged nature of a borrowing affects only the amount of unexpected gain or loss that is appropriately subject to realization-based recognition. Viewed strictly ex ante, a foreign-currency instrument provides the same expected yield as a comparable domestic-currency instrument, whether or not the former is hedged. That same expected return should be subject to accrual recognition through the application of a comparable yield-to-maturity calculation, whether or not the instrument is hedged.

A narrowly targeted legislative response similar to that under either the New Zealand or the US legislation would be consistent with past legislative practice in its limitation to particular financial instruments.[49] In effect, a new tax cubbyhole could be created for either foreign-currency debt generally or a limited set of these instruments, such as hedged foreign-currency debt. Perhaps not surprisingly, the Department of Finance, in the February 28, 2000 budget, has continued to follow this past practice by proposing a new cubbyhole for weak-currency borrowings, defined generally as indebtedness the proceeds of which are converted into another currency that is used for a qualifying income-earning purpose.[50] For a limited range of instruments in this specified category, the

49 An obvious example of this legislative approach is subsection 18(9.2) of the Act, which treats interest prepaid by a corporation, partnership, or trust as a repayment of principal. The legislation was enacted as a response to the issue of long-term (40 to 99 years) "Canadian optional interest rate notes" (COINs) by a handful of Canadian corporations. In the absence of a legislative response, it is arguable that an uncritical acceptance of legal form as the basis for the application of the existing tax cubbyholes to the prepayment of interest on these instruments would effectively permit the issuers to deduct a portion of the repayments of principal as interest. See Stephen R. Richardson, "New Financial Instruments: A Canadian Tax Perspective," in *Income Tax and Goods and Services Tax Considerations in Corporate Financing*, 1992 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1993), 10:1-32, at 10:21-32.

50 Canada, *Budget 2000—Budget Plan*, Ottawa: Department of Finance, February 28, Annex 7-7, Notice of Ways and Means Motion To Amend the Income Tax Act, resolutions (28) to (30). The amount of otherwise deductible interest expense on a weak-currency borrowing will be limited to the amount of interest that would have been payable on an equivalent borrowing in the currency that is used for an income-earning purpose. Disallowed interest expense will be taken into account in determining the amount of foreign exchange gain or loss realized on repayment of a weak-currency borrowing. Such gain or loss, as well as any gain or loss on a related hedge, will be on ordinary income account. The Department of Finance has presumably adopted the conversion of funds as a proxy indicative of a tax-avoidance motive that might otherwise be attributable to a hedged borrowing. Although the proposals avoid the discontinuities associated with a focus on hedged borrowings, other discontinuities will arise in connection with the application of the requirement to trace the conversion of the proceeds of a weak-currency borrowing to an ultimate currency that is used for an income-earning purpose.

department's proposals attempt to approximate the tax treatment of domestic-currency borrowings and thereby realize a limited measure of consistency.[51] The broader policy question is whether these kinds of limited legislative responses are adequate in a world of financial innovation.[52]

There are two schools of thought that reject the extension of past legislative practice and its series of ad hoc responses. The first emphasizes the inadequacy of legislative responses generally. Proponents of this school have called for a moratorium on detailed legislation and have argued for a greater reliance on the courts to develop principled responses. The second school of thought emphasizes the inadequacy of limited legislative responses targeted to particular instruments. Proponents of this school prefer a comprehensive legislative regime developed on the basis of clear general principles that can be translated into detailed regulations for the implementation of those principles.

51 Because of the limited application of the proposals in the notice of ways and means motion, supra footnote 50, to weak-currency borrowings, there is no attempt to equate the treatment of borrowings in a stronger currency with the treatment of domestic-currency debt. Similarly, the proposals are limited to the interest deductibility issue and do not address the tax treatment of lenders. Administrative and compliance considerations also apparently justify the incorporation of three significant exclusions from the application of the proposals for (1) weak-currency borrowings in which the interest rate on the relevant borrowing is no more than 2 percentage points greater than that for an equivalent borrowing in the currency used for an income-earning purpose; (2) weak-currency borrowings in which the outstanding principal is $500,000 or less; and (3) all weak-currency borrowings of corporations whose principal business is the lending of money. To avoid computational complexities, the notice of ways and means motion does not require the amount of any deferred interest expense to reduce the outstanding principal of a weak-currency borrowing; consequently, a borrower will continue to be able to deduct currently a limited portion of the nominal interest expense, even though such portion is offset fully by an expected exchange gain. See Budget 2000, supra footnote 50, Annex 7-4. The narrow legislative proposal for weak-currency borrowings would obviously not extend to shares with paid-up capital denominated in a foreign currency. Realization of consistent treatment with shares denominated in Canadian dollars requires that the issuer account for all gains or losses (whether expected or not) on a return of capital. An exchange loss should be treated as a non-deductible additional payment in Canadian dollars subject to characterization as a dividend under the deemed dividend rules in subsections 84(2) to (4.1) of the Act. An exchange gain should be treated as a non-taxable premium for the issuer. But see *MacMillan Bloedel Limited v. The Queen*, 97 DTC 1446; [1997] 3 CTC 3012 (TCC), aff'd. 99 DTC 5454; [1999] 3 CTC 652 (FCA), where an exchange loss on redemption of US dollar denominated preferred shares was recognized as a deductible loss of the issuer; and John Owen, "Federal Tax and Its Impact on Foreign Exchange Gains and Losses," in *Corporate Tax Minimization Strategies: Innovative Financing and Risk Management Structures* (Toronto: Strategy Institute, May 27, 1998), tab 6, at 17-22.

52 The Department of Finance has provided no indication that the proposals regarding weak-currency borrowings are part of a larger project to design a comprehensive legislative regime for the tax treatment of financial instruments generally.

LESSON TWO: THE FALSE HOPE OF "INTERPRETIVE ACTIVISM"

In an apparent effort to reduce the compliance burden associated with detailed legislative provisions, some tax practitioners have advocated acceptance of the status quo and the imposition of a moratorium on further legislative responses.[53] The taxation of financial instruments would be addressed, instead, through administrative practice and the courts, employing a proactive approach to the application and interpretation of existing provisions.[54] Under this "interpretive activism" approach, the perceived economic substance of a particular financial instrument would be determined and the instrument taxed accordingly within the existing cubbyholes applicable to interest and dividends, capital gains and losses, and business income generally. Unfortunately, the decisions in *Shell* and *Canadian Pacific* tend to expose the flaws of interpretive activism. The decisions are generally consistent with a hesitancy on the part of the Canadian judiciary to ignore legal form and impose a tax result that accords with perceptions of economic substance.[55] Moreover, even if Canadian courts were more inclined to emphasize economic substance as a basis for taxation, certain features of the judicial process undermine the case for reliance on the courts as a significant policy actor in the taxation of financial instruments.[56]

The basic premise underlying interpretive activism is sound. The principal problem with this approach to the taxation of financial instruments involves matters of process or, more particularly, the choice of the most efficient process for the resolution of specific cases. Advocates of interpretive activism tend to

53 See, for example, 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; and David P. Hariton, "The Tax Treatment of Hedged Positions in Stock: What Hath Technical Analysis Wrought?" (Summer 1995), 50 *Tax Law Review* 803-27, where the author suggests the abandonment of detailed legislative rules ("technical analysis") in favour of the resolution of specific cases by applying general principles under a method of "logic, parallelism and judgment." See also May, supra footnote 5.

54 This approach to the taxation of financial instruments is a specific application of "interpretive activism," which has been advocated as an appropriate role for tax courts in interpreting and applying the provisions of income tax legislation generally. See, for example, Brooks, supra footnote 33, who argues that the courts should function as "pragmatic tax analysts" in interpreting and applying the provisions of the Act based on the consequences of alternative interpretations. See also David G. Duff, "Interpreting the Income Tax Act—Part 2: Toward a Pragmatic Approach" (1999), vol. 47, no. 4 *Canadian Tax Journal* 741-98, at 787-97, where interpretive activism is referred to as a "consequentialist" approach to statutory interpretation.

55 See, for example, *Shepp v. The Queen*, 99 DTC 510; [1999] 1 CTC 2889 (TCC), where the court rejected the concept of an economic interest in a corporation independent of the relevant private law concepts.

56 Clearwater, supra footnote 5.

reject, without sufficient justification, the use of a comprehensive legislative regime as the basis for the development of appropriate general principles that can provide a necessary context for such resolution. In short, interpretive activism involves a transfer of the tax-policy making function from the legislature to the courts. At least as an initial proposition, this transfer is not especially problematic, since the courts are charged with the power and responsibility of formulating appropriate tax rules and are free to focus exclusively on relevant policy considerations. Indeed, because judges are free to develop principles that are appropriate in the context of a given legislative framework, there should be a close correlation between particular judge-made rules and the underlying tax policy concerns. However, in the context of the taxation of financial instruments, it is doubtful whether, in practice, courts have the capabilities to craft rules that are sufficiently general in scope, as well as detailed enough to be applied to particular instruments.

Three general problems undermine the potential effectiveness of interpretive activism in this area. First, the judicial process (in Canada and most other countries) does not lend itself easily to the efficient resolution of a large volume of specific cases or the development of necessary general principles for the taxation of financial instruments. In particular, it takes considerable time for an issue to work its way through the audit, assessment, and appeals process, which must be followed before reaching the formalistic and time-consuming court procedures. Without some adjustment of these aspects of the dispute resolution process, it seems absurdly inefficient to rely on the courts for the development of a rational approach to the taxation of financial instruments, particularly if a sensible legislative framework can be designed to address the relevant policy issues.[57] In the absence of specific legislative responses, the judicial process would likely have to be supplemented with an even greater reliance on administrative rulings and the judgment of tax practitioners to resolve specific cases in a timely manner. This inevitable outcome would place significant additional pressure on the rulings process, which would probably have to be altered in many respects to ensure that "appropriate cases get presented . . . in a timely fashion for a ruling."[58] There would also be extreme pressure on tax practitioners in an

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57 See Louis Kaplow, "Rules Versus Standards: An Economic Analysis" (December 1992), 42 *Duke Law Journal* 557-629. Kaplow suggests that detailed legislative rules are the more efficient means to describe the legal consequences of common transactions, because the one-time promulgation costs are likely to be less than the costs associated with the process of defining, after the fact, the details of the application of broad standards to a wide range of transactions.

58 Mark P. Gergen, "Apocalypse Not?" (Summer 1995), 50 *Tax Law Review* 833-59, at 857. In the US context, Gergen suggests that a greater reliance on the rulings process as the principal resolution mechanism would require significant changes to that process. For example, rulings might have to be made retroactive and "conditional on an instrument not later exhibiting

environment of "legal uncertainty," which is characteristic of interpretive activism. One of the dangers in such an environment is that some tax practitioners will attempt to gain an advantage by adopting aggressive positions that involve the resolution of all doubts in favour of their clients.[59] Rulings might have to be issued retrospectively to deter the worst instances of this behaviour,[60] and appropriate penalties and disclosure requirements for filing purposes would also have to be considered.[61]

A second problem with interpretive activism concerns expectations of judicial performance. The judicial performance in *Shell* and *Canadian Pacific* reflects the somewhat inconsistent performance that is characteristic of Canadian courts in tax cases. That inconsistency raises a serious question about the ability of the courts to produce reasonable and timely results in an area as complex as the taxation of financial instruments. It is unclear why the enactment of comprehensive legislation should be so readily dismissed as a policy option if such legislation is, in fact, the best that can be done. There seems to be no defensible reason to wait for lengthy administrative and judicial resolution of matters that can be resolved effectively and immediately through legislation. Interpretive activism appears to reflect doubts that a comprehensive legislative regime can in fact be designed and implemented. However, the solution it offers is a poor alternative: the courts, tax administrators, and tax practitioners are left to do the best that they can to reach defensible results in specific cases based on vaguely articulated notions of economic substance.

A third problem follows from a condemnation of the existing framework of the Act, rather than of the courts. This framework, with its recognized tax cubbyholes, severely constrains the promise of interpretive activism. Instead of one overriding tax treatment applicable to all relationships that take a specified legal form or some economic equivalent, there are several different treatments applicable to various types of financial instruments that often combine characteristics of one another. There is no coherent set of guiding principles to support the legislative framework for the taxation of financial instruments.[62] This lack of

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undesirable properties." In addition, there might have to be some type of notice requirement imposed on taxpayers issuing instruments with novel characteristics. These kinds of general changes would likely be necessary in other countries with rulings systems similar to that in the United States.

59 Ibid., at 857-58.

60 Ibid.

61 Ibid.

62 Anthony J. Frost, "Taxation of Financial Instruments," in *Papers Presented at the Eleventh National Conference of the Taxation Institute of Australia* (Sydney: Taxation Institute of Australia, May 1993), 103-25, at 107.

guiding principles makes it impossible to realize consistent taxation of all financial instruments that provide equivalent cash flows and differ only in their legal form. It is expecting too much of tax administrators, practitioners, and the courts to make sense of what is, in essence, a nonsensical legislative scheme that ignores the reality of financial equivalences. Indeed, within the constraints of the tax cubbyholes reflected in the general principles and rules in most legislation, it is unclear how equivalent cash flows should be taxed.[63] Adoption of interpretive activism that would result in the consistent taxation of financial instruments based on their associated cash flows would, more often than not, require a disregard of existing legislation, which is not within the accepted role of tax administrators or the courts.[64]

The obvious response to the problems associated with interpretive activism is the development of a comprehensive legislative framework that allows tax administrators and the courts to appropriately fill in gaps that inevitably arise.[65] Because even a well thought out legislative regime cannot possibly deal with all circumstances, the courts can usefully perform a supporting role, especially when the legislative framework must, of necessity, be second-best in nature. That role is performed most effectively where there is a clear legislative expression of general principles that the tax administration, practitioners, and the courts can focus on when working through the details of appropriate treatment for specific instruments.[66]

BROAD FEATURES OF A MODEST LEGISLATIVE AGENDA

Accretion Taxation as a Benchmark Approach to Financial Instruments

A tax system that eliminated fundamental differences in the taxation of interest and dividends, as well as the distinction between capital and ordinary income amounts and accrual versus realization-based taxation, would eliminate opportunities for tax avoidance through the creation of financial instruments designed

63 Gergen, supra footnote 58, at 858.

64 Duff, supra footnote 54, at 787-97, criticizes a consequentialist approach to statutory interpretation for its disregard of the wording of the legislative text.

65 Gergen, supra footnote 58, at 859.

66 Lawrence Lokken, “New Rules on Bifurcating Debt—A Good Start” (April 29, 1991), 51 *Tax Notes* 495-504. As an alternative to detailed legislative rules that attempt to address all conceivable circumstances, this type of approach to the drafting of income tax legislation is described and advocated by John Avery Jones, “Tax Law: Rules or Principles?” (August 1996), 17 *Fiscal Studies* 63-89. See also John Prebble, “Should Tax Legislation Be Written from a Principles and Purpose Point of View or a Precise and Detailed Point of View?” [1998], no. 2 *British Tax Review* 112-23.

to take advantage of tax cubbyholes. Such a system would also eliminate tax distortions of financing decisions and thus allow suitable non-tax reasons to govern. Derivatives would be used primarily as risk management instruments that enhance the efficiency and liquidity of capital markets by permitting access to markets that might otherwise be unavailable to users and providers of financial capital.

As a theoretical starting point, most commentators have concluded that a benchmark income tax system applied to all financial instruments, including shares, should incorporate three fundamental principles:

1) inclusion and deduction of the full amount of all gains and losses;

2) annual recognition of net changes in value by marking to market all financial instruments; and

3) elimination of the corporate income tax and its replacement with a tax at the investor level on annual net changes in the value of all financial instruments.

Under this benchmark approach, tax distortions would be eliminated, since there would be no differences of characterization or timing for the cash flows associated with particular financial instruments. Financial instruments would be taxed according to their economic substance represented by annual changes in value. There would be no need to categorize financial instruments and their associated cash flows; nor would it be necessary to attempt to link certain financial instruments and tax them as a synthetic transaction, or to break down a hybrid financial instrument into its component parts and tax those parts separately.

There are historical and well-founded reasons for the reluctance of policy makers to adopt this benchmark tax system. The three most commonly cited ones are the valuation difficulties presented by financial instruments that are not actively traded; liquidity problems for taxpayers forced to pay tax on unrealized gains; and unevenness in the recognition of unrealized gains and losses attributable to fluctuations in value. Given these concerns, the corporate income tax is not about to be eliminated in favour of accretion taxation of all financial instruments. Indeed, without such taxation or the conduit treatment of all legal entities, the corporate income tax must be maintained as a withholding tax on the unrealized capital gains of shareholders, particularly non-residents.

The need for a comprehensive approach to the tax treatment of financial instruments and the existence of practical obstacles to the adoption of accretion taxation raise the issue of alternative reform options. The obvious question is whether there are any feasible, second-best options that approximate an accretion regime. One minimal measure is the elimination of the distinction between capital and ordinary income gains and losses on financial instruments. The question of the timing of the recognition of such gains and losses is a much more difficult issue that, in practice, is closely linked with the debt-equity distinction and the different taxation of interest and dividends.

Considering the debt-equity issue first, there seem to be three principal reform options for the identical taxation of interest and dividends. The first two involve the extension of dividend tax treatment to interest. In the context of an imputation system for dividends, this extension would be realized by denying the deduction of interest for corporate borrowers. Lenders would remain taxable on interest payments but would receive a tax credit to compensate them for corporate tax on the underlying income from which the interest was paid.[67] An alternative recommended by the US Treasury department[68] ("the comprehensive business income tax" or CBIT) would also involve denial of the deduction of dividends and interest for corporate issuers. The returns would not, however, be taxable to shareholders and lenders, so that the corporate income tax would effectively serve as a flat tax on interest and dividends as forms of capital income. A third reform option involves the extension of the tax treatment of interest to dividends. This extension could be realized by providing a deduction for dividends paid or by providing an accrual deduction for the imputed cost of equity capital.[69]

The merits, design details, and the need for the adoption of any of these three reform options have been, and continue to be, the subject of extensive debate in the literature. Notably absent in that debate is the impact of the development of sophisticated financial instruments and whether any of the reform options adequately address the problems that these instruments create for a corporate income tax system. Instead, the debate has been joined on the unrealistic premise that corporate capital takes the form of traditional debt and equity. Continued developments in financial markets may ultimately force policy makers to recognize the basic functional similarity of all corporate investment instruments and accordingly to adopt income tax systems that treat all such instruments identically. Systems of this kind would obviously eliminate the need for artificial distinctions based on the private law rights and obligations associated with particular financial instruments. For a variety of reasons, not the least of which is the implications for the taxation of cross-border capital flows, this sensible

67 This type of credit is described in American Law Institute, *Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes—Reporter's Study of Integration* (Philadelphia: ALI, March 31, 1993), 90-92.

68 United States, Treasury Department, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, DC: US Government Printing Office, January 1992).

69 As a solution to the tax treatment of financial instruments, this reform option is described in Edward D. Kleinbard, "Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System" (December 1989), 67 *Taxes: The Tax Magazine* 943-61, at 955-61; and Edward D. Kleinbard, "Equity Derivative Instruments: Financial Innovation's Newest Challenge to the Tax System" (May 1991), 69 *Texas Law Review* 1319-68, at 1361-68.

approach to tax policy, and the fundamental structural reforms that it entails, remain a long way off. In the meantime, policy makers continue to struggle with the maintenance of traditional classifications in the context of a financial world in which those classifications are largely irrelevant.

A Comprehensive Accrual Regime as a Defensible Second-Best Approach

As an alternative to a system of accretion taxation, an effective legislative regime should be based on the premise that expected and unexpected gains and losses present different policy concerns that require different responses.[70] A comprehensive accrual regime intended to implement the dictates of "expected-return taxation" should be based on the rigorous identification of expected gains and losses associated with disguised and embedded debt in any financial instrument. Accrual recognition of these gains and losses must be required. Realization-based recognition can be applied to unexpected gains and losses arising on the resolution of a specified bet.

This type of regime is already reflected, to varying degrees, in some provisions and principles in the Act, including

- realization-based recognition of unexpected gains and losses associated with forwards, futures, and swap contracts; and
- accrual recognition of the expected gains and losses on fixed-payment debt and some forms of debt with contingent payments.

However, certain modifications and/or extensions of the existing tax cubbyholes under the Act are required, including

- the elimination of the distinction between ordinary income and capital amounts;
- the extension of accrual recognition to the expected return attributable to the embedded debt in prepaid and off-market forwards and swaps, as well as options; and
- the application of accretion recognition to unexpected gains and losses on actively traded instruments that give rise to problems of "selective realization."

Although any approach to the taxation of financial instruments other than accretion taxation cannot address completely the difficulties of taxing problematic hybrid and synthetic instruments, some of the challenges presented by these instruments disappear under a comprehensive system of expected-return taxation.

70 These policy concerns and their significance for the design of a comprehensive accrual regime are described in Edgar, supra footnote 18.

In short, because these complex instruments are composites of the basic building block instruments, appropriate rules for the taxation of the more fundamental instruments can eliminate many tax-avoidance opportunities that depend on the different taxation of the sum of the component parts of a synthetic and the combination of those parts assessed as a whole. As noted above, this approach requires identification and different treatment of expected and unexpected gains and losses in all financial instruments. In effect, consistent tax treatment of equivalent cash flows, defined in terms of the distinction between expected and unexpected amounts, can be provided in a comprehensive manner that encompasses all of the basic building block instruments and, by implication, all hybrid and synthetic instruments.

The significant problems that arise under a thoroughly developed accrual regime are attributable to continued acceptance of the different taxation of interest and dividends and the application of the realization requirement to shares and other non-traded financial instruments and non-financial assets. The principal pressure points arise in the following four areas:

1) *Boundary between debt and derivatives.* The different taxation of debt and derivatives requires some limited application of bifurcation as a tax technique applied to hybrid instruments that are debt in form but have an embedded derivative, or are derivatives in form but have an embedded loan. As applied to the taxation of hybrid instruments, bifurcation is conventionally understood as the process by which an indivisible instrument is broken down into its component parts (the basic building block instruments), and a specified tax treatment consistent with the recognized cubbyholes is applied separately to each of those parts. Several US commentators[71] have pointed out that this conventional concept of bifurcation is virtually impossible to apply as a general approach to the taxation of financial instruments under an income tax system that treats any of the basic building blocks of financial innovation inconsistently. Bifurcation is administratively problematic owing to the varieties of financial equivalences and the sophistication needed to bifurcate complex financial instruments. More fundamentally, the different taxation of the basic component parts of financial instruments renders bifurcation inconclusive in many instances, since different combinations of the basic parts can produce different tax treatments even after bifurcating a complex instrument. These difficulties can be addressed by identi-

71 See, for example, Frank V. Battle Jr., "Bifurcation of Financial Instruments" (December 1991), 69 *Taxes: The Tax Magazine* 821-33; David P. Hariton, "New Rules Bifurcating Contingent Debt—A Mistake?" (April 15, 1991), 51 *Tax Notes* 235-39; Randall K.C. Kau, "Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products" (December 1990), 68 *Taxes: The Tax Magazine* 1003-14; and Kleinbard, "Beyond Good and Evil Debt," supra footnote 69.

fying the embedded debt in all derivative instruments and imputing interest whether the derivative is issued on a stand-alone basis or is embedded in a contingent-payment debt instrument. However, possible revenue loss from increased interest deductions,[72] as well as perceived administrative and compliance problems associated with the logical extension of this approach, leaves an uncertain and troublesome boundary line.[73] On one side of the line are derivative instruments with an embedded debt element that is perceived to be significant enough to require imputation of interest. On the other side of the line are derivatives and contingent-payment debt instruments with embedded derivatives subject to the traditional cubbyholes for contingent payments.

2) *Boundary between debt and equity.* The different taxation of interest and dividends requires a distinction between debt and equity that is exceedingly difficult to draw once a purportedly substantive approach is adopted in place of an approach based on an acceptance of legal form. Reliance on the legal form of an instrument as debt or equity is defensible only if some important features of a corporate income tax are adopted in an attempt to substitute for, and complement, a comprehensive accrual regime. In particular, the corporate income tax must be seen as a proxy for the shareholder-level tax on expected and unexpected gains. This role for the corporate income tax can be implemented successfully only if a comprehensive system of dividend imputation with a compensatory dividend tax is adopted. The Act already reflects this approach to a considerable extent in the preferred share regime,[74] which ensures that shares that are potential debt substitutes bear a tax burden that is roughly commensurate with that on interest income. The limitations of any imputation regime arise primarily with cross-border investment, where differences in national tax regimes provide tax-avoidance opportunities based on the different classifications by source and residence countries of financial instruments. Until greater coordination of national tax regimes is achieved, a facts-and-circumstances approach to the classification of financial instruments as debt or equity may be the only effective means to address avoidance opportunities.[75]

3) *Synthetic replication.* Because accretion taxation must inevitably be limited to traded financial instruments that are easily valued, it remains possible to create financial equivalences that are advantageous from a tax perspective. For example, taxpayers can create offsetting positions with financial instruments

72 See May, “Overview,” supra footnote 13, at 28:10-11; and May, supra footnote 5, at 540.

73 See David P. Hariton, “The Accrual of Interest on Derivative Investments: Where Do We Go from Here?” (December 1996), 74 *Taxes: The Tax Magazine* 1011-22.

74 Parts IV.1 and VI.1.

75 May, supra footnote 5, at 543, footnote 41, suggests that the “real” tax-avoidance activity is focused on cross-border arbitrage of the debt-equity distinction.

that are subject to accretion taxation and other instruments that are subject to expected-return taxation. Similarly, financial instruments subject to expected-return taxation can be used to replicate other instruments subject to accretion taxation. These kinds of transactions are advantageous because expected-return taxation requires the recognition of expected gains and losses on an accrual basis, while accretion taxation captures both expected and unexpected gains and losses. Avoidance opportunities may also be available because of rate differences among taxpayers and any exclusion from an accrual regime of instruments held by individuals. Other problematic areas are the exclusion of non-traded shares from an accrual regime, the provision of exemptions from non-resident withholding tax for portfolio interest payments and payments on derivatives, and the denial of dividend tax credits to non-resident shareholders and tax-exempt entities, such as pension funds. In these instances, long and short positions in financial instruments can be combined to constructively dispose of shares without attracting a disposition transaction for tax purposes, to avoid non-resident withholding tax on interest and dividends,[76] and to transfer the benefit of dividend and foreign tax credits. These kinds of avoidance opportunities can be addressed, to some extent, with specific legislative responses and general anti-avoidance provisions applicable to transactions that involve synthetic replication.[77] Nonetheless, as a practical matter, it is very difficult, if not impossible, to establish a clear dividing line between the tax-driven use of synthetics and legitimate hedging strategies.[78] Consequently, any attempt to draw a boundary and apply an integrated tax treatment to otherwise independent financial instruments appears to be an arbitrary exercise.[79]

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76 For an excellent description of various synthetic instruments that can be used to avoid US withholding tax, see Gregory May, "Flying on Instruments: Synthetic Investment and the Avoidance of Withholding Tax" (November 11, 1996), 13 *Tax Notes International* 1625-35. See also, in the Canadian context, David G. Broadhurst, "Derivatives in International Tax Planning," in International Fiscal Association—Canadian Branch, *1997 International Tax Seminar* (Scarborough, Ont.: Carswell, 1998), 85-101, at 99-101.

77 See, for example, subsections 82(1) and 112(2.3), denying the dividend gross-up and tax credit and the intercorporate dividend deduction for dividends received as part of a "dividend rental arrangement" defined in subsection 248(1); and subsections 126(4.1) to (4.4), denying foreign tax credits in respect of certain credit-trading transactions. See also IRC section 1259, where entry into offsetting positions that eliminate all or substantially all of the risk associated with a long position in certain assets is treated as a constructive sale.

78 Deborah L. Paul, "Another Uneasy Compromise: The Tax Treatment of Hedging in a Realization Income Tax" (1996), vol. 3, no. 1 *Florida Tax Review* 1-50.

79 But see David A. Weisbach, "Line Drawing, Doctrine, and Efficiency in the Tax Law" (September 1999), 84 *Cornell Law Review* 1627-81. Weisbach notes the lack of any normative basis for various boundary lines in tax law but argues that these lines should be drawn at particular points based on efficiency considerations associated with the substitutability of transactions.

4) *Hedge accounting.* A hedge accounting regime is a limited form of integrated treatment, whereby gain or loss on a financial instrument acquired as a hedge of the risk associated with an underlying asset or liability is taxed with reference to that asset or liability. Such a regime presents serious administrative and compliance problems. Indeed, the application of integrated treatment of two or more financial instruments or a financial instrument and a non-financial asset has an intuitive appeal that tends to mask the difficult identification issues in an income tax system with different tax rules for particular types of instruments and assets. The problem centres on the appropriate identification of integrated positions and, in particular, the development of purpose-based identification criteria that can be administered effectively. In many respects, the comparable identification rules developed by the accounting profession (reflected to some extent in the US legislation) are excessively flexible and too subjective to be applied for income tax purposes. To the extent that the distinction between ordinary income and capital amounts can be eliminated, hedging rules may be unnecessary and not worth the considerable administrative and compliance burdens they entail.

Even with the problems noted above, a comprehensive accrual regime is preferable to the application of the conventional tax cubbyholes, primarily because it would reduce much of the tax significance of distinctions among financial instruments and would eliminate various opportunities to disguise expected gains as unexpected amounts. Some ambiguity in setting boundaries between debt and derivatives and debt and equity, along with some anti-avoidance provisions that attempt to address the worst instances of synthetic replication, may be justifiable in order to introduce sufficient legal risk to deter taxpayers from unduly exploiting the remaining cubbyholes.[80] The courts can serve a potentially useful role in policing the relevant boundary lines in these problematic areas. Consistency of result is not even a requirement, since the lines are necessarily arbitrary and vague. In fact, inconsistency may be tolerable as a means to ensure that exploitation of the boundary lines does not "get out of hand."[81] It is not entirely clear, however, that Canadian courts are willing to assume the kind of

80 Mark P. Gergen and Paula Schmitz, "The Influence of Tax Law on Securities Innovation in the United States: 1981-1997" (Winter 1997), 52 *Tax Law Review* 119-97, suggest that an uncertain factors approach to the classification of instruments as debt or equity for US tax purposes is desirable as a constraint on tax-driven innovation along the boundary line between debt and equity. See also David A. Weisbach, "Formalism in Tax Law" (Summer 1999), 66 *The University of Chicago Law Review* 860-87, where the author suggests that purpose-based anti-avoidance rules can be effective in suppressing discontinuities that are the focus of tax-driven or "uncommon transactions."

81 Frank V. Battle Jr., "Corporate Tax Shelters, Financial Engineering and the Colgate Case" (December 1997), 75 *Taxes: The Tax Magazine* 692-705, at 703: "Perhaps the concern is

activist attitude necessary to serve this policing function. In other contexts, they have appeared reluctant to apply specific anti-avoidance rules in an aggressive manner.[82] Arguably, this failure is attributable, in part, to a lack of clearly articulated legislative norms and standards. One of the principal benefits of a comprehensive accrual regime is a clear legislative expression of norms and standards that provide the basis for the development of a sustainable approach to the taxation of financial instruments. An unwillingness on the part of Canadian courts to accept the responsibility of a limited, but necessary, role in the context of such a legislative regime would seriously undermine its effectiveness.

attributable to a belief that the doctrine [taxation on the basis of economic substance rather than legal form] is not a clear principle of law applicable to rich and poor alike but, instead, is a fuzzy notion that has been useful to keep things from getting out of hand."

82 See, for example, *Neuman v. The Queen*, 98 DTC 6297; [1998] 3 CTC 177 (SCC); and *The Queen v. Ferrell*, 99 DTC 5111; [1999] 2 CTC 101 (FCA), aff'g. 97 DTC 1565; [1998] 1 CTC 2269 (TCC), where the courts have ignored portions of the wording of subsection 56(2) and eviscerated the provision as a response to certain income-splitting transactions. For an elaboration on this point, see David G. Duff, "Interpreting the Income Tax Act—Part 1: Interpretive Doctrines" (1999), vol. 47, no. 3 *Canadian Tax Journal* 464-533, at 501-4. The failure of the courts to perform any role in controlling tax avoidance in this particular context forced the Department of Finance to introduce a "kiddie tax." Canada, Department of Finance, 1999 Budget, Budget Plan, February 16, 1999, 193; and Notice of Ways and Means Motion To Amend the Income Tax Act, resolution 4, which proposes that dividends on unlisted shares and certain income from a partnership or trust derived by individuals aged 17 or under be subject to tax at the highest marginal rate.