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Alesco and Mark Resources:
Cross-Border Tax Arbitrage, Economic Reality, and
Anti-Avoidance Rules in New Zealand and Canada.

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Abstract

This essay compares the role given to the concept of economic reality in New Zealand and Canadian cross-border tax arbitration decisions, particularly *Alesco* and *Mark Resources*. *Alesco* and *Mark Resources* both address the problem of drawing the line between acceptable tax mitigation and unacceptable avoidance, and adopt economic substance as a key indicator of where this line lies. This essay considers how the concept of economic reality pervades these cases and evaluates the influence of legislative and judicial context to the significance afforded to the concept of economic reality in the two decisions, as well as reviewing how the economic realities jurisprudence has evolved following these cases.

Key Words:

International Tax – Tax Arbitrage – Cross-border Tax Arbitrage
International Tax– New Zealand – Canada
Tax Avoidance – Anti-Avoidance Rules – GAAR
Economic Reality – Economic Substance

I. Introduction: Avoidance and Cross-Border Arbitrage

This essay considers the role of economic reality in determining when cross-border tax arbitrage might be considered tax avoidance, with particular reference to the New Zealand and Canadian cases of *Alesco New Zealand v Commissioner of Inland Revenue* and *Mark Resources Inc. v Her Majesty the Queen*.¹

The concept of tax avoidance is notoriously difficult to capture in a concise definition,² and the terminology used to describe the concept can vary considerably.³ However, Brown offers an effective starting point for understanding the central tension between avoidance and mitigation:⁴

15 Tax avoidance involves arrangement of a transaction in order to obtain a tax advantage, benefit, or reduction in a manner unintended by the tax law. It is an unacceptable manipulation of the law which is unlike legitimate tax mitigation.

20 Cross-border tax arbitrage refers to a situation where a transaction is subject to the law of two different jurisdictions, allowing taxpayers to engage in tax planning that exploits any profitable asymmetries or inconsistencies between the two national systems in order to lower the taxpayer's liability.⁵
25 Particularly since the 1990s, cross-border tax arbitrage arrangements have become more prevalent,⁶ and correspondingly attracted considerable attention and scrutiny, with the activities of many taxpayers being viewed as abusive forms of tax avoidance.⁷ Many instances of cross-border
30 arbitrage arrangements have been held to cross the elusive

¹ *Alesco New Zealand v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175; *Mark Resources Inc. v Her Majesty the Queen* (1993) 93 DTC 1004.

² Michael Littlewood "The Privy Council and the Australasian Anti-Avoidance Rules" [2007] BTR 175 at 175 ("That tax avoidance is one of the slipperiest ideas in the whole of the law is notorious").

³ For instance, *Ben Nevis* dismissed the distinction between "avoidance" and "mitigation" as being "conclusory and unhelpful", below n 53, at [95].

⁴ Karen B. Brown *A Comparative Look at Regulation of Corporate Tax Avoidance* (Volume 12 of *Ius Gentium: Comparative Perspectives on Law and Justice*, Springer, 2012) at 1; See also John Prebble and Zoe Prebble "The Morality Of Tax Avoidance" (2010) 43:3 *Creighton L Rev* 693 at 705 (John and Zoe Prebble provided the genesis for this definition adopted by Brown).

⁵ Daniel Shaviro "Money on the Table?: Responding to Cross-Border Tax Arbitrage" (2002) 3 *Chi J Int'l L* 317 at 319.

⁶ Stephen A. Whittington and John Prebble "Cross-Border Tax Arbitrage and Convergence of Tax Systems: A Law and Economics Approach" (paper presented to the Australasian Tax Teachers' Association Annual Conference, Sydney, January 2012) at 4.

⁷ Daniel Shaviro "More Revenues, Less Distortion? Responding To Cross-Border Tax Arbitrage" (2004) 1 *NYU J L & Bus* 113.

dividing line between acceptable mitigation and unacceptable avoidance in both New Zealand and Canada,⁸ including the *Alesco* and *Mark Resources* cases.

5 Certainly, cross-border arbitrage, like other methods of avoidance, can pose a great threat to domestic tax bases. The consequences of unbridled cross-border arbitrage may include a reduction in tax compliance, an inequitable distribution of tax liabilities, interference with government policies, as well as overall global economic inefficiencies.⁹

10 Canada and New Zealand are no exception to this growing problem, and they both have been subject to increasingly aggressive forms of cross-border arbitrage. Indeed, in New Zealand, the “bank conduit” cross-border arbitrage cases still stand as the largest avoidance cases in the country’s history.¹⁰
15 The Government of Canada is also alert to this problem, and is proposing new information reporting requirements to address what it acknowledges to be an increasingly troubling trend of avoidance.¹¹

20 The differences between taxation systems that provide the scope for international tax arbitrage tend to be intractable because they often stem from deliberately divergent or competitive policy choices made within the context of distinct political systems.¹² These differences can lead to double taxation where the domestic regimes overlap, or a reduction or
25 absence of taxation where there is a gap.¹³ Cross-border asymmetries that lead to double taxation have typically driven increased measures of multilateral harmonisation, particularly in the form of double tax treaties. However, in the case of asymmetries leading to a reduction or even an absence of

⁸ In New Zealand, see *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) CIV-2004-485-1059 (HC), 24 NZTC 23; *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) CIV-2005-404-2843 (HC), 24 NZTC 23. In Canada, see: *Lehigh Cement Limited v The Queen* (2013) TCC 176; *Paul Antle v Her Majesty The Queen* (2009) TCC 465.

⁹ Robert McMechan *Economic Substance and Tax Avoidance: An International Perspective* (Carswell, Canada, 2013) at 41-55; Stephen A. Whittington and John Prebble “Cross-Border Tax Arbitrage and Convergence of Tax Systems: A Law and Economics Approach” (paper presented to the Australasian Tax Teachers’ Association Annual Conference, Sydney, January 2012).

¹⁰ John Prebble “Tax Avoidance, International Tax Arbitrage, and New Zealand as a Haven for Foreign Capital and Income” (2010) 16 *Revue Juridique Polynésienne* 169 at 171; Michael Littlewood “Tax Avoidance, the Rule of Law and the New Zealand Supreme Court” (2011) 1 *NZLR* 35.

¹¹ McMechan, above n 9, at 41-42.

¹² Diane M. Ring “One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage” 44 *BCL Rev* 79 at 88.

¹³ Ring, above n 12, at 88; Angelo Nikolakakis “The Unthinkable Anathema of Double Non-Taxation: The Relevance and Implications of Foreign Tax Considerations in the Context of Applying GAAR” (2010) 58 *Can Tax J* 243.

taxation, the responsibility has typically fallen on the domestic regimes where the tax base is challenged, rather than being dealt with through international laws.¹⁴ Tax authorities apply domestic law to combat avoidance and protect the national tax base, rather than seeking to prevent the more global effects of non-permissible arbitrage avoidance. Accordingly, tax arbitrage arrangements are considered avoidance only where inconsistencies between regimes are used in a way that offends the purpose or contemplation of the particular domestic legislature. Consequently, in both Canada and New Zealand, the courts and the legislature have developed various tools to combat the challenge posed to national tax bases from cross-border arbitrage, including specific measures targeted at particular instances of tax arbitrage, and increasingly prominently, general anti-avoidance rules.

The New Zealand and Canadian cases of *Alesco* and *Mark Resources* both present striking examples of international tax arbitrage that has been held to be avoidance. This essay will compare these two cases and their approach to cross-border arbitrage. The arguments and reasoning in *Alesco* and *Mark Resources* illustrate a wider trend towards emphasising economic substance as the most prominent hallmark of avoidance, particularly in cross-border arbitrage. The essay will consider the significant influence of the legislative and judicial context in New Zealand and Canada and evaluate whether the trend towards a greater emphasis on economic reality is both theoretically supportable and consistent with the Canadian and New Zealand contexts.

II. New Zealand and Canadian Statutes Applied

Alesco and *Mark Resources* took place in different jurisdictions, at distinct stages in each jurisdiction's developing approach to avoidance. Nevertheless, while the legislation that the two cases were decided under is different in form, ultimately, the underlying issue that the statutes address is how acceptable tax mitigation is to be distinguished from unacceptable avoidance. Erlichman notes the functional equivalence of the statutes, stating that "though framed differently, the Canadian, Australian, and New Zealand anti-avoidance statutes clearly have the same general intent".¹⁵

In New Zealand, *Alesco* attracted section BG 1 of the Income Tax Act 1994, which the 2007 Act identically

¹⁴ Ring, above n 12, at 106.

¹⁵ Harry Erlichman "Tax Avoidance in the United Kingdom, New Zealand, and Australia" in David G. Duff and Harry Erlichman (eds) *Tax Avoidance In Canada After Canada Trustco and Matthew* (Irwin Law Inc, Toronto, 2007) 181 at 183.

replicates. The section is referred to as the general anti-avoidance rule, or GAAR. It provides that “A tax avoidance arrangement is void as against the Commissioner for income tax purposes”.¹⁶ Section OB 1 further defined a “tax avoidance arrangement”.¹⁷

The statutory phrasing of the GAAR is imprecise and tautologous; adding little to the circular idea that a tax avoidance arrangement is one that avoids tax. Much writing has been devoted to either critiquing the ambiguity or justifying the necessity of the imprecision.¹⁸ New Zealand courts have also recognised the inescapable uncertainty of the provision, with the Supreme Court in *Glenharrow* holding that “it is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of precise definitions”.¹⁹ Whatever the normative conclusions reached regarding the effectiveness of the statutory definition, it is apparent that the GAAR leaves the New Zealand courts with a significant role in determining what tax avoidance is. The wide discretion also paves the way for an analysis based on economic reality.

In Canada, *Mark Resources* was dealt with under two different sections of the Canadian Income Tax Act;²⁰ paragraph 20(1)(c) and paragraph 245(1). The successful challenge to the taxpayer arose under paragraph 20(1)(c), which allowed a deduction for:²¹

- (c) an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer’s income), pursuant to a legal obligation to pay interest on
 - (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy).

In effect, paragraph 20(1)(c) provided that a deduction was available for borrowed money used for the purpose of earning income from a business or property. The Minister argued that the borrowed funds had not been used for the purpose of earning income from a business or property.

Additionally, the Minister challenged the deduction of

¹⁶ Income Tax Act 2007, s BG 1.

¹⁷ See Appendix. The section is now replaced by the Income Tax Act 2001, s YA 1.

¹⁸ Rebecca Prebble and John Prebble “Does The Use Of General Anti-Avoidance Rules To Combat Tax Avoidance Breach Principles of the Rule of Law?” (2012) 2 VUWLRP 8.

¹⁹ *Glenharrow Holdings Ltd v CIR* [2007] NZSC 116, at [48].

²⁰ Income Tax Act RSC 1952 c 148, para 245(1).

²¹ Income Tax Act RSC 1952 c 148, para 20(1)(c).

interest on the basis that it resulted in an artificial reduction of interest under paragraph 245(1). Following *Mark Resources*, paragraph 245(1) was repealed and replaced by a general anti-avoidance provision, adding Canada to the steadily increasing number of countries with such a rule.²²

The Canadian GAAR, introduced in 1998, generally applies to transactions entered into after 13 September of that year. Thus, *Mark Resources* was decided under the earlier section because it concerned deductions made for the 1985 and 1986 tax years. The move towards a GAAR may be interpreted as evidence of the Canadian Government's increasing preference for consideration of the substantive effects of a transaction, above the legal form, because the GAAR, in theory, confers greater freedom upon the court to look behind the form of the transaction. Nevertheless, paragraph 245(1) essentially acted as a statutory precursor to the GAAR that served a similar purpose of countering unacceptable tax avoidance, except that the paragraph applied to deductions only,²³ whereas the GAAR can apply to any tax avoidance arrangement. Under paragraph 245(1), the avoidance inquiry was primarily determined under the heading of artificiality. It provided that:²⁴

In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

Thus, the Canadian rule under paragraph 245(1) was essentially equivalent to the New Zealand rule in BG 1. The differences between legislation become relevant insofar as they support differing approaches to economic reality, with the existence of a GAAR arguably directing a greater deference to economic reality. The complementary relationship between the GAAR and an economic reality analysis is illustrated by a comparison of *Alesco*, which was determined under a section similar to the Canadian GAAR's predecessor in paragraph 245(1), and *Mark Resources*, which was analysed with greater difficulty under paragraph 20(1)(c), where the paragraph did not lend itself as fluidly to the consideration of economic reality.

²² Other countries with a GAAR include Australia, South Africa, Norway, France, Germany, Singapore, and Hong Kong.

²³ See also Brian J. Arnold "In Praise of the Business Purpose Test" (Report of Proceedings of the Thirty-Ninth Tax Conference, Toronto, 1988) at 10 ("Even on a superficial examination, it does not apply to deductions in computing taxable income, deductions in computing tax payable, or transactions that artificially reduce income but do not involve deductions").

²⁴ Income Tax Act RSC 1952 c 148, para 245(1).

III. The Meaning of “Economic Reality”

“Economic reality” has been interpreted differently in a variety of cases and contexts. Neither Canada nor New Zealand has formalised an economic substance consideration within the anti-avoidance provisions, unlike the United States, which has a codified doctrine of economic substance.²⁵

All taxation systems necessarily involve a discrepancy, often referred to as ectopia,²⁶ between the true economic income of an entity and what is actually subject to taxation under the particular taxation system. The notion of true economic income refers to a wide understanding of the accretion of wealth, as compared to the narrow understanding adopted for taxation purposes. Having accepted the gap between the legal and economic concept of income, reasoning based on economic reality emphasises the underlying economic results of the arrangement, stressing a substance-over-form approach.²⁷ In most contexts, “economic reality” and “economic substance” mean much the same.

Legal “substance” and economic “substance” are distinct.²⁸ Legal substance-over-form refers to the true legal obligations and relationships of an arrangement prevailing over the form or labels given to a transaction. For example, labelling a business relationship a partnership will not make it one unless it fulfils the substantive, underlying legal rights and requirements for a partnership. In contrast to legal substance, economic substance will look beyond the legal characteristics of a relationship or transaction to its true economic consequences. For example, even if an instrument was labelled and treated as “debt” for the non-tax purposes of commercial law, the instrument could be considered equity if it has the economic characteristics of equity. Consequently, following the economic substance approach, interest paid by the issuer of the instrument would not be deductible.

²⁵ Section 1409 of the Health Care and Education Reconciliation Act of 2010 amended section 7701 of the Internal Revenue Code of 1986 and inserted a new section clarifying the economic substance doctrine, which was previously a common law doctrine.

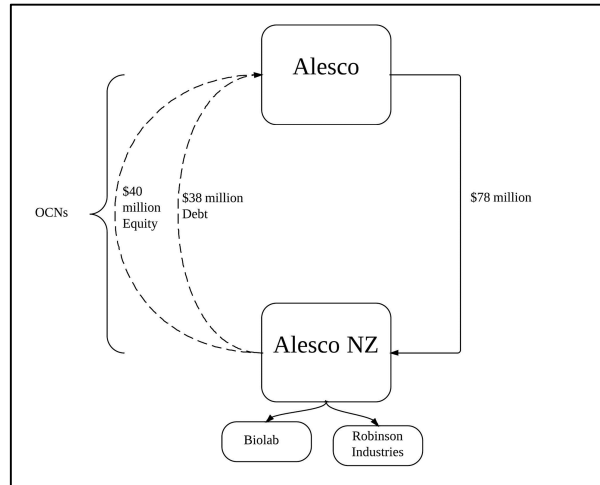
²⁶ John Prebble “Ectopia, Formalism, and Anti-Avoidance Rules in Income Tax Law” (1994) 1 VUWLRP 27.

²⁷ Whittington and Prebble, above n 6, at 13.

²⁸ Jinyan Li “‘Economic Substance’: Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance” (2006) 54(1) Can Tax J 23 at 43.

IV. *Alesco and Mark Resources: An Outline*

A. *Facts of Alesco*



- 5 Alesco Corporation (Alesco) was the Australian parent of Alesco New Zealand Ltd. (Alesco NZ). In 2003, Alesco NZ bought two other New Zealand companies; Biolab Ltd and Robinson Industries Ltd. Before the purchase, Alesco sought advice from the accounting firm KPMG on how to structure the acquisition to reduce tax. Alesco adopted the “Hybrid Instrument into New Zealand” (HINZ) product that was
- 10 suggested. The HINZ involved Alesco funding the acquisition of the New Zealand businesses by providing \$78 million to Alesco NZ. In return, Alesco NZ issued three separate series of optional convertible notes (OCNs) to Alesco. The OCNs were non-interest bearing and issued for a fixed period of ten years at a price of \$1 each. At the end of the ten years, Alesco had the option of redeeming the notes for cash or converting them into shares; that is, Alesco could be repaid the \$78 million or could
- 15 convert the notes into 78 million shares in Alesco NZ.

- 20 In New Zealand, instruments like the OCNs, which contain elements of both debt and equity, are generally subject to the financial arrangement rules.²⁹ The purpose behind these rules is to impose spreading methods to financial arrangements so that income and expenditure is accrued on a “fair and reasonable basis” that allows for the time value of money.³⁰ The spreading methods allocate an appropriate amount of the total income and expenditure of the financial arrangement to each income year of the arrangement’s term, without having to determine
- 25 whether a return should be classified as income or capital. The spreading methods provide for a fairer and more reasonable
- 30

²⁹ *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2012] 2 NZLR 252 (HC) at [97].

³⁰ Income Tax Act 2007, s EW 1(3).

treatment of certain debt instruments than the general rule that allocates income to the income year in which it is derived.³¹

The financial arrangement rules are further subject to determinations released by the Commissioner.³² Determinations ensure that the financial arrangement rules remain operable in particular circumstances where the rules are too generalised to apply properly. Determination G22,³³ which was replaced with determination G22A following *Alesco*,³⁴ stipulated a formula for splitting the OCNS into debt and equity, which Alesco used to determine the amount that would be deductible under the financial arrangement rules. Taken together, determination G22 and the financial arrangement rules deem an interest cost to be paid by the issuer of the OCNS, even in the absence of an actual interest liability, because the value is determined according to the difference between the maturity value and the net present value of the debt component.

Applied to the *Alesco* case, this meant that Alesco NZ applied determination G22 to split the OCNS into debt and equity components. Although the OCN instrument was more like equity in terms of economic substance, the financial arrangement rules adopt a hybrid characterisation. The net present value of the debt component was calculated with reference to the government stock rate for a ten-year term, consistent with the ten-year term of the OCNS. The calculated present value of \$38 million was subtracted from the maturity value of the debt of \$78 million, to leave \$40 million, which was treated as the equity element. In essence, determination G22 split the \$78 million from the OCNS into debt and equity components of \$38 million and \$40 million respectively and spread the \$40 million over the term of the debt. The \$40 million equity component was considered “expenditure incurred” under the financial arrangement rules and treated by Alesco NZ as deductible interest, under the relevant provisions of the Income Tax Act.

³¹ Income Tax Act 2007, s BD 3.

³² Tax Administration Act 1994, s 90AC.

³³ New Zealand Tax Regulations and Determinations “Determination G22: Optional convertible notes denominated in New Zealand dollars” (CCH New Zealand Limited, 2013), 424.

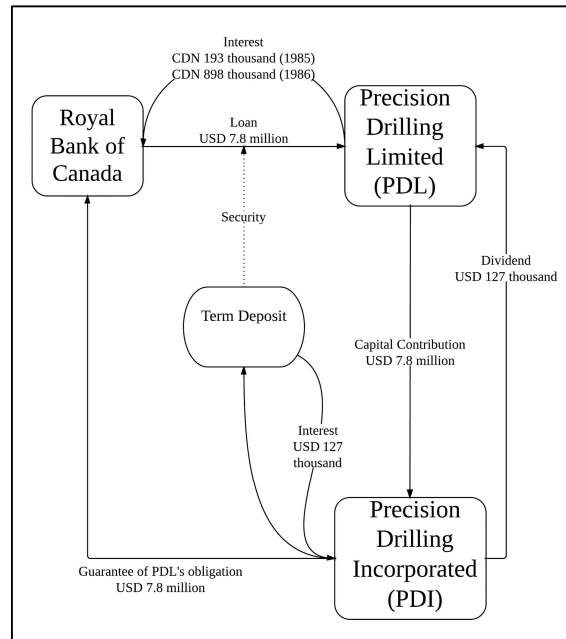
³⁴ New Zealand Tax Regulations and Determinations “Determination G22A: Optional convertible notes denominated in New Zealand dollars” (CCH New Zealand Limited, 2013), 436.

The Court of Appeal observed at [145] that G22A, which was enacted following *Alesco* on 26 September 2006, “used explicit and unambiguous terms to exclude the operation of the debt and equity separation methodology contained in G22 when applied to OCNS issued between wholly owned group members”. This point was advanced in argument by counsel for Alesco, who argued that the Commissioner’s clarification that this methodology did not apply in the case of intragroup transfers illustrates that the position prior to this change was arguably contrary to the change.

The Commissioner treated the result as a tax avoidance arrangement under s BG 1 of the Income Tax Act 1994 (the equivalent of the 2007 section) and declared the interest deductions claimed by Alesco between 2003 and 2008 to be void. The High Court and Court of Appeal upheld the Commissioner's view.³⁵

B. Facts of *Mark Resources*

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Similarly, *Mark Resources* involved intragroup transactions between a parent company and its foreign subsidiary that resulted in the deduction of interest expenses. The appellant, Mark Resources, was the successor of a Canadian company, Precision Drilling Ltd (PDL). In 1979, PDL incorporated a wholly owned subsidiary, Precision Drilling Incorporated, PDI, in America. PDI did not succeed and instead accumulated business losses of us \$707,000, meaning that it essentially became a shell company. PDI's only value lay latently in its losses, if they could be utilised for tax purposes. However, these losses were about to expire under the loss carry-forward rules of the United States Internal Revenue Code.

In 1985, PDL borrowed around \$7.8 million from the Royal Bank of Canada for a 67 day loan ending at the conclusion of the fiscal year of both PDL and PDI. PDL forwarded the borrowed funds into PDI's account and listed the forwarded funds as a capital contribution. On the same day, PDI purchased a term

³⁵ *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2012] 2 NZLR 252 (HC); *Alesco New Zealand Limited v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

deposit from the Royal Bank's London branch, which PDI used as security for the loan to PDL. The term deposit earned less interest than was owed on the loan to PDL, the interest on the loan being 9.625 per cent per annum, and the term deposit
5 being 8.75 per cent per annum. The term deposit was also timed to coincide with the fiscal year end to ensure that the interest would be earned by PDI in 1985 and be absorbed by PDI's losses in 1980.

PDI set off its accumulated US losses and paid tax-free
10 dividends to PDL. The amount of the dividends represented the interest earned by PDI on the term deposit. PDI cashed out the term deposit and lent it to PDL to repay the loan it had taken out. PDL claimed a deduction of the interest paid on the loan from the Royal Bank of Canada. The sum of the interest paid on the
15 money borrowed was \$193,684 in 1985 and \$898,241 in 1986.

The Tax Court of Canada held that Mark Resources had not breached paragraph 245(1), which contained the "artificial reduction" precursor to a GAAR. However, the deductions were not made for the "purpose of earning income" in paragraph
20 20(1)(c), meaning that Mark Resources was not entitled to the deductions claimed for the interest expense.

C. The Arbitrage Advantages and Objectionability

25 In both *Mark Resources* and *Alesco*, the objectionability of the transactions to the national tax authorities seems to be derived from the arrangements' cross-border nature.

In the case of *Alesco*, differences in tax treatment between Australia and New Zealand gave rise to tax benefits, with the
30 Court of Appeal noting that "the OCNS' attraction lay in this asymmetrical cross border taxation treatment".³⁶ OCNS are hybrid instruments, which often enjoy different classifications of debt or equity under different tax systems, giving rise to arbitrage opportunities. In Australia, the tax authorities treated
35 OCNS as a 100 per cent equity instrument,³⁷ whereas the New Zealand system splits the notes into debt and equity components. This meant that the interest Alesco NZ paid to Alesco was not assessable in Australia, but the interest paid on the debt incurred to finance the acquisitions was deductible by
40 Alesco in Australia, subject to thin capitalisation rules.³⁸ New Zealand law allowed Alesco NZ to claim interest even without a corresponding obligation to pay any actual interest, by deeming Alesco NZ to be paying Alesco notional interest, as previously explained. The interest paid by Alesco NZ was not subject to

³⁶ At [14].

³⁷ Income Tax Assessment Act 1997 (Cth), div 974.

³⁸ Income Tax Assessment Act 1997 (Cth), div 820.

resident withholding tax and was tax deductible in New Zealand, although Alesco NZ never actually paid interest.

5 In *Mark Resources*, the source of the relevant tax benefits relates to practices adopted in the absence of a loss consolidation regime in the Canadian law, rather than asymmetries between systems as in *Alesco*. At the time of *Mark Resources*, Canada had no formal loss consolidation or loss transfer rules for a related group of companies.³⁹ This formal position means that stand-alone companies are generally taxed
10 without recognition of the relationships between members of a corporate group. This single-entity approach differs from many other jurisdictions,⁴⁰ including New Zealand, where there are both loss transfer provisions and group consolidation options that allow taxpayers to elect for a group of consolidated
15 domestic companies to be treated as if it were one company.⁴¹

In the absence of formal rules for loss consolidation, arrangements such as those used in *Mark Resources* were the standard method for consolidating losses between Canadian companies. The Canada Revenue Agency (CRA) did not
20 typically challenge this approach. A technical note released by the CRA recognised that transactions undertaken to transfer income or deductions are a commonplace method of ensuring that one member of a corporate group does not pay income taxes while another is in a loss position. The CRA stated that the
25 basic parameters to these loss utilisation transactions are simply that the transactions must be “legally effective and otherwise comply with the technical provisions of the *Income Tax Act*”.⁴² The CRA also observed that the general anti-avoidance rules may be relevant, but following from the Department of
30 Finance’s explanatory notes for the GAAR, loss utilisation transactions are not usually considered to result in a misuse or abuse, therefore the GAAR will generally not apply.⁴³ Indeed, the Canadian Government has noted that exceptions in rules such

³⁹ Despite much consultation and examination of the issue, the 2013 Federal Budget confirmed that introducing a corporate group taxation regime was still not a priority. See: Minister of Finance *Jobs, Growth, and Long-Term Prosperity: Economic Action Plan 2013* (March 21, 2013), Annex 2- Tax Measures: Supplementary Information and Notices of Ways and Means Motions, p 364.

⁴⁰ Examples of jurisdictions with different systems include the United States, France, Australia, New Zealand, Italy, Japan, the Netherlands, and Spain. See generally: Antony Ting *The Taxation of Corporate Groups Under Consolidation: An International Comparison* (Cambridge, Cambridge University Press, 2012).

⁴¹ Section FM 2 of the Income Tax Act 2007 outlines consolidation rules. subpart ID of that act deals with the treatment of tax losses by consolidated groups and subpart IC allows for losses to be offset between group companies.

⁴² Canada Revenue Agency, *Income Tax: Technical News* (Canada Revenue Agency, No. 30, May 21 2004) at 6.

⁴³ Canada Revenue Agency, above n 42, at 6.

as the corporate loss limitation rules “are intended to apply with respect to transactions that would allow losses, deductions, and credits earned by one corporation to be claimed by related corporations”.⁴⁴ Moreover, the explanatory note stated that “the scheme of the Income Tax Act as a whole, and the expressed object and spirit of the corporate loss limitation rules, clearly permit such transactions between related corporations where these transactions are otherwise legally effective and comply with the letter and spirit of these exceptions”.⁴⁵

10 In view of the many statements made by Canadian tax authorities that recognise arrangements similar to the arrangement in *Mark Resources* as a legitimate method of loss consolidation,⁴⁶ it is difficult to follow Bowman rccj’s statement that “the consolidation for tax purposes of the financial results of domestic companies is not contemplated by our Act and this holds true *a fortiori* in the case of foreign subsidiaries”.⁴⁷ Bowman rccj labels the loss consolidation practice an “administrative concession” which cannot be relevant to the decision.⁴⁸ While a formal regime for loss consolidation does not exist in the Income Tax Act, it seems difficult to sustain an assertion that loss consolidation was not, nevertheless, intended to be achieved, at least for domestic transactions, through similar arrangements to the one employed in *Mark Resources*. The objection to the use of this method of loss consolidation seems to lie instead in the cross-border dimension of the arrangement. Most likely, this is because this transaction imported the losses from the American jurisdiction, unacceptably lowering the net tax payable in Canada by circumventing the Canadian position whereby the losses of a foreign subsidiary cannot be offset by a Canadian parent against the parent company’s income. Boidman notes that before *Mark Resources* was decided, the Standing Committee on Public Accounts of the House of Commons had recommended action by the Department of Finance to curtail perceived abuses arising from arrangements that involve importing the losses of foreign subsidiaries.⁴⁹ This further suggests that the Canadian Government viewed cross-border

⁴⁴ Minister of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (June 1988) at 466.

⁴⁵ Minister of Finance, above n 42, at 466.

⁴⁶ Additionally, In a 2010 consultation paper, the Canadian Department of Finance commented that the flexibility of this approach to loss utilisation allowed many corporate groups to use financing arrangements to transfer losses: Department of Finance Canada *The Taxation of Corporate Groups: Consultation Paper* (November 2010) at 5.

⁴⁷ At [58].

⁴⁸ At [61].

⁴⁹ Nathan Boidman “Mark Resources Inc.: Court Attacks Canada-U.S. Tax Avoidance Plan” (1993) 22:9 Tax Man Intl J 499 at 500.

loss consolidation arrangements, in particular, as an unacceptable threat to the domestic tax base. Accordingly, *Mark Resources* was primarily concerned with the cross-border element of the arrangement, rather than its innate structure; the objectionability instead lay in the arrangement's internationality and the resulting challenge to the Canadian tax base.

Overall, the result of the *Mark Resources* arrangement was that, for American tax purposes, PDI was able to utilise the losses while avoiding income tax on the interest income because the interest was sheltered from US income tax by the relevant loss carry forward rules. In Canada, PDL was able to deduct the interest paid on the loan, and PDL received the dividend receipts tax free. The interest income was therefore offset for the purposes of calculating PDL's foreign accrual property income.⁵⁰

Paragraph 20(1)(c) continues to contain no restrictions on international transactions, although the situation would not arise again as it has been addressed by changes in the foreign affiliate provisions of the Income Tax Act.⁵¹ The changes to the Act have the result that only losses from property and businesses (other than an active business) may reduce foreign accrual property income.

Neither the *Alesco* nor the *Mark Resources* judgment appears to consider how international cases are to be distinguished from domestic arrangements with the same structure. This question suggests that placing a greater emphasis on economic substance may be appropriate in certain situations to differentiate identical domestic transactions from cross-border transactions, as the differing economic effects separate otherwise legally indistinguishable domestic arrangements from cross-border arrangements. The legal substance of the transaction remains the same whether these arrangements occur domestically or internationally, as the parties still owe the same substantive obligations. However, as illustrated by the facts of *Mark Resources* and *Alesco*, the economic reality can differ because of the disparity between rules applied in each jurisdiction or from the use of domestic laws in cross-border transactions in a manner not contemplated by parliament.

⁵⁰ The Canadian foreign accrual property income (FAPI) regime taxes the passive income of controlled foreign affiliates. The rules are contained in ss 91-92 of the Income Tax Act RSC 1952 c 148. The purpose of the FAPI rules is to protect the Canadian tax base by preventing passive income from being deferred or avoided in foreign jurisdictions. See generally: Jinyan Li and Arthur Cockfield and J. Scott Wilkie *International Taxation in Canada* (LexisNexis, Canada, 2006) at 204.

⁵¹ This change was brought about by amendments to the Income Tax Act, s 93 and to the Income Tax Regulations CRC c 945 reg 5903(1).

V. Economic Reality in *Alesco* and *Mark Resources*

5 In both *Mark Resources* and *Alesco*, the economic reality of the arrangements was central throughout many aspects of the decision.

A. Framing the Issue

10 In the case of *Alesco*, the Court of Appeal initially formulated the primary issue as being whether Alesco's use of the financial arrangements rules and determination G22 to claim deductions for expenditure fell outside of Parliament's contemplation when enacting the rules.⁵² The Court of Appeal was evidently
15 concerned to frame the issue in a way that was an entirely orthodox application of the Supreme Court's parliamentary contemplation test, as formulated in *Ben Nevis*.⁵³ The parliamentary contemplation test first considers whether the use made of a specific provision was within its intended scope, and
20 then whether the use of the provision, viewed in the light of the arrangement as a whole, was nevertheless used in a way that was outside of Parliament's contemplation when it enacted the provision.⁵⁴

The Court of Appeal in *Alesco* went on to reformulate the
25 question in two different stages. From the starting point, where the phrasing of the central issue adopted the language and construction of the parliamentary contemplation test,⁵⁵ the issue was rephrased until the ultimate question was expressed as:
30 "should the anti-avoidance provisions be applied in a way that ignores the economic reality of the OCNS as contemplated by the deductibility provisions and G22?".⁵⁶ The court describes these reformulations as being mere repetitions of the same central question "expressed slightly differently".⁵⁷ However, with each
35 rephrasing of the issue, the emphasis shifts towards the economic substance of the arrangement. The result of this reframing of the issue is that the substantive economic reality of an arrangement became the dominant and explicit concern in

⁵² At [56].

⁵³ *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue* [2009] NZSC 40, [2009] 2 NZLR 358.

⁵⁴ Craig Elliffe and Jess Cameron "The Test for Tax Avoidance in New Zealand: A Judicial Sea Change" (2010) 16 NZBLQ 440 at 449.

⁵⁵ The Court of Appeal initially phrased the question at [56]: "if it is established that Alesco NZ did not incur either a legal liability to pay interest or any economic cost on the loan, did its use of the financial arrangements rules and G22 to claim income tax deductions for expenditure incurred fall outside Parliament's contemplation when enacting the rules?"

⁵⁶ At [56].

⁵⁷ At [56].

delineating acceptable and unacceptable avoidance. These reformulations of the parliamentary contemplation test move the issue towards one of economic reality and equate the parliamentary contemplation test with an inquiry into economic substance; Parliament is presumed to intend that the anti-avoidance provisions are applied in a way that reflects the economic reality of the arrangement. While many cases have expressed economic reality as a backdrop principle informing the parliamentary contemplation test, it is unusual for a New Zealand court to read it into the test as explicitly as it is in *Alesco*. This recognition of economic substance further suggests the growing significance of the doctrine, and maintains consistency with the purpose of the financial arrangement rules, which is to reflect the economic reality of these financial arrangements.

Mark Resources similarly placed great weight on the economic substance of the arrangement in the way it framed the primary issue, although interestingly, this seemed to be exclusively considered in relation to deductibility under the paragraph 20(1)(c) heading, rather than when considering the artificiality provision of paragraph 245(1). Indeed, when considering artificiality, *Bowman TCCJ* followed the decision in *Irving*,⁵⁸ and held that “the borrowing at a rate that does not and cannot yield an economic return as a means of achieving a predetermined economic result is in itself not artificial”.⁵⁹ It is difficult to reconcile the conclusion that the arrangement did not meet the purpose test of paragraph 20(1)(c) with the conclusion that the arrangement was not artificial under paragraph 245(1).⁶⁰ Paragraph 245(1), which was the functional equivalent of the GAAR, was more specifically targeted at tax avoidance transactions than the purpose test read into paragraph 20(1)(c). Accordingly, paragraph 245(1) seems to provide a less complicated route to arrive at the decision against the taxpayer, as well as a more natural path for considering economic realities. Indeed, the New Zealand bank conduit cases came to the opposite conclusion regarding the borrowing of interest at a rate that does not yield an economic return,⁶¹ which allowed the court to arrive at a decision against the taxpayer through a much neater and less conflicting analysis than was available under paragraph 20(1)(c).

⁵⁸ *Canada v. Irving Oil Ltd.* [1991] 1 CTC 350, 91 DTC 5106.

⁵⁹ At [31].

⁶⁰ Boidman remarks on the “apparent conflict between the two findings in: “Nathan Boidman “Mark Resources Inc.: Court Attacks Canada-U.S. Tax Avoidance Plan” (1993) 22:9 Tax Man Intl J 499 at 503.

⁶¹ *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) CIV-2004-485-1059 (HC), 24 NZTC 23; *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) CIV-2005-404-2843 (HC), 24 NZTC 23.

This further highlights the significance of judicial context for the application of economic substance. Absent of the *Irving* precedent, Bowman tccj may have been able to deal with economic substance more straightforwardly under paragraph 245(1), in a way similar to the New Zealand courts in the bank conduit cases. Instead, Bowman tccj framed the issue as being whether deductions under paragraph 20(1)(c) were allowable for an arrangement that had the utilisation of losses of the American subsidiary as the “economic object”.⁶² Similar to *Alesco*, there was no statutory cue to examine the “economic object” of the transaction, but the statute was interpreted so that this inquiry was a corollary of the “purpose” requirement of paragraph 20(1)(c).

B. Arguments Related to Economic Substance

Furthermore, the arguments advanced in *Alesco* and *Mark Resources* responded to the court’s preoccupation with substantive economic reality.

Alesco argued that the financial arrangement rules and determination G22 accurately identified the economic substance of the ocns as involving debt and equity components. If *Alesco*’s argument was correct it would follow that the statutory provisions in combination with determination G22, which presupposed a genuine interest cost to *Alesco* NZ as the issuer of the notes, reflected the intention of Parliament. The Commissioner argued that the purpose of the ocns was to alter the incidence of tax without suffering a real economic cost under the ocns.

In *Mark Resources*, the appellant argued that PDL had used the borrowed money to earn dividend income, and that this was the economic object of the arrangement. The Minister argued that the focus should be on the direct use of the funds, rather than on their underlying purpose, and that the direct use of the borrowed money was to contribute capital to PDI, despite this contribution producing no economic income.

C. Focus of the Reasoning

Throughout the *Alesco* decision, the economic reality of an arrangement is linked back to Parliament’s contemplation, on the basis of the conclusion that Parliament would not have contemplated that the statutory deduction rules would apply in the absence of a real economic consequence to those seeking to take advantage of the rules. To this end, the Court of Appeal affirmed that the financial arrangement rules were intended to

⁶² At [1].

give effect to “real economic benefits and costs”.⁶³ Alesco’s argument was therefore dismissed on the basis that the financial arrangements rules were “intended to give effect to the reality of income and expenditure- that is real economic benefits and costs”.⁶⁴ In view of this purpose of the rules, the Court of Appeal held that Parliament would not have contemplated that Alesco would be able to use the financial arrangement rules to claim deductions for notional interest when interest was not paid and there was no liability to pay it. By explaining the purpose of the financial rules as being to give effect to economic reality rather than to the legal or accounting form or treatment of the arrangement, economic reality remains the decisive factor in this judgment.

In *Mark Resources*, Bowman TCCJ agreed that the direct use of the borrowed funds was the injection of capital into PDL, but added that the necessary intended consequence was that PDL would earn interest and pay dividends to PDL. Yet Bowman TCCJ ultimately found that the “real purpose” of the borrowed funds was the importation of losses from the United States. In this sense, Bowman TCCJ focused on the purpose requirement of the section so emphatically that he effectively read into paragraph 20(1)(c) a substantive anti-avoidance test, which was based on the “true purpose” of the funds, to be understood with reference to the economic consequences of the arrangement. The test considered what the overriding and “ultimate economic objectives” of the money was.⁶⁵ Bowman TCCJ explained that “it is true that the overall economic result... is a net gain to the appellant, but this type of gain is not from the production of income but from a reduction of taxes otherwise payable in Canada”.⁶⁶ The earning of dividend income could not be regarded as the ultimate economic purpose of the arrangement since this net economic gain was derived from the tax benefits. As a result of this focus on the ultimate economic purpose of the arrangement, the conclusion was that the interest was not deductible under paragraph 20(1)(c) as the money was held not to have been borrowed for the purpose of earning income.

Thus, in both cases, despite the materially similar statutes operating in Canada and New Zealand, both of which did not expressly require consideration of economic substance, the economic reality of the arrangement was central to the courts’ analysis and findings against the taxpayer, which is evident in the way the issue is framed, argued, and decided.

⁶³ At [71].

⁶⁴ At [70].

⁶⁵ At [45].

⁶⁶ At [45].

D. Other Indicators: Artificiality and Commercial Reality

On the surface, *Alesco* and *Mark Resources* are analysed against numerous other indicators of avoidance, such as “artificiality” or “commercial reality”. Yet, a closer inspection of these indicators reveals that they are often firmly grounded in the concept of economic reality.

For instance, both cases describe “artificiality” as a significant indicator of avoidance. *Alesco* cited a passage of *Ben Nevis* that described an “artificial or contrived” use of a specific provision as being a “classic indicator” of avoidance.⁶⁷ In *Mark Resources*, the wording of paragraph 245(1) prescribed artificiality as being the central hallmark of avoidance. However, the notion of “artificiality” adopted in these cases is closely tied to the concept of economic substance. That is to say, whether an arrangement is artificial is largely determined in accordance with whether it lacks economic substance.

In *Alesco*, the OCNS were held to be artificial on the basis that *Alesco NZ* was already a wholly owned subsidiary. That is, the option to convert the notes to shares at the end of the ten-year period was artificial because *Alesco* already had the ability to issue more shares. The High Court observed that if *Alesco* had exercised the option, “no change to *Alesco NZ*’s status as a wholly owned subsidiary would have been effected” by having 78,100,000 shares rather than 100,000. The crux of this finding is located in the arrangement’s economic substance; the option had no economic value, because even without the OCNS *Alesco*, as the holder of 100 per cent of *Alesco NZ*’s capital, was able to procure the issue of new shares. Therefore, according to the underlying economic substance, the court held that the OCNS were an artificial interest free loan, which should not receive the interest deductions arising under the financial arrangement rules.

Mark Resources took a different view of artificiality, which was more concerned with the legal substance of the arrangement. The legal technique adopted by *Mark Resources* was not artificial because the arrangement involved “real transactions” and despite the fact that *PDL* borrowed the money at a higher rate than the anticipated return, the interest was still not excessive. It is difficult to square this focus on legal substance under the artificiality inquiry of paragraph 245(1) with the strong focus on economic substance in relation to deductibility under paragraph 20(1)(c). This shift in approach may be explicable in view of the influence of the Federal Court

⁶⁷ At [22].

of Appeal's decision in *Canada v. Irving Oil Ltd.*⁶⁸ In that case, an arrangement involving an offshore company that sat between the taxpayer's suppliers and the taxpayer, which served no purpose other than to increase the price of the oil, was not artificial because the price was still found to be at fair market value. The Court in *Mark Resources* stated that "if the Irving scheme was not artificial this one cannot be",⁶⁹ leaving deductibility under paragraph 20(1)(c) as the alternative avenue to reach the result against the taxpayer through reasoning based on economic reality.

In this respect, *Mark Resources* may have missed an opportunity to moderate the *Irving* precedent, which is open to criticism. The *Irving* conclusion that the existence of market value prices shields the arrangement from being considered artificial should be resisted because while market value may provide valuable evidence of what the taxpayer's income is, it cannot be determinative to the issue of artificiality as there may be good reasons why a market value price is not paid in certain circumstances. In the New Zealand case of *Penny v Commissioner of Inland Revenue*, where two orthopaedic surgeons structured their business to pay artificially low salaries, the findings on artificiality were reached without giving significant recognition to the fair market salary.⁷⁰ The Supreme Court noted that it is commonplace for family transactions to not be based on market valuations,⁷¹ which recognises that market value is only one factor going towards artificiality, which may be displaced by other circumstances.

Mark Resources and *Alesco* also considered commercial reality as an indicator of avoidance. The Court of Appeal did not impugn the underlying commercial rationale of the transaction in *Alesco*, because *Alesco NZ* was pursuing the real commercial objective of acquiring the businesses. However, the Commissioner still challenged the particular ocn arrangement chosen to fulfil this objective on the basis that it was not commercially realistic. The Court agreed with this, observing that there was no commercial purpose for the ocns, predominantly because of the lack of economic value that the arrangement had for *Alesco*. Thus, the conclusion that the arrangement was not commercially realistic was again essentially based on the lack of economic substance of the ocn option.

The notion of economic substance also underpins the discussion of commercial reality in *Mark Resources*. The court

⁶⁸ *Canada v. Irving Oil Ltd.* [1991] 1 CTC 350, 91 DTC 5106.

⁶⁹ At [31].

⁷⁰ *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433 at [47].

⁷¹ At [49].

cited *Irving* again in support of the proposition that a fair market price “offend[s] no principles of commercial normality”.⁷² This duplicates the focus on economic substance for the same reasons the Court gave when considering “artificiality” in *Mark Resources*.

VI. *Mark Resources* and *Alesco* in Context

The treatment of economic substance in *Mark Resources* and *Alesco* must be viewed in the appropriate jurisprudential context. While there is similarity in the intent of the legislation and in the way that neither the Canadian nor the New Zealand statutes directly prescribed economic substance to be part of the avoidance inquiry, the judicial analysis of economic reality in New Zealand and Canada has differed significantly.

Generally, New Zealand has more readily accepted economic substance as an indicator of avoidance. *Ben Nevis* stands as the most authoritative case from the New Zealand Supreme Court on the issue of avoidance.⁷³ In *Ben Nevis*, economic reality was undoubtedly significant, with the court emphasising that transactions were to be viewed in a “commercially and economically realistic” way.⁷⁴ Additionally, the decision itself reflected a willingness to look behind the form of the transaction.⁷⁵ Similarly, the importance of economic substance was affirmed in *Glenharrow*,⁷⁶ where the Supreme Court decision against the taxpayer held that “the intention of the [1985 Goods and Services Tax] Act will be defeated if an arrangement has been structured to enable the avoidance of output tax, or the obtaining of an input deduction in circumstances where that consequence is outside the purpose and contemplation of the relevant statutory provisions”.⁷⁷ *Penny v Commissioner of Inland Revenue* was consistent with this line of Supreme Court authority. The court found that “the

⁷² At [29].

⁷³ The Supreme Court has also delivered tax avoidance judgments under the GAAR in *Glenharrow Ltd v Commissioner of Inland Revenue*, below n 59, and *Penny v Commissioner of Inland Revenue*, below n 61. However, *Glenharrow* concerned the GAAR under the Goods and Services Tax Act 1985, and *Penny v Hooper* followed *Ben Nevis*.

⁷⁴ At [109].

⁷⁵ The Supreme Court decided that despite formal compliance with the provisions for deductions and depreciation allowances, the promissory notes given in *Ben Nevis* were not, in substance, payment because the economic burden of payment was lacking.

⁷⁶ *Glenharrow Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZ

⁷⁷ At [40].

taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had”.⁷⁸

5 The approach of the Canadian courts has typically been marked by a much greater reluctance to look to the economic substance of an arrangement as a key determinant of avoidance. There is a spattering of judgments that support economic reality and the reasoning of *Mark Resources*, such as *Bronfman Trust*, which considered the trend towards “true commercial and practical nature of the taxpayer's transactions” to be laudable.⁷⁹
10 However, judgments subsequent to *Mark Resources*, such as *Shell Canada* and *Singleton* have rejected this approach.⁸⁰

Following *Mark Resources*, Bowman TCCJ initially affirmed the economic realities reasoning in *Singleton* in the Federal Court of Appeal,⁸¹ even repeating some parts of the *Mark Resources* decision verbatim. However, the true economic purpose reasoning was later rejected in *Singleton* at the Supreme Court in the wake of *Shell Canada*, despite *Mark Resources* being selectively cited by the Supreme Court as a “significant decision” of the lower courts on economic realities
20 jurisprudence.⁸² The *Shell Canada* decision was determined under the same former paragraph 245(1) as *Mark Resources*.⁸³ *Shell Canada*⁸⁴ emphasised the distinction between legal and economic substance, with the court holding that the economic substance cannot prevail over the legal substance. The Supreme
25 Court acknowledged that the “courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form”.⁸⁵ However, this endorsement of economic reality was drastically limited by two significant caveats. First, that economic realities could not
30 be used to recharacterise *bona fide* legal relationships, and secondly, that an inquiry into economic realities could not replace the duty of the Court to apply clear and unambiguous statutory terms. Arnold and Li observe that although *Shell Canada* does not expressly reject all consideration of economic
35 reality, it severely reduces its relevance because it is difficult to contemplate a situation where economic reality would be relevant, outside of the characterisation of an arrangement,

⁷⁸ *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433 at [47].

⁷⁹ *Bronfman Trust v The Queen* [1987] 1 SCR 32 at [39].

⁸⁰ *Shell Canada Ltd. v Canada* 2005 SCC 54, [1999] 3 SCR 622; *Singleton v Canada* 2001 SCC 61, [2001] 2 SCR 1046.

⁸¹ *The Queen v Singleton* (1996) DTC 1850.

⁸² At [51].

⁸³ The former section applied because the relevant debenture agreements and forward exchange contract were entered into prior to the enactment of the Canadian GAAR in 1988.

⁸⁴ *Shell Canada*, above n 80.

⁸⁵ At [39].

unless a provision expressly referred to economic reality, which is very unusual.⁸⁶ This near-total rejection of economic reality in *Singleton* and *Shell Canada* leads Akin to summarise the Canadian Supreme Court's view as being that "legally binding relationships created by a taxpayer's transactions cannot be ignored or recharacterized for tax purposes, notwithstanding the fact that those transactions may have been entered into solely for tax purposes".⁸⁷

The tide may be turning following the enactment of the GAAR in Canada. *McNichol*⁸⁸ the first case to consider the Canadian GAAR, required that a surplus-stripping transaction be "viewed realistically",⁸⁹ seemingly invoking economic reality. In *Trustco*,⁹⁰ the Canadian Supreme Court's seminal consideration of the GAAR noted that economic substance is indeed relevant at various stages of the analysis, but that it must be considered in relation to the proper interpretation of the specific provisions involved.⁹¹ The court in *Trustco* quoted from the explanatory notes that "Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax."⁹² This recognition of economic substance suggests a shift back in the direction of the *Mark Resources* decision.⁹³

Both *Mark Resources* and *Alesco* sit within significantly different contexts. While New Zealand has typically been alert to economic reality, *Mark Resources* stands as an outlier in its jurisdiction in terms of its willingness to look to economic realities. Consequently, later Supreme Court cases severely limited *Mark Resources*. However, following the enactment of the GAAR, there is some suggestion that the wide rejection of an approach involving the recharacterisation of a transaction according to its economic substance, may be changing.

Leave has been granted to *Alesco* to appeal to the Supreme Court of New Zealand on the ground of whether, in the light of the principles laid down in *Ben Nevis* and other tax avoidance cases, the structure used for funding the transactions is a tax

⁸⁶ Brian J. Arnold and Jinyan Li "Justice Bowman on Substance over Form" (2010) 58 Can Tax J 127 at 129-130.

⁸⁷ Tom Akin "Canada" (paper presented as part of the American Bar Association – Section of Taxation Meeting, Washington D.C., May 2004).

⁸⁸ *McNichol et al. v The Queen* (1997) 97 DTC 111.

⁸⁹ At [25].

⁹⁰ *Canada Trustco Mortgage Co. v Canada* 2011 SCC 36, [2005] 2 SCR 601.

⁹¹ At [76].

⁹² At [48].

⁹³ But see Tom Aikin and others "Economic Substance Around the World (Part 1)" (2005) 16(1) JIT 50 at 55 ("... the Canadian judiciary has generally rejected use of the [economic substance] test even after the enactment of the general anti-avoidance rule").

avoidance arrangement. It will be interesting to observe whether the Court of Appeal's decision will attract as much judicial criticism as *Mark Resources* received in later judgments, although an examination of the New Zealand context, which has paid much closer attention to economic substance, suggests that a similar response is unlikely.

VII. Criticisms of Economic Realities Jurisprudence

Shell Canada contains the most direct criticism of *Mark Resources*. *Shell* was particularly critical of the economic substance reasoning used in *Mark Resources*, stating that a “misplaced reliance on ‘economic realities’ caused the court to stray from the express terms of s. 20(1)(c)(i)”.⁹⁴ The concern expressed in *Shell* was that deference to economic substance would overshadow conventional statutory interpretation of the specific section invoked and, in turn, the legislative function of Parliament would be usurped. The court in *Shell* warned against the judiciary importing economic policy concerns into the inquiry when Parliament did not seek to introduce economic policy. McMechan labels this as a concern against “judicial redrafting”.⁹⁵

The argument against “judicial redrafting” was perhaps more persuasive before the enactment of the GAAR in Canada, which has mandated a greater scope for the courts to define the borders of tax mitigation and avoidance. Indeed, the introduction of the GAAR seems to have been highly influential in the recognition of economic reality by the Supreme Court in *Canada Trustco*, where the court acknowledged that the GAAR “superimposed a prohibition on abusive tax avoidance” that would necessitate a less literal approach to the Act's provisions, and affirmed that economic substance is relevant at various stages of the analysis.⁹⁶ Arnold cautions that the failure to afford sufficient importance to economic reality will actually render the GAAR ineffective and defeat the entire purpose of its introduction.⁹⁷

McMechan considers New Zealand's approach to be “light years away from where Canadian courts presently are in regard to recognition of the essential role that economic substance plays in tax avoidance cases” and concludes that a legislative push would be required to bring the Canadian jurisprudence in line. Yet, while the few tax cases to come before New

⁹⁴ At [43].

⁹⁵ Robert McMechan *Economic Substance and Tax Avoidance: An International Perspective* (Carswell, Canada, 2013) at 108.

⁹⁶ McMechan above n 95, at 76.

⁹⁷ Brian J. Arnold “The Long, Slow, Steady Demise of the General Anti-Avoidance Rule” (2005) 52(2) Can Tax J 488 at 510.

Zealand's Supreme Court have been a relatively recent phenomenon, it should not be forgotten that New Zealand has had a significantly longer time to adapt to the environment established by a GAAR, with the first general anti-avoidance provision introduced in 1873,⁹⁸ and the first application of such a provision to income tax in 1891.⁹⁹ The approach to the Canadian GAAR, enacted almost a century later in 1988, may simply take time to evolve. Bearing in mind this comparatively short timeframe since the enactment of the GAAR, additional measures such as amendments to the GAAR expressly directing consideration of economic substance may be unnecessary action for a problem that may soon resolve itself.

Additionally, the concern about "judicial redrafting" overlooks the unique nature of tax law that demands that the courts play an active role in gap filling and closing loopholes, as the legislature simply cannot predict some of the arrangements that taxpayers create.¹⁰⁰ Indeed, the prompt enactment of new rules to close legislative gaps and prevent similar situations from arising by New Zealand and Canadian tax authorities seems to vindicate the Court's interpretation of parliamentary contemplation based on economic reasoning in *Mark Resources* and *Alesco*.

Moreover, cross-border arbitrage, in particular, requires the attention of the courts, because arbitrage arrangements are particularly effective at complying technically with the letter of the law while acting outside of parliament's contemplation. Unlike wholly domestic attempts at avoidance, cross-border arrangements are very often able to conform very strictly to the legal requirements or entitlements, as well as the domestic economic policy, under the respective tax regimes. In this way, profit is derived from exploiting conflicting or inconsistent rules, rather than from exploiting ambiguities within a domestic regime. Therefore, it is easier to comply technically and formalistically with the laws and economic policy of the two jurisdictions than to strain the statutory regime within a single jurisdiction.

⁹⁸ Land Tax Act 1878, s 62.

⁹⁹ Land and Income Tax Assessment Act 1891, s 40.

See generally Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective" (2009) 19(1) Revenue Law Journal 1 at 4.

¹⁰⁰ Rebecca Prebble and John Prebble "Does The Use Of General Anti-Avoidance Rules To Combat Tax Avoidance Breach Principles of the Rule of Law?" (2012) 2 VUWLRP 8 at 38; Brian M Studniberg "Minding the Gap in Tax Interpretation: Does Specificity Oust the General Anti-Avoidance Rule Post-Copthorne?" (2012) 38:1 Queen's LJ 209 at 210.

VIII. Conclusion

In some situations, such as those present in *Alesco* and *Mark Resources*, cross-border tax arbitrage may amount to tax avoidance. In both of these decisions, consideration of the economic substance of the arrangements was paramount, even in the absence of any specific legislative demands to look to economic reality. The concern for economic substance permeates the cases; the legal issues and tests are phrased to position economic substance as a dominant factor for analysis, counsels' arguments reflect this concern, the reasoning adopted in these cases focuses strongly on economic substance, and other existing indicators of avoidance are closely tied to notions of economic reality. This focus is a consistent, albeit more explicit, expression of New Zealand tax avoidance jurisprudence. In comparison, the approach to economic reality in Canada varies significantly. The difficulty that the Court in *Mark Resources* had in bringing an economic substance analysis into the decision in a straightforward way, as well as the subsequent rejection of the *Mark Resources* analysis in several significant decisions reflects this inconsistent, and often reluctant, consideration of the doctrine in Canada. The introduction of the Canadian GAAR may reverse this trend and bring the Canadian approach to economic realities in line with New Zealand. This change would be desirable because, viewed in context, *Alesco* and *Mark Resources* affirm that the centrality of economic reality in a way that appropriately reflects the importance of the concept to determining the boundaries of avoidance in cross-border arbitrage.

30

IX. Appendix

Income Tax Act 2004 (New Zealand)

BG 1 Tax avoidance

Avoidance arrangement void

(1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

Reconstruction

(2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

OB 1 Definitions

Arrangement means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:

tax avoidance includes—

- (a) directly or indirectly altering the incidence of any income tax:
- (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
- (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

Tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

- (a) Has tax avoidance as its purpose or effect; or
- (b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental.

Income Tax Act RSC 1952 c 148 (Canada)

20 Deductions permitted in computing income from business or property

(1) Notwithstanding paragraphs 18(1)(a),(b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the

following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

.....

(c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),

(ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),

or a reasonable amount in respect thereof, whichever is the lesser.

245 Artificial Transactions

(1) In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

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iii. Canada

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XI. Word Count

The length of this research paper is 7998 words, excluding abstract, appendices, footnotes, and bibliography.