# Kluwer International Tax Blog

## Is the first taste of the PPT Maple flavour?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Friday, September 21st, 2018

The Tax Court of Canada decision in *Alta Energy Luxembourg S.A.R.L. v. The Queen*, 2018 TCC 152 (CanLII) on August 22, 2018 may provide useful pointers to the meaning and application of the PPT found in Article 7(1) of the MLI and Article 29(9).

A Luxembourg resident company claimed exemption from Canadian income tax under Article 13(5) of the Canada-Luxembourg Treaty in respect of a large capital gain from the sale of shares in its wholly-owned Canadian subsidiary. The Canadian subsidiary had a licence to explore, drill and extract hydrocarbons in Canada. These interests were initially owned by US investors but were transferred to the Luxembourg company pursuant to a restructuring of the ownership.

The Canadian Revenue Agency challenged the treaty exemption on the basis that (a) the shares were immoveable property, since more than 50% of their value was based on the Canadian company's working interest in the licence (more about this later), and (b) that it infringed the Canadian domestic general anti-avoidance rule (GAAR) which is drafted, in terms, to override Canada's tax treaties. Although the Canadian GAAR is not identical to the PPT. It has important features in common.

**Was the transaction abusive?**

The Luxembourg company accepted that it derived a tax benefit from the restructuring of ownership from the US to Luxembourg. The Appellant also conceded that the restructuring was not arranged primarily for a bona fide purpose other than to obtain a tax benefit. In PPT terms, this element is addresed by the requirement that "obtaining that [treaty] benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit". The restructuring thus qualified as an "avoidance transaction" within the Canadian GAAR.

The only issue was therefore, whether the avoidance transaction was "abusive". To determine whether there was abuse, the Canadian courts have adopted a two-step approach:

- First step: identify the object, spirit and purpose of the relevant rule;
- Second step: determine whether the avoidance transaction falls within, or frustrates, that rationale.

This is not dissimilar from the PPT, under which, an arrangement is outside the PPT if "it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

The CRA argued that the misuse or abuse results from the fact that the Luxembourg company, although a resident of Luxembourg for the purposes of Article 4 of the treaty, was created and became the owner of the shares for no purpose other than avoiding Canadian tax on the gain that it realised on the disposal of the shares. It noted that the company paid no tax in Luxembourg.

The Court however ruled that the purpose of the treaty "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital" as set out in the preamble, is indicative of the general purpose of the Treaty. It considered this statement vague regarding the application of specific treaty articles of the. Under the GAAR analysis, it said, the Court must identify the rationale underlying the relevant articles (1, 4 and 13), and not a vague policy supporting a general approach to the interpretation of the Treaty as a whole.

**Treaty shopping**

The Court devoted considerable attention to the question of whether "treaty shopping" constitutes an abuse of the treaty. It notes that the term is not defined in any Canadian tax treaties or in the Income Tax Act. The beneficial ownership requirement in articles 10,11 and 12 were a limited anti-abuse or treaty shopping rule and there was no limitation on benefits article to prevent treaty shopping as found in the Canada-US treaty. The Court followed the Federal Court of Appeal in *St. Michael Trust Corp. v. Canada*, 2010 FCA 309 (CanLII), at para 90 to decide that if the company is a resident of the other contracting state for treaty purposes, then it cannot misuse or abuse the treaty by claiming the exemption provided by the treaty.

The OECD Commentary, at the time the treaty was concluded, on Article 13, paragraph 28.12 noted that that some states do not tax capital gains. In such cases, it is the responsibility of the state that does tax capital gains to prevent a double exemption if it wishes to do so. Canada and Luxembourg did not choose this option. The Court said that it is not the role of the Court to disturb their bargain. This paragraph was deleted from the 2017 Commentary.

**McDonald's: EU State Aid decision**

The Tax Court of Canada ruling was followed shortly by the European Commission announcement on 19 September 2018 concluding that a Luxembourg ruling that the of profits of McDonald's Europe Franchising attributable to a permanent establishment in the US are exempt in Luxembourg even if they are also not taxable in the US even does not violate the Luxembourg -US Treaty. Such a conclusion is only possible on the basis that the ruling merely confirmed the correct legal position and did not confer a selective tax advantage. Double non-taxation was, consequently, a conclusion that may properly be reached in interpreting a tax treaty.

**Indirect transfers**

The case touched on another hot button in international taxation – indirect transfer of immovable property. Article 13(4) permits the source state to tax the alienation of shares in a company if more than 50% of the value of the company is based on immovable property in the source state. In this treaty, "property in which the business is carried on" is excluded from the definition of immovable property. The CRA accepted, for purposes of the exception in article 13(4), that "business is carried on in a working interest in a licence where the company's activities exercise the rights granted by the lease or license". The Court concluded that all of the Canadian company's working interest was excluded from the definition of immovable property and the share sale thus qualified for exemption under article 13(5).

Differences between the Canada-Luxembourg treaty and the MLI/ 2017 OECD Model include the new preamble, which encompasses the non-creation of opportunities of non-taxation or avoidance through treaty shopping, and a revised Commentary on the OECD Model. The *Alta Energy* decision is also likely to be appealed to the Federal Court of Appeal. Regardless of the outcome of that appeal, the case gives useful insights into the interpretation and application of the PPT. Perhaps the real moral of the story on both aspects of the case is for treaty negotiators: say clearly and precisely when and how treaties should apply.

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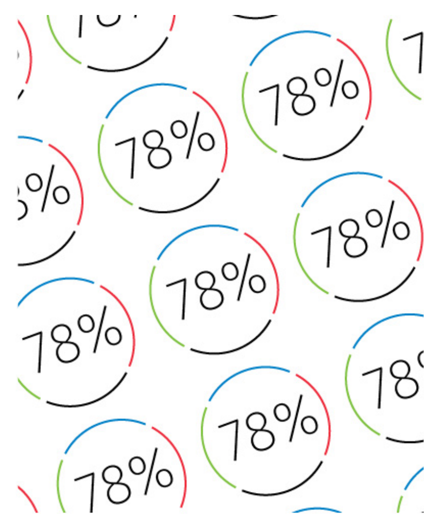

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