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Alta Energy: Treaty shopping is no abuse

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The Canadian Federal Court of Appeal has upheld the Tax Court of Canada decision in *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2020 FCA 43 (CanLII). The case is of some significance because the Canadian Revenue Agency ("CRA") sought to apply the Canadian domestic general anti-avoidance rule (GAAR) in order to deny treaty relief. The GAAR has considerable similarity to the PPT in article 7 of the OECD MLI and article 29((9) of the 2017 OECD and UN model treaties. I discussed the Tax Court of Canada decision in my blog on 21 September 2018.

The facts were relatively straightforward. Shares in a Canadian resident oil and gas company were owned by US investors. A restructuring was undertaken which resulted in the interposition of a Luxembourg resident company to own the Canadian company, which itself in turn was owned by the US investors. The case was of considerable significance to both taxpayer and tax authority because the sale of the shares in the Canadian company resulted in a capital gain in excess of $380 million.

Article 13(5) of the Canada-Luxembourg double tax treaty prevented Canada from taxing the gain. The equivalent provision in the Canada-United States double tax treaty would have permitted Canada to tax the gain. The gain was not taxed by Luxembourg.

In the Tax Court, the CRA disputed that article 13 of the Canada-Luxembourg treaty prevented Canada from taxing the gain, but on appeal confined their grounds to the application of the GAAR.

GAAR requirements

The Canadian GAAR has three requirements for its application:

- a tax benefit;
- an avoidance transaction; and
- an abuse of the provisions of the Income Tax Act or, in this case, the treaty.

The taxpayer accepted that there was a tax benefit in the form of the relief from Canadian tax under article 13 and that there was an "avoidance transaction" because the purpose of the restructuring was only to obtain the tax benefit. The case therefore turned on whether there was an abuse of the provisions of the treaty.

Abuse

The test to determine whether there was an abuse of the treaty provisions was explained by the Federal Court of Appeal as involving two stages as follows:

The first stage requires the determination of the object, spirit and purpose of the provisions giving rise to the tax benefit. This determination is discerned by way of interpretation of the relevant provisions. Interpretation involves a textual, contextual and purposive analysis of the provisions on which the tax benefit is based.

The second stage turns on whether the provisions, so construed, were frustrated by the tax benefit achieved.

The Canadian courts have ruled that once a taxpayer has shown compliance with the wording of a provision, it is up to the tax authorities who seek to rely on the GAAR, to show that the object or purpose of the provisions have been frustrated or defeated. In other words, the taxpayer should not be required to disprove violation of the object or purpose of the provision. The reason is that the tax authority is better placed to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

OECD Commentary rejected

Reliance on the Commentary to the OECD Model by the CRA was criticised by the Court. In particular, reliance upon later Commentary was rejected. The treaty was concluded in 1989 and only Commentary dated 1998 and later was cited. The Commentaries, to which the Crown referred, related to an OECD Model Tax Convention created after the particular exemption in issue was included in the first treaty between Canada and Luxembourg. The Commentary cited was written for a Model that was not adopted by Canada and Luxembourg.

The Court ruled that a person is a resident of a contracting state, if that person is liable to tax for the reasons stated in Article 4, namely, a person ““who, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, place of management or any other criterion of a similar nature”. The level or amount of tax is not relevant. To add or infer a condition that a resident will only be a resident of Luxembourg if a certain amount of tax is paid, would alter the words in the article. No additional conditions or requirements could be added.

For the same reason, there is no distinction between Luxembourg residents with strong economic or commercial ties and those with weak or no commercial or economic ties if they satisfy the definition of resident in Article 4. Similarly the Court said It was inappropriate, in the absence of express language to that effect, to search for an underlying rationale for corporate residence that would require the Court to pierce the corporate veil to determine who owns the shares of the resident corporation. If the exemption was only intended to apply to certain corporate residents of Luxembourg, then whatever qualification was intended could have been specified in the treaty.

Impact on the PPT

The decision is bound to impact on the PPT. The same three GAAR criteria are present in the PPT:

- a benefit under the treaty;
- a principal purpose of any arrangement or transaction that resulted directly or indirectly in that benefit (the “avoidance transaction”);

- unless, granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention (the absence of abuse).

Guidance from the Federal Court of Appeal in *Alta Energy* on how the object and purpose is determined, will undoubtedly inform on this question. There may be a difference between demonstrating abuse and demonstrating its absence, but in practice analysis of object and purpose will be the same.

Treaty shopping and the MLI preamble

Federal Court of Appeal focused entirely on the relevant treaty provisions in deciding whether there was an abuse of those provisions. Unlike the Tax Court, who considered but rejected, the preamble as a source of interpretation of the specific provisions, the Federal Court of Appeal determined the question without reference to the preamble.

The preamble to the 2017 Model treaties and article 6 of the MLI express the purpose of the treaty in eliminating double taxation "without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)".

Similar language was used in argument advanced by the CRA before the Federal Court of Appeal about the purpose of the provisions. The Court observed that the difficulty with this was that it is worded in the negative and it is a general statement of what was asserted not to be the intent of these provisions. In other words, it does not explain what the intent was.

The CRA relied on a statement in the leading Canadian decision on tax treaty interpretation, *Crown Forest Industries Limited v. The Queen*, 1995 CanLII 103 (SCC), [1995] 2 S.C.R. 802 that:

'"Treaty shopping" might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the U.S. as the resident country would tax the income.'

However, the Court ruled that that the object and purpose of the relevant provisions of the treaty is reflected in the words as chosen by the contracting states. Since the provisions operated as intended, there was no abuse. Thus, *obiter dicta* in *Crown Forrest* about treaty shopping did not establish abuse arising from the choice of the most beneficial treaty. Is the fate of the preamble language the same?

The case is very likely to go to the Supreme Court of Canada. In any event, the Canadian authorities do not seem to show much confidence in the GAAR or PPT in such circumstances. At the Canadian Tax Foundation Annual Conference in December 2019, the Department of Finance confirmed that they would be seeking to include limitation on benefit provisions along the lines contained in article 29 of the OECD Model in treaties where appropriate.

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