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Mr. Brian Ernewein
General Director, Tax Policy Branch
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140 O'Connor St
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Dear Mr. Ernewein,

ANTI-TREATY SHOPPING PROPOSALS – DELOITTE'S COMMENTS

We are writing to provide our comments on the anti-treaty shopping proposals outlined in Budget 2014. The anti-treaty shopping proposals represent a significant change in Canadian tax policy and we commend the Government for seeking input from stakeholders in this regard.

If enacted in their current form, the proposals will discourage inbound foreign investment into Canada. Moreover, the framework, while providing greater certainty to the Government in terms of opportunity to capture perceived abuses, introduces significant commercial uncertainty to taxpayers in terms of being able to adequately predict the Canadian taxes that will be applicable in respect of particular transaction flows. It also significantly reduces the clarity provided by Canada's network of income tax conventions.

Predictability is a key element of any tax system and it should be reasonably maintained. Tax policy changes should be carried out in a manner that provides taxpayers with a clear and predictable framework so that they can adequately determine the impact of the changes on potential Canadian investments and make informed decisions. Without clear guidance, taxpayers are forced to model a worst case scenario. This has been negatively affecting investment decisions since the proposals were announced.

Canada is a small, open economy and has capital needs well beyond that which its residents can provide. Foreign investors have a broad range of opportunities as to where to invest their capital. Thus, introducing Canadian tax policy changes that create uncertainty and reduce investment yields will undermine foreign inbound investment into Canada. To attract foreign capital, Canadian projects generally must support higher potential yields than comparative investments located in the home country of a capital source (e.g., the United States). We are hearing this message loudly from our clients.

This is a particular issue for the energy and resources sector, given this sector's significant need for and difficulty in accessing capital. While private equity has recently begun to fill this void, the anti-treaty shopping proposals, if enacted, will divert a substantial portion of this capital (as relative yields on investments in other jurisdictions become more attractive), thereby, reducing development of Canadian assets. Reduced investment translates into a slower pace of economic development which negatively affects the economic well-being of Canadians in general.

On this basis, we urge the Government to carefully consider the impact of the proposed rule, particularly given the current state of the economy.

If a decision is made to move forward with some form of anti-treaty shopping measure, we do not favour the implementation of a domestic anti-treaty shopping rule. We recommend the negotiation of treaties with clear limitation on benefits (LOB) provisions for benefits not intended to be available to all taxpayers resident in a treaty partner.

Our comments

1. Framework for our comments

Our comments are based upon principles that have been reflected in Canadian tax policies for many years. Since the Canadian tax system is a self-assessment system, tax provisions must be clear and consistent. Taxpayers must be able to comply with their income tax obligations at a reasonable cost relative to the complexity of their business operations. Ministerial discretion to override what appears to be clarity in the tax laws (such as is reflected in treaties) should be restricted to the most egregious situations. Canadians expect their tax laws to be consistent, predictable and fair and to be applied in a manner which is consistent, predictable and fair. Our courts have commented that relying upon ministerial discretion to restrict the application of anti-avoidance provisions to situations in which the "tax avoidance" is unacceptable is hampered by the problem that unacceptability is in the eye of the beholder. It creates the spectre of similarly situated taxpayers being treated differently for no objective reason. Absent clear legislative wording, the law should apply equally to all taxpayers.

This suggests that any anti-treaty shopping provision should be framed in a manner in which it should be applied rarely. We believe, for example, that it would be unnecessary if the relevant treaty has a comprehensive LOB clause, together with a clear statement that the treaty is not to restrict the right of a contracting state to deny benefits where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the convention.

If a multilateral instrument is agreed to by Canada and many other countries, which effectively imports into Canada's treaties with signatory jurisdictions a comprehensive LOB provision together with a prohibition of abuse, any domestic anti-treaty shopping provision should not be applied in situations involving a resident of such jurisdiction. The relevant treaties would then recognize that the general anti-avoidance rule (GAAR) has relevance so the interpretative concerns arising from decisions like *MIL (Investments) S.A. v. The Queen*, 2006 TCC 460 (Aff'd 2007 FCA 236) should be rendered academic.

Our preference to restrict reliance on a domestic anti-treaty shopping provision is based on the absence of guidance as to how the selected words should be interpreted. LOB provisions at least benefit from judicial and regulatory interpretation in other jurisdictions and to a degree in Canada. A multilateral instrument incorporating similar features would accumulate relevant guidance much more quickly than a Canada-only anti-treaty shopping provision. We remember the uncertainty which accompanied the introduction of the GAAR and the procedural steps Canada had to adopt to ensure that it was applied in a uniform manner. The frequency with which taxpayers and tax auditors will be required to address treaty-shopping concerns raises similar issues.

We believe that our tax system should be stable. Any fundamental changes should be introduced with an appropriate transition period to allow taxpayers to rearrange their affairs, or to render the changes prospective. Article XIII(9) of the Canada-US treaty (dealing with capital gains) demonstrates how such relief might be effected in a manner which does not require taxpayers to undertake restructuring transactions.

The instruction “do unto others as you would have them do unto you” is relevant here as well. Inbound investment into Canada should be treated in the same manner as we would expect other countries to treat Canadian outbound investment. The Canadian foreign affiliate system is designed to allow our multinational corporations to use reasonable means to reduce foreign taxation of business income, within the ambit of relevant foreign tax laws. Any anti-treaty shopping provision should be tested to ensure that if it were adopted by a foreign government, it would not adversely affect normal Canadian corporate tax planning.

Finally, it should be noted that in recent years, the Government has acted on the belief that it is in Canada’s economic interest to maintain competitive Canadian tax rates. Policies that increase effective Canadian tax rates should be challenged to confirm that they do not undermine this principle.

Before concluding that a robust anti-treaty shopping regime is necessary, let us be clear what the advantages will be. If there are limited advantages to be gained, the administrative burden imposed on taxpayers and the government itself should not be large, or the proposals fail that basic test of having benefits greater than their costs.

2. Targeted domestic legislative refinement

The most significant change that Canada could make to combat treaty shopping would be to modernize the withholding tax regime.

Part XIII withholding tax rates were set at a time when both corporate and individual tax rates were much higher than today. Further, Canada has a vast network of tax treaties in which the withholding rates have been reduced. We therefore recommend that any anti-treaty shopping solution involve the reduction of these domestic withholding rates to 5% for non-portfolio dividends, 15% for portfolio dividends, and 10% for royalties and non–arm’s length interest, with a possible carve-out in respect of income that is physically linked to Canada, such as real property rents or resource royalties.

Some might object to the revenue loss such change would entail. As parties outside government, we do not have access to the detail, but Canada Revenue Agency records should enable you to identify a reasonable maximum estimate of the revenue loss. We suspect that very little income, outside of real property rentals, is actually taxed at the 25% rate. Even real property rentals, given the reduction in Part I tax rates, are unlikely to be taxed at 25% of the gross because taxpayers have the option to elect under section 216 to be taxed effectively under a Part I regime. Going forward, if indeed the 25% withholding tax would be broadly applicable as a result of an overly broad anti-treaty shopping rule, our concern is that these investments would not be made.

Lower Part XIII tax rates are, we believe, consistent with the guidance from modern economic thought. In a small open economy, the actual burden of withholding taxes on the return to capital falls largely on domestic factors of production (i.e., upon Canadians) because financial capital is highly mobile. Capital goes where the risk-adjusted expected rates of return are highest.

There appears to be a general international consensus that the taxation of gains arising from the disposition of resource properties or real property should be preserved in the host country (i.e., Canada).

To the extent that negotiated treaties have led to a different result, the Government could consider amending those provisions. We understand that there are relatively few treaties at issue. One might consider using the Canada-UK treaty as a model because it distinguishes between those situations in which the real property is a business property other than a rental property. The allocation of value between business properties is a difficult matter, and if Canada has a continuing right to tax the business income, it is perhaps reasonable to suggest that the ownership of the entity may be passed untaxed from one party to another without causing Canadian concern – especially in circumstances where Canada is seeking to attract capital.

These refinements would provide a logical framework that will provide clarity and certainty to taxpayers and potential investors, and would materially reduce the incidence of treaty shopping.

3. Tax treaty revision

In the 2014 budget, the Government appeared to reject the possibility of treaty revision to address treaty shopping, largely in the interest of expediency. If timing is the issue, we suggest using a "hierarchy of application" to encourage treaty revision. Canada has taken a similar approach to providing incentives to perceived tax havens to encourage them to enter into Tax Information Exchange Agreements. We should be equally respectful of jurisdictions more similar to Canada. Accordingly, any treaty signed after the implementation of a domestic anti-treaty shopping provision should extend benefits notwithstanding that provision.

There is a challenge to Canada in this. Canada would be forced to negotiate treaties with appropriate LOB provisions including a denial of benefits in circumstances in which the treaty is being abused. If that is the international consensus as to how treaties should be applied, then we anticipate that the negotiation process will not be excessively onerous and we can revert over time to a situation in which the language of Canada's treaties is respected without a domestic override.

If Canada enters into a multilateral agreement on treaty interpretation which has the effect of clarifying the interpretive standard to accord with its views on treaty shopping – and presumably it will not enter into such an accord if it does not have that effect – the result may be the rapid exclusion of many treaties from the ambit of the anti-treaty shopping domestic legislation.

Effectively, we are suggesting that for most non-residents, there should be a sunset provision built into the anti-treaty shopping rules. As treaties are revised to render the concerns which led to the domestic rule irrelevant, taxpayers should not be forced to confront double jeopardy. We fear, for reasons outlined in examples below, that interpreting a domestic anti-treaty shopping will be fraught with opportunities for reasonable people to disagree. That in turn is a recipe for confusion and conflict, and is not consistent with the principles of consistency, predictability and fairness that our tax system should follow.

Derivative benefits and base erosion and profit shifting (BEPS)

This issue is addressed directly in the recently released first draft of the Organisation for Economic Cooperation and Development (OECD)'s treaty abuse paper and perhaps indirectly in Example 2 of the treaty shopping discussion in the budget which assumes that (in considering whether or not derivative benefits would be available) that an indirect shareholder would be subject to tax on dividends paid.

The OECD has for now left open the issue of whether an LOB provision should include a derivative benefits provision out of concern that derivative benefits provisions contribute to BEPS since they may allow for reductions in withholding taxes while at the same time potentially avoiding or deferring tax in the hands of the ultimate shareholder by paying the amount to an intermediary that is not subject to tax on a current basis.

Given the necessary complexity of corporate structures for legal and other reasons, derivative benefits are essential. Taxpayers cannot be expected to only make direct investments in order to enjoy treaty benefits.

The BEPS issue, in this context, is properly addressed through controlled foreign corporation (CFC) legislation and not through a denial of derivative benefits. From a competitive perspective, it is not in Canada's interest to modify our foreign accrual property income rules unless Canada's trading partners are indeed going to be making similar changes to their CFC legislation. Being first out of the gate in this area would put Canada at a competitive disadvantage.

4. Comments on the specifics of the budget proposal

We offer the following comments regarding the specifics of the budget proposal.

- The "one of the main purposes" test is a very low threshold. From a practical perspective, virtually all Canadian inbound investments will consider Canadian taxation and planning will be conducted with a view to optimizing the overall tax results. This would seem to cause the rule to potentially apply to almost all significant inbound investments which, in our view, is inappropriate. The frequency of such occurrences must be low if we are to maintain an orderly and cost effective self-assessment system.

- The definition of an "avoidance transaction" in subsection 245(3) of the Income Tax Act should be adopted as part of any domestic anti-treaty shopping provision. If one examines GAAR cases, it is clear that this definition still sets a low threshold, especially where there is no misuse or abuse carve-out. It implicitly accepts that taxpayers may plan their tax affairs within reason, and there is considerable jurisprudence regarding the interpretation of these words.

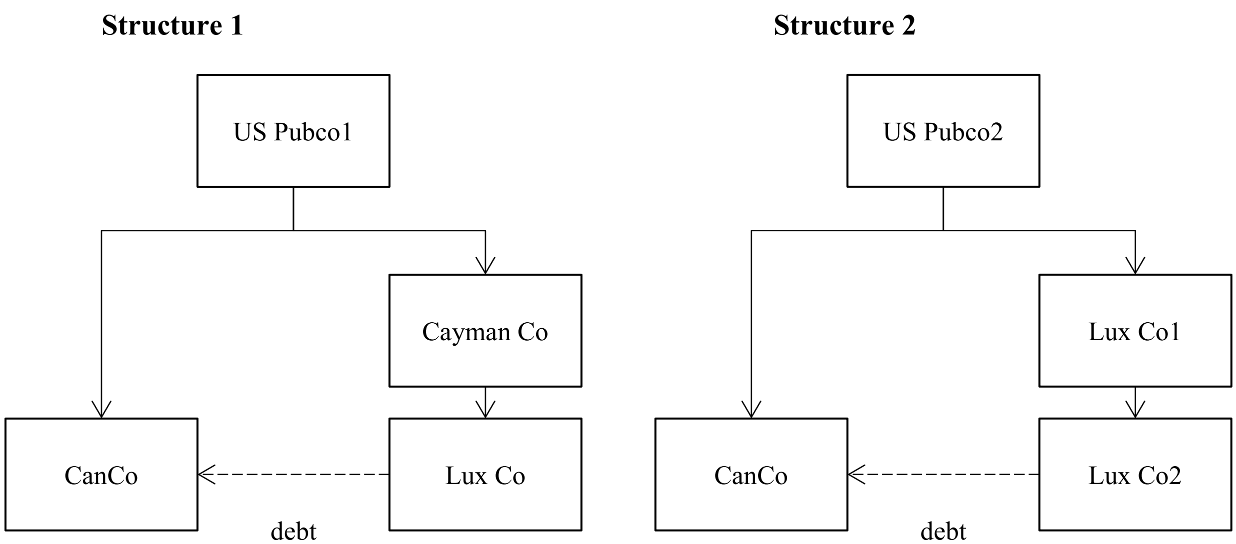
- The safe harbour presumption is ineffective as worded in the budget documents. The rule can still apply if the main purpose test is met and the conduit presumption asserts that the main purpose test is to be met unless the taxpayer has proof to the contrary. Taxpayers must prove a negative proposition. In this regard, the language of the conduit presumption "used … at any time or any form..." to pay or transfer directly or indirectly to a person, etc., is far too open-ended. In our view, the conduit presumption is not necessary; the "avoidance transaction" test described above should be sufficient to address the concern.

- The rules do not appear to acknowledge a need for collective investment vehicles to aggregate capital and establish presence somewhere. Often a "blocker entity" is put in place to reduce the substantial amount of Canadian tax filings (and related administrative costs for both taxpayers and the Government) that would otherwise arise if Canadian investments were directly held by funds. A significant number of collective investment vehicles are partnerships, many of which also have partnerships as members.

- The relieving provision is unworkable when coupled with the low threshold in the main purpose test. The rule will generally have broad application and taxpayers cannot adequately determine the tax that would be applicable, as "reasonable in the circumstances" is by its nature highly subjective. This combination creates an unreasonable level of commercial uncertainty and promises an increase in tax disputes, reduced only by the likely fall in cross-border investments.

5. Examples

Example 1: US Public Company Structures

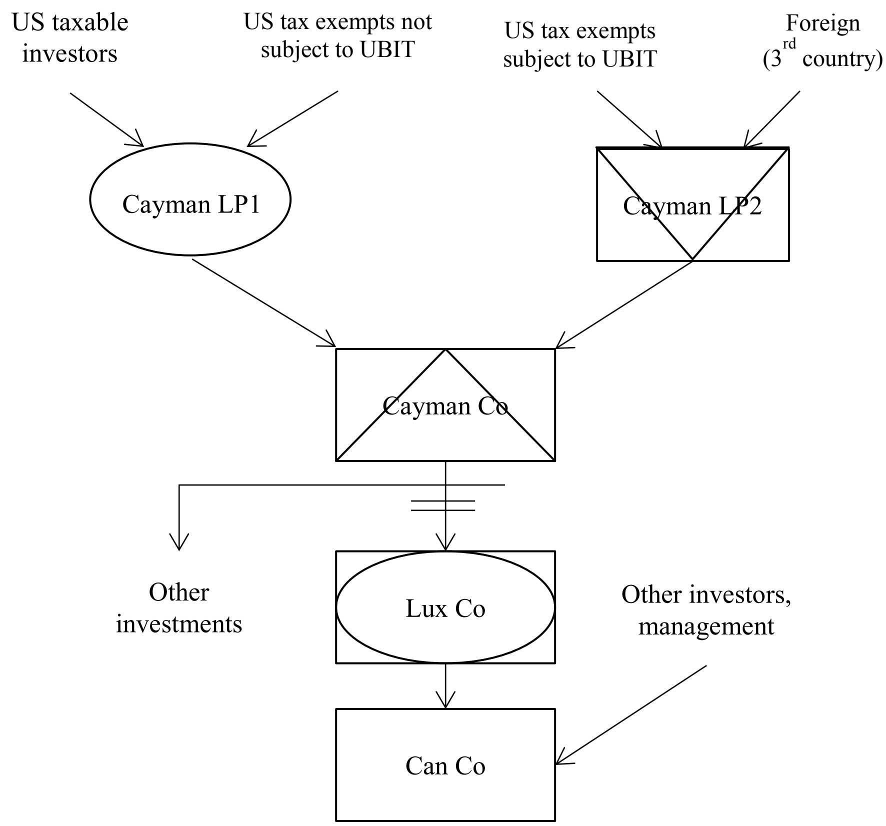


Should the Luxembourg financing subsidiary of US Pubco1 (Lux Co) be entitled to the same treaty benefits as the parallel Luxembourg financing subsidiary of US Pubco2 (Lux Co2)? The difference between the two is that the first group has an intermediary between US Pubco1 and Lux Co which is itself not entitled to treaty benefits against Canada. However, US Pubco1 could achieve the same structure as US Pubco2 displays either by migrating mind and management of Cayman Co into Luxembourg or by continuing into Luxembourg. Historically, the decision as to whether Structure 1 or Structure 2 was appropriate would have been driven by commercial considerations and non-Canadian tax considerations.

Structure 2 lacks the first of the indicia of treaty shopping in that the rate of Canadian withholding tax would have been no greater than that under the Canada-Luxembourg treaty wherever the debt instrument was located in the ownership chain between US Pubco2 and Lux Co2. Should we conclude that in both structures the reasonable rate of withholding is 10%?

Example 2: Private equity structuring

- US-based management
- Diverse investors
- Canadian oil and gas investee



What treaty entitlements are reasonably allowed to Lux Co? Although Lux Co was set up as a special purpose entity to invest in Can Co, the fund has global investments. This is a classic collective investment vehicle in which diverse investors avail themselves to the expertise of a particular management team. The structure is carefully balanced to maintain equity between the investors. All share together the fruits of their collective investment.

Lux Co could properly assert limited benefits under the Canada-US treaty and depending on the investor mix, its entitlement to reduced withholding tax on dividends is somewhere between zero and 25%. US tax-exempt investors not subject to unrelated business income tax (UBIT) generally would be exempt from Canadian tax under Article XXI(1). Depending on their ownership percentage, US taxable investors would face either a 5% or 15% tax on dividends. US tax-exempt investors subject to UBIT would face no Canadian withholding tax on dividends but for the interposition of Cayman LP2. Because that is an entity for US tax purposes, no benefits flow through under the Canada-US treaty. The use of the Cayman blocker is designed to ensure that "business income" in the structure, and gains on the disposition of related business corporations are not subject to US taxation. Can Co may be related for US purposes because relationship is tested at the partnership level and that is why the UBIT sensitive investors need the blocker entity.

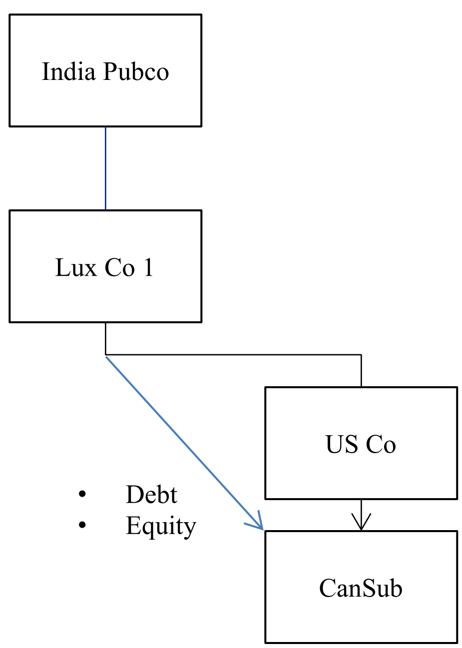
Do we want to create a situation in which it becomes significantly more difficult for Canadians to raise capital from US tax-exempt sources? Private equity has traditionally provided intermediation to those capital sources, but part of private equity's proposition has been that all investors should be treated equally.

If one concludes that foreign private equity should be allowed to treat intermediaries as if they were Luxembourg mutual funds – see Example 4 in the 2014 budget – why should Canadian private equity be put at a disadvantage? Canadian private equity funds have also set up offshore structures to allow their investors to benefit from similar arrangements. If one class of a private equity fund should be allowed to use treaty-based structuring, should the other be treated similarly? Under the budget's framework, it is possible that because Canadian private equity is focused domestically, the implied answer might be that domestic funds should not be allowed to attract foreign capital because when foreign capital invests with Canadian private equity, the focus is likely largely upon Canadian investments and at that point Canadian tax structuring is too significant.

To the extent that fund structures bundle capital from largely arm's length investors, some central place of aggregation is needed. Traditionally, Canada has strived to have a neutral tax system, not biasing the choice of business vehicle including investment vehicles.

We suggest that Canada ensure that all collective investment vehicles be on an equal footing. The logic of Example 4 in the budget documents should be followed but not restricted to trusts and corporations. Provided the ownership chain is restricted to entities subject to exchange of information provisions – so there is no facilitation of tax evasion – treaty benefits should be available.

Example 3: Foreign multinational structure



Should Lux Co1 be entitled to treaty benefits under the Canada-Luxembourg treaty? The conduit presumption looks to whether at **any** time the funds **may** be paid on directly or indirectly to someone not entitled to equivalent benefits which suggests that all corporations are conduits since at some time earnings are distributed as dividends or upon liquidation.

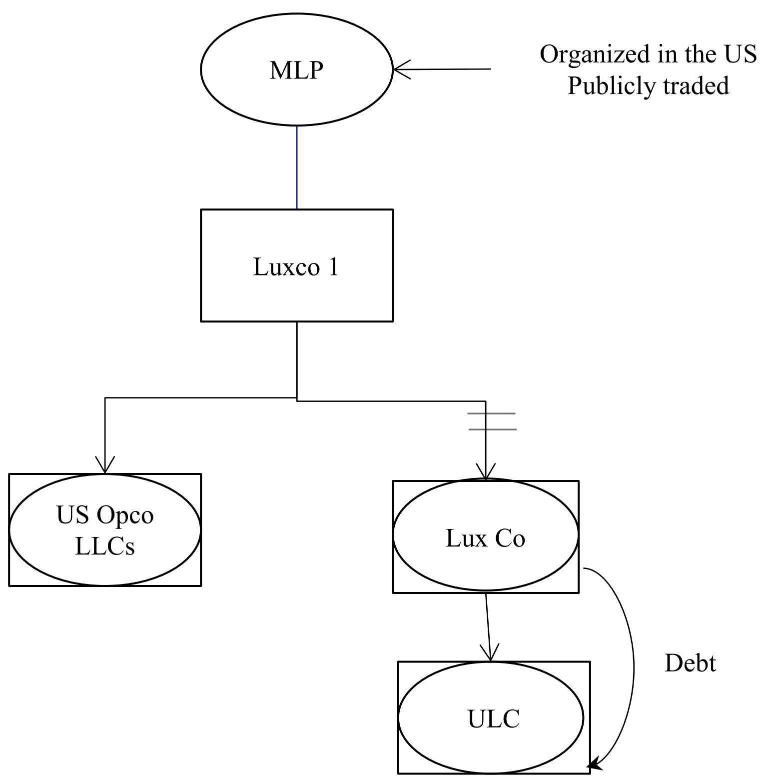
Under the Canada-India treaty, interest and direct dividends are not taxed as generously as under the Canada-Luxembourg Treaty, but financing Canada in this manner is likely driven by a desire to avoid subjecting those earnings to US taxation. The indirect Canadian investment likely resulted from the acquisition of a US group, and extracting the Canadian subsidiary would have imposed an intolerable US tax burden.

Services provided by US Co to CanSub apparently benefit from the Canada-US treaty, but that benefit is more generous than that under the provisions of the Canada-India treaty, assuming that the services are rendered partly in Canada. Is it necessary for taxpayers to contemplate what is reasonable in the circumstances? We suggest that compliance with the Canada-US LOB clause is sufficient, but the budget proposals do not include a clear safe harbour.

Example 4: Accessing capital from a master limited partnership

- Master limited partnerships (MLPs) are publicly-traded US partnerships or limited liability companies treated as partnerships for US tax purposes
- Focused upon natural resource infrastructure investments such as pipeline, gas plants, etc.

Typical MLP structure into Canada



- What treaty benefits are reasonable in the circumstances? All income is subject to US taxation. Lux Co was introduced to reduce the rate of withholding tax on dividends.

- Lux Co has the secondary benefit of ensuring that on any sale there is only one taxpayer for Canadian purposes. Coordinating with all the partners would require significant and costly income tax (including section 116) compliance.

We acknowledge that our examples are much less clear than those contained in the budget documents. However, we think that they are illustrative of real world situations.

6. Transition

As this proposal may cause many taxpayers to reorganize their investments into Canada, it would be inappropriate for the rules to come into effect shortly after they have been finalized. We recommend that the effective date should be the commencement of the second year following enactment. Thus, if the legislation is enacted in December of this year, for example, it would take effect from January 1, 2016.

Also, for any investments into Canada in existence at budget date, there should at least be a proportionate reduction (if not full grandfathering or a more lengthy transition period such as was the case with the introduction of the specified investment flow-through legislation) in any loss of treaty benefits related to capital gains as a result of this change, based on the overall ownership period. For example, if an investment was owned for 8 years as at budget date (and the proposal resulted in a loss of treaty benefits relative to capital gains) and the investment was sold two years later, 80% of the gain should be exempt.

7. Community feedback

These rules create a hurdle for non-residents investing in Canada that did not exist previously. As such, we can anticipate that it will have a negative impact on the inflow of capital into Canada. This view is shared by many of our clients. Equity investments are necessarily characterized by uncertainty because outcomes depend on future events; it is inappropriate for tax measures to materially increase the range of uncertainties.

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We would be pleased to meet with you to further discuss our views on the anti-treaty shopping proposals. Please do not hesitate to contact the undersigned to arrange a time of mutual convenience.

Yours very truly,

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Copy to: Ms. Nancy Horsman, Senior Assistant Deputy Minister, Department of Finance