International tax alert

Taxpayer victory in *Alta* case leaves important questions unanswered

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On February 12, 2020, the Federal Court of Appeal (FCA) delivered its judgment in the case of *R. v. Alta Energy Luxembourg S.A.R.L*[1] (*Alta*), dismissing the Crown's appeal in a unanimous decision. The Court's findings have been eagerly anticipated by many in the tax community, given their potential relevance to one of the issues of utmost importance to multinational enterprises; namely, the availability of treaty benefits

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[1] 2020 FCA 43.

following Canada's ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI) in August of 2019. While *Alta* dealt with the applicability of the general anti-avoidance rule (GAAR) to deny treaty benefits in a pre-MLI taxation year, the analytical framework applicable under the GAAR is substantially similar to the so-called Principal Purpose Test (PPT) which represents the cornerstone of the MLI. While the FCA's decision doesn't go as far as some may have liked, insofar as it does not endorse the reasons of Justice Hogan in the Tax Court of Canada's (TCC's) decision outright, neither does it reject or overrule those reasons. This case is another decisive taxpayer victory in Canada in the "treaty shopping" area, notwithstanding the significant uncertainty that remains concerning the applicability of the PPT in light of its newness and the lack of guidance on the topic.

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Background

The facts in *Alta* concern the disposition by a Luxembourg-resident corporate taxpayer of shares of a Canadian-resident corporation that constituted taxable Canadian property (TCP) under domestic legislation, but which, by virtue of paragraphs 4 and 5 of Article 13 of the Canada–Luxembourg tax treaty, qualified as treaty-protected property, thus causing the resulting gain to be exempt from Canadian tax. At the TCC, the Crown sought to argue that, in the first place, the shares in question did not qualify as treaty-protected property, and secondly, that the GAAR should apply to deny the benefits of the treaty on the basis that certain transactions undertaken in contemplation of the disposition of the shares constituted avoidance transactions that abused the provisions of the Income Tax Act and the treaty.

The TCC's decision

Both of the Crown's arguments were dismissed by the TCC, but it was Justice Hogan's decision concerning the non-applicability of the GAAR that the Crown appealed to the FCA. In analyzing the abuse question, Justice Hogan reiterated the need to identify the object, spirit and purpose of the relevant provisions. More specifically, and of particular interest to taxpayers, were his comments to the effect that it is necessary to identify the rationale underlying specific articles of the treaty, rather than relying on the preamble of the treaty which represents only a general and vague statement concerning the purpose of the treaty overall.

Having dismissed the preamble as a relevant source of interpretive guidance, the TCC made a number of findings in the course of analyzing the object, spirit and purpose of the specific treaty provisions relied on by the taxpayer, including the following:

- The purpose of Paragraph 4 of Article 13 of the Canada-Luxembourg treaty is to encourage foreign direct investment by residents of Luxembourg.
- Paragraph 4 of Article 13 of the treaty represents a departure from the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. Such a departure is indicative of the

parties' deliberate intentions to strike a bargain in the course of treaty negotiations.

- Parties to a tax treaty are presumed to know the other country's tax system when they negotiate the treaty and amendments thereto. Where one state does not impose tax on capital gains, it is the responsibility of the other state to prevent instances of double non-taxation if it wishes to do so. Canada and Luxembourg did not choose this option, and it was not the role of the Court to disturb their bargain in this regard.
- There is nothing in the Canada-Luxembourg treaty that suggests that a corporation resident in Luxembourg should be denied the benefit of the treaty simply because its shareholders are not themselves residents of Luxembourg. For example, the treaty does not contain a Limitation on Benefits provision that imposes additional conditions on a person's eligibility for treaty benefits, as does the Canada-US treaty.

The FCA's decision

As noted above, Justice Webb, in writing for the FCA, did not specifically endorse the reasons of the TCC, nor did he reject or override them. Indeed, he did not even comment on them directly. Rather, the FCA took a more circumspect approach, relying exclusively on the text of the treaty provisions themselves – as Crown counsel was unable to cite any authority that would illuminate the underlying rationale of the relevant provisions - in an attempt to determine their object, spirit and purpose. Of note, the FCA declined to give any weight to OECD commentary (Justice Webb observed that the commentaries cited by the Crown related to model conventions that did not contain the exemption provision at issue), instead choosing to focus on the text of the treaty. At paragraph 69 of the decision, Justice Webb stated that "the rationale for the relevant provisions of the Luxembourg Convention can be found in the text of these provisions. These provisions are neither lengthy nor complex".

On the subject of treaty shopping, at paragraph 77, Justice Webb stated the following:

> "The Tax Court Judge also referred to the steps that the Department of Finance indicated that it would be taking to curb treaty shopping. However, there were no steps that were taken prior to the transactions in this case. Any actual steps that were taken after the transactions in this case were completed, or that may possibly be taken in the future, are not applicable in this case but may have an impact on future transactions."

This reluctance on the part of the Court to seek other indicia as to the rationale underlying specific provisions of the treaty led to a reliance on the principles established in other notable decisions, including *MIL (Investments) S.A. v. Canada*[2] and *Garron Family Trust v. The Queen*[3]. In particular, the Court refused to reach a conclusion that would effectively create multiple classes of treaty residents whose eligibility for treaty

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[2] 2007 FCA 236.
[3] 2009 TCC 450.

benefits might depend on various factors, including the amount of tax paid in Luxembourg, or their degree of commercial connection to Luxembourg.

Observations

The MLI came into effect for matters relating to withholding taxes for certain of Canada's tax treaties (referred to as "covered tax agreements"), including the treaty with Luxembourg, as of January 1, 2020. The MLI will come into effect for all other matters in those covered tax agreements for taxation years that begin on or after June 1, 2020.

Article 7 of the MLI provides that the PPT will not apply to deny treaty benefits where the granting of such benefits can be considered to be in accordance with the objects and purposes of the treaty provisions in question.

In analyzing how the MLI will apply to existing and contemplated structures, taxpayers will need to determine, among other matters, whether continuing eligibility for benefits under Canada's covered tax agreements will be considered to be in accordance with the objects and purposes of those treaties. Indeed, under the MLI, the burden of proof with respect to the determination of the objects and purposes of treaty provisions appears to rest with the taxpayer. In the context of the GAAR, such burden of proof rests with the Minister of National Revenue.

The FCA has, in its decision, failed to provide the degree of clarity that many taxpayers may have hoped for with regard to the purpose of the treaty and its intended beneficiaries. Significant uncertainty remains. Accordingly, many organizations will likely wish to continue to pursue strategies which help to mitigate exposure resulting from the MLI, including both structural and commercial changes, where warranted. Nevertheless, a number of helpful take-aways can still be drawn from the FCA's decision, as well as the TCC's decision, given that the TCC's reasons continue to be relevant, having not been rejected by the FCA.

Firstly, the courts have confirmed that transactions of the sort undertaken by the taxpayer in *Alta*, which seek to take advantage of the carve-out from the TCP definition for real property used in an active business carried on in Canada, should not be subject to the GAAR. Accordingly, organizations that currently find themselves in a position to benefit from this provision in the Canada–Luxembourg treaty may wish to consider implementing transactions to step up the cost base of qualifying shares in advance of the date on which the MLI comes into effect. In considering such transactions, it should be borne in mind that the Crown may yet seek leave to appeal the FCA's decision to the Supreme Court of Canada.

Secondly, on a prospective basis, Justice Hogan's comments, to the effect that Paragraph 4 of Article 13 of the Canada – Luxembourg treaty is intended to encourage foreign direct investment, continue to be helpful for taxpayers required to determine the object and purpose of that provision.

One important question that remains unanswered in the wake of the *Alta* case is whether, and to what extent, the expanded preamble of Canada's treaties, as implemented by virtue of Article 6 of the MLI, should be considered relevant in the determination of the object and purpose of particular treaty provisions relied upon by taxpayers. The FCA has made it clear that the rationale underlying specific treaty provisions, absent authoritative guidance, can only be ascertained by looking to the text of those provisions as specifically agreed to by the contracting states. Article 6 of the MLI expands the scope of the preamble of any covered tax agreement to clarify that the treaty is not intended to create "opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)".

In dismissing the Crown's appeal, the FCA nevertheless did make reference to the fact that future agreements reached by the parties to a given tax treaty would be relevant in determining the rationale underlying particular provisions, and potentially indicating an intention to further restrict the availability of treaty benefits along the lines suggested by the Crown in *Alta*. The key question is thus whether the ratification of the MLI by Canada and a given treaty partner, and the resulting importation of the preamble in Article 6 of the MLI into a particular covered tax agreement, constitutes a meaningful new agreement by the two parties. While it is obvious that the parties to a covered tax agreement have agreed to something new, there is significant uncertainty as to the meaning or scope of the new preamble such that one might reasonably question just what the parties to a given covered tax agreement have, and have not, agreed to. In particular, on the issue of what constitutes treaty shopping, Article 29 of the OECD Model Tax Convention provides several examples that are meant to clarify when the PPT should or should not apply to deny treaty benefits. Many of these examples include relatively extreme facts, while other more common examples (such as traditional holding company scenarios) are conspicuously absent. Thus, one might reasonably conclude – having regard to the diversity of the countries comprising the Inclusive Framework that participated in the negotiation of the MLI – that there was considerable difficulty in reaching a true consensus (i.e., one with mutual intentions) on the meaning of treaty shopping in other than artificial or highly contrived cases. Further jurisprudence is required to determine more precisely what constitutes treaty shopping. In the meantime, taxpayers and their advisors will have to decide whether the MLI has moved the needle in the Canadian context.

For any questions, or to discuss the relevance of the *Alta* decision to your organization, please contact your Deloitte advisor or any of the International Tax professionals listed on this alert.

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