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Tax Court rules on scope of Canadian foreign affiliate anti-avoidance rule in *Lehigh*

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For many years, the Canada Revenue Agency (CRA) has asserted a broad view of paragraph 95(6)(b) of the Income Tax Act and has used it to challenge many financing transactions involving the establishment of a foreign affiliate of a Canadian taxpayer. On May 29, 2013, the Tax Court of Canada released its decision in *Lehigh Cement Limited v. the Queen and CBR Alberta Limited v. the Queen.* While the taxpayers were ultimately successful since the most reasonable alternative transaction would have achieved the same Canadian tax result, the Court did state that the rule is broadly applicable to any acquisition or disposition of shares that is principally tax-motivated.

Paragraph 95(6)(b)

Paragraph 95(6)(b) is an anti-avoidance rule that may apply to deem foreign affiliate shares not to have been issued for certain purposes. If the rule applies in respect of shares of a foreign corporation on which dividends have been paid, the shareholder must include the dividends in income but is not allowed to claim a deduction in respect of the dividends received, since the deduction requires the dividends to be paid on shares of a foreign affiliate owned by a taxpayer.

The provision generally applies where a person or partnership acquires or disposes of shares of a corporation "and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax…that would otherwise be payable". Unlike the General Anti-avoidance Rule (GAAR), there is no exception for transactions that are not abusive, there is no reference to a series of transactions including the acquisition or disposition and there are no rules with respect to re-characterizing the transaction or series of transactions that occurred. The shares are simply deemed not to have been acquired or disposed of if the rule applies.

The example of the rule's application provided in the technical notes issued by the Department of Finance discusses a situation where 11% of the shares of a non-resident corporation are acquired by a foreign affiliate of an unrelated Canadian parent company in order to obtain foreign affiliate status in respect of the non-resident corporation and avoid the taxation of interest income on a loan to that corporation.

The shares will be sold back to the vendor when the loan is repaid. Consistent with that example, most commentators have considered the rule to be a “status rule” that is intended to apply in situations where shares are issued or disposed of either to obtain the 10% threshold for foreign affiliate status with respect to the issuer or to avoid controlled foreign affiliate status (which requires the shareholder to include in income any foreign accrual property income of the issuer).

CRA assessing policy

The CRA has taken a broader view of the provision. In the 1990s, the CRA applied the rule to reassess many so-called “second-tier finance company” structures, including *Lehigh*, in which a Canadian subsidiary of a foreign parent company capitalized a foreign affiliate to provide financing to a related foreign company in which it did not hold an equity interest. The introduction of the “indirect loan rule” in subsection 17(2) in 1998 forced taxpayers to unwind these structures, but litigation is still pending for many taxpayers. The CRA did not accept that the 2005 decision of the Tax Court in *Univar Canada Ltd. v. the Queen*, which held that the provision did not apply to such a structure, was generally applicable but rather continued to pursue these cases.

The CRA has also recently applied paragraph 95(6)(b) to reassess at least one Canadian subsidiary of a foreign parent company for borrowing to acquire preferred shares of a related non-resident corporation. That litigation is still pending.

Income Tax Technical News Number 36 was released in 2007 to describe the CRA’s current assessing policy on paragraph 95(6)(b). In general, the CRA applies a mathematic approach, comparing the before-tax and after- tax return from the investment. With respect to borrowing to acquire preferred shares of a foreign affiliate, for example, the CRA considers the principal purpose of the acquisition to be the avoidance of tax since the after-tax return from the interest deduction and the dividend exemption far exceeds the economic return from the investment. However, the CRA indicates that it will not mechanically apply the provision to an investment in a financing entity used to finance another foreign affiliate of the taxpayer, since the return from the investment in the other foreign affiliate is unquantifiable and may exceed the tax benefit from the financing structure.

Lehigh decision

In *Lehigh*, a Canadian subsidiary (CBR Canada) of a Belgian parent company borrowed money in 1995 and, in conjunction with its Canadian subsidiary, CBR Alberta, established a US limited liability company (NAM LLC). NAM LLC made two loans totaling $100 million to an indirect US subsidiary of the same Belgian company (CBR US). CBR Canada owned preferred shares in the US parent of CBR US but those preferred shares were redeemed as part of the re-financing. CBR US and its US parent company used the funds to repay existing intercompany financing, including the redemption of the preferred shares. CBR US paid interest on the loans to NAM LLC that was deemed to be exempt surplus under the tax rules in effect at the time. NAM LLC paid dividends to CBR Canada and CBR Alberta in 1996 and 1997 which were included in income under section 90 and deducted in computing income as exempt surplus dividends received from a foreign affiliate. CBR Canada also claimed over $12 million of interest expense relating to the investment over the relevant period.

The structure was unwound in late 1997 and CBR Canada invested the $100 million in shares of CBR Alberta which in turn invested in preferred shares of CBR US (CBR Alberta was used as an intermediary due to a restrictive bank covenant).

The CRA applied paragraph 95(6)(b) to deny the section 113 deduction for the dividends received in 1996 and 1997. The GAAR was also originally assessed, but later abandoned.

The Tax Court rejected the taxpayers' contention that paragraph 95(6)(b), based on its text, context and purpose, is only intended to apply to the acquisition or disposition of shares in order to manipulate foreign affiliate status, and that the lack of a "series of transactions" test within the rule means that one cannot consider related transactions, such as the borrowing, in order to determine the purpose of the acquisition or disposition of the shares. The broad wording of the provision and the lack of an exception for transactions that are not abusive led the Court to conclude that Parliament must have intended the provision to apply to all acquisitions or dispositions of shares of a foreign corporation that are principally tax-motivated.

However, the Court concluded that the provision did not apply to the taxpayers. The Court stated that in order to apply the provision, three tests must be met:

1. One must identify the tax that would "otherwise be payable" that the taxpayers are alleged to have avoided;
2. The acquisition or disposition of the shares must have permitted this reduction, avoidance or deferral of tax; and
3. The purpose of the acquisition or disposition must have been to achieve the reduction, avoidance or deferral of tax.

The provision was held not to apply because the first test could not be met. In determining the "tax otherwise payable" by the taxpayers if the acquisition of the NAM LLC shares had not occurred, the Court did not accept the Crown's argument that the deductions claimed by the taxpayers in respect of the dividends received were sufficient to indicate that there was tax otherwise payable if the shares had not been acquired, similar to the concept of "tax benefit" that applies for purposes of the GAAR.

The Court accepted the taxpayers' argument that the existence of tax otherwise payable can only be determined by comparing the transaction that occurred to another transaction that might reasonably have been undertaken by the taxpayer. The Court held that the most reasonably alternative transaction would have been a borrowing to acquire shares of CBR US directly, as occurred when the structure was unwound in 1997. This finding was made despite the Crown's argument that a bank covenant prevented CBR Canada from acquiring the shares directly and in any event, the losses of CBR US would have prevented the payment of exempt surplus dividends on those shares.

While it was not necessary to decide the issue given the finding that no Canadian tax was "otherwise payable", the Court found that, since no tax would have been payable in Canada had the alternative transaction been undertaken, the principal purpose of the acquisition of the NAM LLC shares (test 3) was to avoid US tax (by allowing CBR US to deduct interest expense on the loans from NAM LLC).

With the exception of one interpretive issue, the Court virtually ignored the previous decision of the Court in *Univar*. With very similar facts, the Court in *Univar* also held that paragraph 95(6)(b), and the GAAR, did not apply because there was no tax otherwise payable (which was expressed in *Univar* as being the equivalent of the GAAR requirement for the transaction to give rise to a "tax benefit")[1]. In that case, the

[1] The Court in *Lehigh* disagreed that the tests are equivalent.

Court also held that an alternative transaction must be determined. Since there was testimony at the trial that the taxpayer would not have considered acquiring directly the debts of the Netherlands sister company that were acquired by its Barbados affiliate, this was not a reasonable alternative transaction to consider. Therefore, the Court held that there was no tax benefit achieved or tax otherwise payable and the provision did not apply.

Implications

It is unknown whether or not the Crown will choose to appeal this case on the basis that the mere deduction of the dividends should be enough to satisfy the tax "otherwise payable" requirement. If they were to do so, presumably the taxpayer would cross-appeal on the findings with respect to the scope of the provision.

If the decision stands, there may be a concern that many generally accepted tax planning structures could be swept into the ambit of paragraph 95(6)(b) on the basis that a particular entity was created principally for a tax-motivated purpose, even if the overall structure has a business purpose and is facilitated by specific tax rules designed to accommodate such planning.

There will also be uncertainty in many situations with respect to the alternative transaction to be considered in determining the tax "otherwise payable" and what evidence must be provided to determine that the most reasonable alternative transaction would not result in a significant Canadian tax liability. It is worth noting that the alternative transaction in *Lehigh* that was considered by the Court to be an acceptable alternative that would not presumably attract the application of paragraph 95(6)(b), was borrowing to acquire preferred shares of a related foreign sister corporation, a transaction that the CRA believes also attracts the application of the provision.

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