File number: ______

IN THE SUPREME COURT OF CANADA
(ON APPEAL FROM THE FEDERAL COURT OF APPEAL)

BETWEEN:

HER MAJESTY THE QUEEN

Applicant
(Appellant)

and

ALTA ENERGY LUXEMBOURG SARL

Respondent
(Respondent)

APPLICATION FOR LEAVE TO APPEAL

(Pursuant to paragraph 58(1)(a) of the *Supreme Court Act* and subrule 25(1) of the *Rules of the Supreme Court of Canada,* SOR/2006-203)

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PART I – STATEMENT OF FACTS

Overview

1. This application raises significant issues of public importance that this Court has yet to consider: the application of the General Anti-Avoidance Rule ("GAAR") in s. 245 of the *Income Tax Act* to benefits claimed under one of Canada's bilateral tax conventions, and the proper approach to interpreting a bilateral tax convention in the context of the GAAR.

2. In 2004, Parliament retroactively amended the *Income Tax Act* and the *Income Tax Conventions Interpretation Act* to make explicit that the GAAR applies to tax benefits derived from Canada's tax treaties. Parliament made it clear that a tax benefit obtained under one of Canada's tax treaties should be denied where it results from a misuse or abuse of treaty provisions.

3. This Court's analytical framework for applying the GAAR when tax benefits are obtained under domestic tax legislation applies equally to the provisions of a tax treaty. A unified textual, contextual, and purposive inquiry into the object, spirit, and purpose of the provisions relied on to obtain the tax benefit is required. In this case, although the Federal Court of Appeal acknowledged this approach, it did not fully carry it out. Instead, despite numerous contextual and purposive indicators of the rationale for the provisions at issue, the court confined the object, spirit, and purpose of the operative provision to its words alone.

4. By doing so, the Federal Court of Appeal permitted a treaty provision clearly intended to encourage particular investments in Canadian businesses by Luxembourg residents to be used to facilitate the divestment, free of Canadian tax, of an investment previously made by residents of other states. The overall result of the avoidance transactions in this case is patently abusive of the provisions of the Canada-Luxembourg treaty.

5. In addition to frustrating the intent of the 2004 amendments, the Federal Court of Appeal's decision will create significant problems in the administration of Canada's tax treaty network. It undermines Canadian sovereignty by preventing Canada from controlling when and for whose benefit Canada's taxing jurisdiction is ceded to other states through tax

treaties. In an era of heightened awareness of international tax avoidance, the effect of this decision is to transform a tax benefit granted under one bilateral treaty into a benefit provided indirectly to the world at large. The decision alters the bargains struck between Canada and its treaty partners.

Facts

The investment in Canadian oil and gas properties through Alta Energy Partners Canada Ltd.

6. Alta Energy Partners Canada Ltd. (**"Alta Canada"**) was incorporated in Alberta in 2011. It was the operating subsidiary in an investment structure created by Alta Resources LLC (a Texas-based oil and gas firm) and Blackstone Group LP (a New York-based private equity firm) to conduct unconventional oil and gas exploration in North America.[1]

7. Alta Canada's shares were held by Alta Energy Partners, LLC, a Delaware company. Entities affiliated with Alta Resources and Blackstone were the Delaware LLC's shareholders.[2]

8. Approximately 50% of the investors in the Blackstone private equity funds that invested in the venture were US citizens or residents, and the remainder were not.[3] The Blackstone entities held their investment through partnerships originally established in Delaware. Later, the partnerships were converted to the Cayman Islands.[4]

9. Alta Canada acquired various petroleum and natural gas licenses in Alberta and carried on an unconventional shale oil exploration business.[5]

10. The shares of Alta Canada were "taxable Canadian property" for purposes of the *Income Tax Act* because more than 50 percent of their value was derived from Canadian resource

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[1] Reasons for Judgment of the Federal Court of Appeal (**"FCA Reasons"**) paras 4-5 (Tab 4); Reasons for Judgment of the Tax Court of Canada (**"TCC Reasons"**) para 10 (Tab 2).

[2] TCC Reasons para 13 (Tab 2).

[3] Statement of Agreed Facts (**"Agreed Facts"**) paras 7-9, Appendix A to TCC Reasons (Tab 2); TCC Reasons para 14 (Tab 2).

[4] Trial testimony of Chaim Miller, p. 319, line 10 to p. 320, line 18 (Tab 7A).

[5] FCA Reasons paras 4-5 (Tab 4).

properties. Under para. 2(3)(c) and s. 115, a capital gain from the disposition of those shares by a non-resident of Canada is taxable in Canada unless exempted by a tax treaty.[6]

11. By late 2011, it was expected that the value of Alta Canada would increase substantially over the next few years. Blackstone and Alta Resources were also informed that the existing investment structure was not ideal from a Canadian tax perspective.[7]

12. So, in 2012, Blackstone and Alta Resources restructured their Canadian investment. Alta Energy Luxembourg S.A.R.L. (**"Alta Luxembourg"**) (i.e., the respondent) was formed under the laws of Luxembourg and the shares of Alta Canada were transferred to it.[8] The shares of Alta Luxembourg were held by Alta Energy Canada Partnership (the **"Partnership"**), a new partnership formed by the Alta and Blackstone entities under the laws of Alberta. The shareholders of the US LLC became the partners. In effect, the restructuring replaced the US LLC that had controlled Alta Canada with a Luxembourg resident.[9]

13. As part of the restructuring, Alta Luxembourg and the Partnership entered into financing arrangements, including a Profit Participating Facility Agreement (**"PPL"**), which required Alta Luxembourg to pay virtually all of its adjusted net profit to the Partnership.[10]

14. Alta Luxembourg retained a Luxembourg corporate services company to provide various corporate administration, accounting, and tax compliance services.[11]

15. In February 2013, Blackstone and Alta Resources began to explore the possibility of selling Alta Canada. In June 2013, Chevron Canada Ltd. submitted a bid. By August 1, 2013, a deal

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[6] FCA Reasons paras 11-14 (Tab 4); *Income Tax Act,* RSC 1985, c. 1 (5th Supp), as amended, ss. 2(3)(c), 115(1)(b) and 248(1) ("taxable Canadian property" and "treaty-protected property").

[7] FCA Reasons para 7 (Tab 4).

[8] FCA Reasons para 8 (Tab 4).

[9] FCA Reasons para 9 (Tab 4).

[10] Agreed Facts paras 63-64, Appendix A to TCC Reasons (Tab 2).

[11] Agreed Facts para 67, Appendix A to TCC Reasons (Tab 2).

was finalized whereby Alta Luxembourg sold the shares of Alta Canada to Chevron for proceeds of $680 million effective April 1, 2013.[12]

16. Chevron paid the sale proceeds directly to the Partnership, which in turn disbursed the proceeds to its members. The Partnership issued promissory notes to Alta Luxembourg, which offset those notes against its financing liabilities to the Partnership in its books.[13]

17. Following the disposition of Alta Canada, Alta Luxembourg did not conduct any other business or hold any other investments.[14]

The capital gain and Alta Luxembourg's treaty exemption claim

18. Alta Luxembourg recorded a capital gain of more than $380 million on the disposition of the Alta Canada shares. Alta Luxembourg claimed an exemption from Canadian tax on the basis that the gain was not included in its taxable income earned in Canada under para. 115(1)(b) of the *Income Tax Act* because shares were "treaty-protected property".[15] Alta Luxembourg relied on Articles 13(4) and (5) of the *Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (the **"Convention"**).[16]

19. Article 13(4) of the Convention provides that gains derived by a resident of Luxembourg from the alienation of shares of a private Canadian company that derive their value principally from immovable property situated in Canada are taxable in Canada, except where the Canadian company carried on business in the immovable property. When that exception applies, then pursuant to Article 13(5) the capital gain is taxable only Luxembourg.

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[12] Agreed Facts paras 96-105, Appendix A to TCC Reasons (Tab 2).

[13] Agreed Facts paras 104, 107, 110, 111, 115, Appendix A to TCC Reasons (Tab 2).

[14] Agreed Facts para 117, Appendix A to TCC Reasons (Tab 2).

[15] FCA Reasons para 10 (Tab 4).

[16] 10 September 1999, Can TS 2000/22.

20. The Minister of National Revenue assessed Alta Luxembourg to deny the exemption claimed under the treaty. Alta Luxembourg appealed to the Tax Court of Canada.[17]

The Tax Court of Canada decision

21. Before the Tax Court of Canada, the Crown raised two alternative arguments: first, that Alta Canada did not carry on business in its portfolio of oil and gas leases and licenses in Alberta such that the exception in Article 13(4) did not apply; and, second, that the GAAR applied.[18]

22. The trial judge found that Alta Canada carried on business in the immovable property at issue, such that the "carve-out" for business property in Article 13(4) applied and Alta Canada's shares were treaty-protected property exempt from Canadian tax.[19]

23. With respect to the GAAR, Alta Luxembourg conceded that the 2012 restructuring resulted in a tax benefit, and that the restructuring sequence included at least one avoidance transaction that was not undertaken or arranged primarily for a *bona fide* purpose other than to obtain the benefit of the Article 13(4) exemption.[20] That exemption would not have been available under the Canada-US convention if the US LLC had disposed of the shares.

24. Therefore, the only GAAR issue before the Tax Court was whether the avoidance transaction resulted in a misuse or abuse of the provisions of the *Income Tax Act* or the Convention. The trial judge found no abuse of either.[21]

25. In conducting the abuse analysis, the trial judge acknowledged the two-part inquiry outlined by this Court in its GAAR jurisprudence.[22] In the course of his object, spirit, and purpose

[17] TCC Reasons, paras 1-2 (Tab 3).

[18] TCC Reasons paras 2-7 (Tab 3).

[19] TCC Reasons paras 68-69 (Tab 3).

[20] TCC Reasons para 70 (Tab 3).

[21] TCC Reasons paras 74 and 100 (Tab 3).

[22] TCC Reasons paras 71-72 (Tab 3).

analysis, the trial judge identified the following principles and contextual and purposive factors relevant to Article 13(4):

a. as an international convention, a tax treaty should be given a liberal interpretation with a view to implementing the true intention of the parties;[23]

b. the scheme of Article 13 of most tax treaties that are based on the OECD Model Tax Convention, including the Convention itself, is that the source state cedes its jurisdiction to tax a capital gain realized within its jurisdiction in favor of the state of the taxpayer's residence in order to promote capital inflows into the source state. This scheme is reflected in the treatment accorded to capital gains under Article 13(5) of the Convention;[24]

c. the scheme of Article 13(4) of the Convention embodies an intention that the state of source will retain jurisdiction to tax a capital gain that derives directly or indirectly from an increase in the value of immovable property located in the source state, including from the disposition of private company shares that derive their value principally from that immovable property;[25]

d. the "carve-out" for business property in Article 13(4) of the Convention is an exception to the principle of source state taxation of gains relating to immovable property. It serves as a form of tax incentive to encourage investments by Luxembourg residents in immovable property in Canada for use in a company's business;[26] and

[23] TCC Reasons para 64 (Tab 3).

[24] TCC Reasons para 40 (Tab 3).

[25] TCC Reasons paras 41 and 79 (Tab 3).

[26] TCC Reasons paras 41, 43, 67-68, and 79 (Tab 3).

e. Article 13(4) of the Convention reflects a compromise reached between the two Contracting States, Canada and Luxembourg.[27]

26. The trial judge concluded that the rationale underlying the carve-out in Article 13(4) is to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business. However, the trial judge did not examine the overall result of the transactions in light of the contextual and purposive factors identified in his analysis. The trial judge held that the GAAR did not apply.[28]

27. The trial judge declined to characterize the restructuring as "treaty shopping". Instead, he characterized the Crown's reliance on the GAAR as an impermissible attempt to fill an unintended legislative gap.[29]

The Federal Court of Appeal decision

28. The Federal Court of Appeal acknowledged the two-step approach to the misuse and abuse inquiry under the GAAR. The court focused its object, spirit, and purpose analysis on the provisions of the Convention, not on the *Income Tax Act.*[30]

29. The Federal Court of Appeal held that the rationale underlying Articles 1, 4(1), 13(4), and 13(5) of the Convention was expressed fully in the text of those provisions.[31] The Court held that, since those provisions operated as intended, the avoidance transactions were not abusive.[32] The Court did not conduct a further analysis of the second step under the two-part abusive tax avoidance inquiry.

30. In its object, spirit, and purpose analysis, the Federal Court of Appeal declined to consider commentaries to the OECD Model Tax Convention because those commentaries related to a

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[27] TCC Reasons para 41 (Tab 3).

[28] TCC Reasons para 100 (Tab 3).

[29] TCC Reasons paras 90-98 (Tab 3).

[30] FCA Reasons paras 31-32 (Tab 4).

[31] FCA Reasons paras 66-70 and 73 (Tab 4).

[32] FCA Reasons para 80 (Tab 4).

version created after Canada and Luxembourg had first negotiated the Article 13(4) carve-out provision in a prior convention.[33]

31. The Federal Court of Appeal also characterized the Crown's position as an impermissible attempt to introduce unexpressed conditions on who qualifies as a resident of Luxembourg under Article 4 of the Convention.[34]

PART II – QUESTIONS IN ISSUE

32. The issue is whether the proposed appeal raises one or more matters of public importance such that this Court should grant leave to appeal.

33. The proposed appeal raises issues of public importance, namely the proper application of the GAAR to Canada's bilateral tax treaties, and the correct interpretive approach to those treaties in the context of the GAAR analysis, including the proper weight to be given to commentaries to the OECD Model Tax Convention as extrinsic aids.

PART III – ARGUMENT

The Federal Court of Appeal decision frustrates Parliament's intent that the GAAR apply to abusive treaty shopping

34. The improper use of bilateral tax treaties in international tax planning has the potential to erode national tax bases. It has long been recognized that some uses of tax treaties are abusive. The OECD, of which Canada is a member, first addressed this issue in the commentaries to the 1977 Model Tax Convention.[35] Subsequently, in 1986, the OECD

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[33] FCA Reasons para 36 (Tab 4).

[34] FCA Reasons paras 46, 49, 52, 58-59, and 65 (Tab 4).

[35] Commentary to Article 1 of the 1977 OECD Model Tax Convention, paras 7-10 (Paris: OECD, 1977).

published a report dedicated to the use of "conduit companies".[36] These concerns have recurred repeatedly over the following thirty-five years, most recently in publications by the Department of Finance in 2013[37] and in the OECD's Base Erosion and Profit Shifting (BEPS) project that began in 2013.

35. This Court also recognized the problem in its only decision to date that considers the interpretation of a bilateral tax treaty, *Crown Forest Industries Ltd. v. The Queen.*[38] Although *Crown Forest* was not a GAAR case, this Court clearly acknowledged that the use of a bilateral tax treaty by residents of a third party state to access tax benefits that Canada intended to extend only to residents of the treaty partner was improper treaty shopping:

> 52. …"Treaty shopping" might be encouraged in which enterprises could route their income through a particular state 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…

36. In 2004, Parliament addressed the issue of tax treaty abuse by amending s. 245 of the *Income Tax Act* to make explicit that the GAAR applies to transactions that result in a misuse or abuse of a tax treaty. At the same time, Parliament amended the *Income Tax Conventions Interpretation Act* to declare expressly that the law of Canada is that the GAAR applies to any benefit obtained under one of Canada's tax treaties.[39] These amendments were notable in that Parliament made them retroactive to the introduction of the GAAR in 1988 (coincidentally, the year before Canada's first tax treaty with Luxembourg was signed).

37. The 2004 amendments to s. 245 and to the *Income Tax Conventions Interpretation Act* reflect a clear Parliamentary intent that the GAAR apply to prevent the abuse of Canada's bilateral

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[36] OECD, "Double Taxation Conventions and the use of Conduit Companies" (Paris: OECD, 1986).

[37] Consultation Paper on Treaty Shopping – The Problem and Possible Solutions (Ottawa: Department of Finance, August 12, 2013).

[38] [1995] 2 SCR 802.

[39] *Budget Implementation Act, 2004, No 2,* SC 2005, c. 19, ss. 52 and 60 (received royal assent May 13, 2005).

tax treaties. Yet, where the issue has arisen to date, Canadian courts have declined to apply the GAAR to tax treaties.[40]

38. By limiting the object, spirit, and purpose of the provisions of the Convention at issue to their text, the Federal Court of Appeal's decision effectively prevents the application of the GAAR to Canada's tax treaties. So long as a taxpayer is a resident of the other contracting state under the laws of that state, and the transaction at issue complies with the text of the treaty, it will never be abusive for the taxpayer to claim a treaty benefit.

39. This outcome is contrary to Parliament's clear intent that the GAAR apply to Canada's tax treaties. Indeed, as a provision of last resort, the GAAR could only ever apply where a taxpayer has already complied with the text of the relevant provisions.[41] If provisions in bilateral tax treaties are interpreted as having no rationale beyond their textual meaning, then the GAAR can never apply to them and the 2004 amendments are read out of existence.

Tax treaties are not the same as domestic taxing statutes and raise different interpretive considerations under the GAAR

40. Tax treaties are different from domestic taxing statutes enacted unilaterally by Parliament. A tax treaty is an agreement between Canada and another sovereign state. The provisions of a tax treaty reflect a bargain negotiated between the two states.

41. In *Crown Forest,* this Court held that, unlike an ordinary taxing statute, a tax treaty should receive a liberal interpretation.[42] The purpose of the interpretive process is to ascertain and implement the true intention of the parties. Accordingly, when applying this Court's s. 245(4) framework to benefits obtained under a tax treaty, the object, spirit, and purpose of the relevant treaty provisions must be identified by reference to the common intention of the

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[40] In addition to this case, refer to *MIL (Investments) SA v The Queen,* 2006 TCC 460, affirmed 2007 FCA 236; and *Garron Family Trust v The Queen,* 2009 TCC 450, affirmed as *St Michael Trust Corp v Canada,* 2010 FCA 309, affirmed by this Court on other grounds as *Fundy Settlement v Canada,* 2012 SCC 14.

[41] *Copthorne Holdings Ltd v Canada,* 2011 SCC 64 at para 66.

[42] *Crown Forest* at para 43.

parties. The question must be whether the conferral of a tax benefit frustrates the goals, purposes, and objectives of the relevant provisions.

42. As this Court has repeatedly outlined, the abuse analysis under s. 245(4) proceeds in two steps. The first step is to identify the object, spirit, and purpose of the provisions at issue. This step is undertaken using a unified textual, contextual, and purposive approach. Unlike in traditional statutory interpretation, the purpose of this exercise is not to ascertain what the words of a provision mean, but rather to ascertain the rationale that underlies the provision.[43]

43. Moreover, in the second step, the overall result of the transaction must be compared to the rationale behind the relevant provisions, in order to determine whether the transaction is consistent with their object, spirit, and purpose or whether it defeats, circumvents, or frustrates that object, spirit, and purpose.[44]

44. In conducting the object, spirit, and purpose inquiry, a court must consider that the "relevant provisions" include not just the provision relied on for the tax benefit, but also other provisions that are part of an integrated statutory scheme that includes the operative provision. Provisions that operate together, or in sequence, to result in a tax benefit are also relevant and comprise the statutory scheme to be considered in the GAAR analysis.[45]

45. In this case, the operative provisions giving rise to the exemption claimed by Alta Luxembourg is Article 13(4). An object, spirit, and purpose interpretation of Article 13(4) in a GAAR context requires the provision to be contextually and purposively considered within its place in the scheme of the Convention as a whole. That scheme includes the preamble to the Convention, and Articles 1, 4 and 13(5), which operated with Article 13(4), along with relevant sections of the *Income Tax Act* relating to the taxation of non-residents.

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[43] *Copthorne* at paras 70 and 109; also *Canada v Oxford Properties Group Inc.,* 2018 FCA 30, leave to appeal dismissed 2018 CanLII 119135, at paras 42-45 FCA.

[44] *Canada Trustco Mortgage Co. v Canada,* 2005 SCC 54 at paras 45, 49, and 55; *Copthorne* at paras 71-72.

[45] *Lipson v Canada,* 2009 SCC 1 at paras 34-37; *Copthorne* at para 91.

46. Because a tax treaty is an agreement between two states, the contextual and purposive elements of the object, spirit, and purpose inquiry must be given weight. The words of a treaty cannot be interpreted without due regard to the true intentions of the parties. Contextual and purposive considerations—including extrinsic aids such as commentaries to model tax conventions on which the provisions are based—shed light on the parties' intentions and can inform the determination of the object, spirit, and purpose of the provisions.

47. Bilateral tax treaties serve a variety of purposes, but their principal purpose is to encourage the growth of trade and investment flows by removing tax barriers such as double taxation, which might result when a resident of one state earns income from a source situated in another state.[46] The primary mechanism for achieving this goal is a series of distributive rules that allocate taxing jurisdiction as between the contracting states. Article 13(4) is such a distributive rule which allocates taxing jurisdiction as between Canada and Luxembourg.

48. Under the OECD Model Tax Convention framework—which Canada follows in all of its tax treaties—the state of source generally cedes taxing jurisdiction over gains from the alienation of most forms of property over which the source state asserts its taxing jurisdiction, in favour of the state of the taxpayer's residence. As the trial judge recognized, the purpose of this aspect of the inter-state bargain expressed in the treaty is to encourage investment and capital inflows from the state of residence into the source state.[47] This element of the inter-state bargain thus furthers the broader goals of reducing tax barriers to trade and investment.

49. Article 13 of the Convention illustrates this scheme and purpose. Article 13(5) reflects a general agreement that gains from the alienation of most forms of property will be taxable only in the taxpayer's state of residence. Articles 13(1) through (4) reflect specific gains in respect of which the contracting states have agreed to preserve the source state's taxing rights. In particular, the specific provisions of Articles 13(1) and (4) reflect a scheme of preserving source-state taxing jurisdiction over gains from immovable property situated in

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[46] Commentary to Article 1 of the OECD Model Tax Convention, 2017, para 54 (Paris: OECD, 2017).

[47] TCC Reasons, para 40 (Tab 2).

one of the contracting states. The combined effect of Articles 13(1) and (4) is to preserve source state taxation over gains from the alienation of immovable property whether those gains are realized directly or indirectly from the alienation of shares of a private company.

50. The carve-out embedded in Article 13(4) of the Convention excludes immovable property in which a private company carried on business from the broader scheme of source state taxation for gains deriving from immovable property. This carve-out is not present in the OECD Model Tax Convention, nor in all of Canada's tax treaties, and it is notably absent from the convention with the United States.[48] In the context of the Convention with Luxembourg, the presence of this carve-out indicates that Canada and Luxembourg intended to pursue an additional purpose beyond preserving source state taxation over gains from immovable property. The trial judge identified this additional purpose as encouraging investments by residents of one state in immovable property situated in the other state for use in a company's business.[49] Accordingly, he characterized the exemption as a tax incentive.

51. As a sovereign state, it was open to Canada not to agree to extend the benefit of the Article 13(4) carve-out to Luxembourg residents. Indeed, as noted by the Federal Court of Appeal, Canada has not conferred the same benefit in all of its bilateral tax treaties, including significant treaties such as the treaty with the United States. Therefore, to the extent that the contracting states intended the tax concession in Article 13(4) of the Convention to encourage investment in businesses in each other's jurisdictions, their shared mutual intention was to encourage investment by each other's residents, not by residents of third party states.

52. When the object, spirit, and purpose of Article 13(4) is informed by these contextual and purposive elements, and a results-focused analysis is performed under step two of the abuse analysis, the abusive nature of the avoidance transactions in this case becomes clear. The transactions do not accord with the rationale of the provisions, which is to encourage capital investment in Canadian businesses by residents of Luxembourg. The overall result of the

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[48] FCA Reasons para 29 (Tab 4).

[49] TCC Reasons paras 43 (Tab 2).

transactions in this case did not encourage or facilitate investment in Canadian businesses or immovable property by residents of Luxembourg. Instead, the result of the transactions was to permit an investment that had been made by residents of third party states to be liquidated free of Canada tax, when those persons could not have accessed this particular tax benefit directly.

53. The result of the transactions in this case is patently not what Article 13 of the Convention, read in conjunction with Articles 1 and 4 and the Convention as a whole, contemplates. As this Court stated in *Crown Forest,* such a result cannot have been within the contemplation of the contracting states when Canada agreed to cede taxing jurisdiction over this particular, narrow class of capital gain to Luxembourg. The avoidance transactions defeated, circumvented, and frustrated the object, spirit, and purpose of the provision.

54. In his contextual and purposive analysis, the trial judge identified the broader purposes of bilateral tax treaties, the broader scheme for taxing capital gains under Article 13 of the Convention, and the narrower purpose of Article 13(4). However, he then restricted the rationale for the Article 13(4) carve-out to the meaning of its words.[50] He accorded no significance to the contextual and purposive elements that he had identified.

55. Although the Federal Court of Appeal identified the scheme for the taxation of gains under the Convention, the contextual and purposive elements identified by the trial judge played no role in the Court's object, spirit, and purpose analysis. Like the trial judge, the Federal Court of Appeal did not look beyond the text of the provision.

56. As a result, the Federal Court of Appeal did not conduct a complete two-step GAAR analysis under s. 245(4). It did not examine the result of the avoidance transactions against the object, spirit, and purpose of the Convention provisions properly construed. If the Federal Court of Appeal had done so, it would have recognized that the avoidance transactions clearly used provisions of the Convention intended for one purpose to achieve a completely different and opposite purpose.

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[50] TCC Reasons para 100 (Tab 2).

57. If the Federal Court of Appeal had properly examined the overall result of the avoidance transactions, it would have recognized the relevance of factors identified by the Crown that contribute to the abusiveness of the result achieved. Those factors include: the original investment was made by non-residents of Luxembourg who moved their Canadian asset into a Luxembourg entity created for the purpose of disposing of it; Alta Luxembourg could not realize any gain in Luxembourg from the investment in Canada because the financing arrangements with its parent stripped it of virtually all profit; Alta Luxembourg had no business presence in Luxembourg; and the sale proceeds were paid directly to shareholders resident in another state. It is apparent that the result of the avoidance transactions in this case is not consistent with the true intentions of the contracting states.

58. Instead of acknowledging how these factors contribute to an abusive result, the Federal Court of Appeal dismissed them as part of an argument that "residency" for treaty purposes means more than what the provisions of the Convention say. The failure to appreciate the overall result of the avoidance transaction led the Federal Court of Appeal to erroneously focus on whether the transactions abused the residency provisions of the Convention. The central issue in this case, however, is whether the avoidance transactions abused Article 13(4) in light of the treaty as a whole and related provisions in the preamble and Articles 1 and 4.

59. If followed, the Federal Court of Appeal's failure to engage in a full and proper GAAR analysis of the Convention will render the GAAR broadly inapplicable to Canada's tax treaties. The FCA's decision precludes an inquiry into the underlying rationale for the allocation of taxing jurisdiction agreed to by the contracting states. This outcome will have significant ramifications for Canada's tax treaty network and the intended tax results underpinning s. 115 of the *Income Tax Act*. That result is clearly contrary to Parliament's intent and requires this Court's intervention.

OECD Model Tax Convention commentaries are necessary and appropriate extrinsic aids

60. The proper use of the commentaries to the OECD Model Tax Convention in interpreting tax treaties that are based on that model is an issue of public importance. The commentaries are a rich source of interpretive guidance relating to tax treaties based on the OECD model. Few—if any—similarly authoritative extrinsic aids exist in relation to tax treaties. The Federal

Court of Appeal's refusal to consider those commentaries deprives courts applying the GAAR to tax treaties of essential tools to conduct a proper textual, contextual, and purposive analysis with a focus on the true intention of the parties.

61. As this Court has previously recognized, the OECD Model Tax Convention and its commentaries are a highly persuasive interpretive tool.[51] Absent specific reservations or observations registered by member states, the model and commentaries represent the consensus of OECD member states with respect to the interpretation and application of treaty provisions based on the OECD model. In addition, commentaries on the provisions of the OECD model are widely accepted as authoritative guides because the provisions of the model have been incorporated into a majority of bilateral tax conventions entered into by OECD member states.[52]

62. The OECD model and commentaries fill a void of interpretive materials. Canadian tax treaties are negotiated with a foreign state and are not prepared in the same manner as domestic tax legislation. They are not typically the subject of Budget papers, extensive study in Parliamentary committees, notices of ways and means motions, or technical notes. As a result, little extrinsic material similar to what is often available in interpreting domestic tax legislation is available in relation to tax treaties.

63. The OECD model and commentaries permit the states parties to speak to their shared intentions and their shared understanding of the provisions. Even when commentaries are amended or updated subsequent to the conclusion of a tax treaty, those commentaries are still useful in interpreting the treaty to the extent that they reflect the shared understanding of the states parties. In this regard, it is important to note that a state that does not agree with a commentary may register an observation to indicate its non-agreement. A state that does not do so is taken as having endorsed the commentary.

64. The OECD Model Tax Convention and commentaries thus give a court interpreting a tax treaty an advantage that is not normally enjoyed when interpreting domestic legislation. In

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[51] *Crown Forest,* paras 54-55.

[52] Introduction to the OECD Model Tax Convention 2017, para. 15.

effect, the commentaries allow the court to hear directly from the parties to the treaty as to what was intended, instead of the traditional task of determining the intention of Parliament from the text, context, and purpose of a statute or from official published statements by the Department of Finance, which forms part of the executive branch.

65. Considering such commentaries, even subsequent ones, is appropriate and even required under principles of international treaty interpretation. To the extent that such commentaries are adopted without contrary observations, those commentaries are an example of a subsequent agreement between states as to the application and interpretation of treaties based on the OECD model. Agreement with subsequent commentaries could also be viewed as a subsequent state practice. At international law, both subsequent agreements between states and state practice must be considered when interpreting a treaty.[53]

66. Accordingly, Canadian courts have previously accepted that subsequent commentaries to the OECD model convention should be considered as extrinsic aids given their importance and broad acceptance.[54] The Federal Court of Appeal did not acknowledge that prior jurisprudence, nor did it provide reasons for departing from it. This Court's intervention is warranted.

The non-application of the GAAR to treaty shopping has adverse consequences for the Canadian tax system and Canadian sovereignty

67. Unless corrected by this Court, the Federal Court of Appeal's decision will have adverse consequences for the Canadian tax system and for Canada's ability to exercise its sovereignty internationally.

68. A broad inapplicability of the GAAR to treaty benefits claimed by non-residents of Canada disadvantages Canadian resident taxpayers as compared to non-resident taxpayers. Canadian resident taxpayers who engage in avoidance transactions are subject to a full and vigorous application of the GAAR under the applicable jurisprudence. The overall result of an

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[53] *Vienna Convention on the Law of Treaties,* 23 May 1969, Can TS 1980/37, Articles 31-32; also *Crown Forest* at para 54.

[54] *Crown Forest* at para 55; *Canada v Prévost Car Inc.,* 2009 FCA 57 at paras 10-11.

avoidance transaction is examined against the object, spirit, and purpose of the relevant provisions construed textually, contextually, and purposively in a comprehensive manner.[55] The nature of that object, spirit, and purpose analysis is sophisticated and has been well-developed in domestic jurisprudence. Domestically, then, avoidance transactions may be found to be abusive even when they comply with a textual reading of the *Income Tax Act.*

69. Limiting the object, spirit, and purpose of tax treaty provisions for GAAR purposes to their text creates a lower bar for non-residents of Canada who engage in avoidance transactions primarily to obtain Canadian treaty benefits. Such uneven treatment cannot reasonably have been Canada's intention in negotiating its network of tax treaties. Nor can this have been Parliament intention in enacting retroactive amendments to clarify that the GAAR applies to benefits obtained under Canada's tax treaties.

70. An unduly restrictive reading of the GAAR in relation to treaties will also adversely affect Canada's ability to exercise its sovereignty internationally. It will permit residents of states with which Canada did not negotiate particular treaty benefits to access those benefits anyway, and it will undermine Canada's ability to control by whom those benefits are enjoyed. In the context of this case, a bilateral treaty signed with Luxembourg effectively becomes a multilateral treaty whose benefits are available to the world at large. Canada's intention or policy as expressed in one treaty can always be disregarded in favour of a more advantageous tax treaty.

71. Canada decided to extend the benefit of the Article 13(4) carve-out for business property to residents of Luxembourg, but not to extend a similar benefit to residents of the United States. In addition, Canada has not opted to conclude a bilateral tax treaty with the Cayman Islands at all. The negotiated agreement between Canada and Luxembourg to extend the benefit of the Article 13(4) carve-out to each other's residents was not a decision to allow residents of other states, including those with which no equivalent benefit was negotiated, to access that

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[55] For example, refer to *Canada Trustco; Mathew v Canada,* 2005 SCC 55; *Lipson*; *Copthorne; Oxford Properties; Canada v 594710 British Columbia Ltd.,* 2018 FCA 166, leave to appeal dismissed 2019 CanLII 11808; *Birchcliff Energy Ltd v Canada,* 2019 FCA 151, leave to appeal dismissed 2019 CanLII 1070007.

benefit indirectly when liquidating their investments in Canadian business using immovable property. The Federal Court of Appeal's decision permits precisely that result.

72. Further, if benefits extended under one treaty become indirectly available to residents of other jurisdictions, Canada risks losing its leverage to negotiate favorable terms in its treaties with those other jurisdictions. The broader context of a treaty as a mutual and reciprocal agreement between two sovereign states must not be forgotten.

73. It does not answer these concerns to suggest that Canada should simply renegotiate treaties to insist on limitation clauses that restrict when residents of other states may be entitled to benefits, or to suggest that Canada could respond with a comprehensive legislative response. Those considerations are not relevant to the object, spirit, and purpose of the treaty provisions and legislation as they read when the transactions occurred. It is no more appropriate to interpret the object, spirit, and purpose of treaty provisions at a particular time in light of actual or potential treaty or legislative responses than it would be to interpret the object, spirit, and purpose of legislation in light of subsequent or possible amendments.[56] This extends both to domestic legislative responses such as a comprehensive anti-treaty shopping provision, and to international responses such as the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* which took effect for Canada in 2020.[57]

74. In addition, tax treaties are not identical to domestic statues. They cannot be amended quickly or frequently through annual budget measures as the *Income Tax Act* is. Amendments must be made by negotiation of a separate protocol, or by the termination and renegotiation of a new treaty. Those processes are lengthy and depend on the involvement of other states whose responses Canada does not control.

75. Parliament has chosen to address the abuse of tax benefits conferred through its treaties by amending the GAAR, retroactive to its introduction in 1988, and the *Income Tax Conventions Interpretation Act.* Those provisions form part of the statutory context in which

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[56] *Oxford Properties* at para 46.

[57] 24 November 2016, Can TS 2019/26.

the Convention applied when the transactions in this case were undertaken. That legislative response must be given its proper effect.

PART IV – COSTS

76. There is no reason why costs should not follow the cause in this matter.

PART V – ORDER SOUGHT

77. The applicant requests that this application for leave to appeal from the judgment of the Federal Court of Appeal be granted with costs in the cause.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 8th day of April, 2020.

Michael Taylor
Natalie Goulard
Christopher Bartlett

Counsel for the Applicant

PART VI – TABLE OF AUTHORITIES (with hyperlinks)

			CITED AT PARAS
Statutory Provisions Relied On			
1. Income Tax Act, RSC 1985, c. 1 (5th Supp.)			
(a) para. 2(3)(c)	*English*	*Français*	10
(b) s. 115(1)(b)	*English*	*Français*	10, 18
(c) s. 248(1) ("taxable Canadian property" and "treaty-protected property")	*English*	*Français*	10, 18
(d) s. 245	*English*	*Français*	1, 36, 37, 41, 42, 56
2. *Income Tax Conventions Interpretation Act*, RSC 1985, c. I-4			
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7. *Canada Trustco Mortgage Co. v Canada,* 2005 SCC 54			43, 68
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9. *Crown Forest Industries Ltd v Canada,* [1995] 2 SCR 802			35, 41, 53, 61, 65, 66
10. *Garron Family Trust v The Queen,* 2009 TCC 450, affirmed as *St. Michael Trust Corp v Canada,* 2010 FCA 309, affirmed as *Fundy Settlement v Canada,* 2012 SCC 14			37
11. *Lipson v Canada,* 2009 SCC 1			44, 68

12. *Mathew v Canada,* 2005 SCC 55 — 68

13. *MIL (Investments) SA v Canada,* 2006 TCC 460, affirmed 2007 FCA 236 — 37

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14. *Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital,* September 10, 1999 Can TS 2000/22 — 18, 19, 49, 50

15. *Vienna Convention on the Law of Treaties,* *23 May 1969, Can TS 1980/37* — 65

16. Commentary to Article 1 of the OECD Model Convention, 2017 — 47

17. "Double Taxation Conventions and the use of Conduit Companies" (Paris: OECD, 1986) — 34

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15. Consultation Paper on Treaty Shopping – The Problem and Possible Solutions (Ottawa: Department of Finance, August 12, 2013) 34
(Hyperlink not available)

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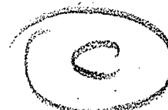

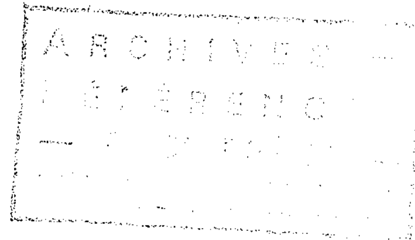

MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL

Report of the OECD Committee on Fiscal Affairs

1977

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS

The Organisation for Economic Co-operation and Development (OECD) was set up under a Convention signed in Paris on 14th December, 1960, which provides that the OECD shall promote policies designed:

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ANNEX II

COMMENTARIES ON THE ARTICLES OF THE MODEL CONVENTION

COMMENTARY ON ARTICLE 1 CONCERNING THE PERSONAL SCOPE OF THE CONVENTION

1. Whereas the earliest conventions in general were applicable to "citizens" of the Contracting States, more recent conventions usually apply to "residents" of one or both of the Contracting States without distinction of nationality. Some conventions were of even wider scope inasmuch as they apply more generally to "taxpayers" of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. The Convention is intended to be applied between OECD Member countries and it has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States. It is recalled that the meaning of the term "resident" is defined in Article 4.

Application of the Convention to Partnerships

2. The domestic laws of the various OECD Member countries differ in the treatment of partnerships. The main issue of such differences is founded on the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries disregard the partnership and tax only the individual partners on their share of the partnership income.

3. These differences in views have many effects on the application of the Convention in the case of partnerships, especially where one or more partners are not residents of the State in which the partnership was created or organised. First the question arises, whether a partnership as such may invoke the provisions of the Convention. Where a partnership is treated as a company or taxed in the same way, it may reasonably be argued that the partnership is a resident of the Contracting State taxing the partnership on the grounds mentioned in paragraph 1 of Article 4 and therefore, falling under the scope of the Convention, is entitled to the benefits of the Convention. In the other instances mentioned in paragraph 2 above, the application of the Convention to the partnership as such might be refused, at least if no special rule is provided for in the Convention covering partnerships.

4. Moreover, different rules of the Convention may be applied in the Contracting States to income derived by a partner from the partnership, depending on the approach of such States. In States, where partnerships are treated as companies, distributions of profits to the partners may be considered to be dividends (paragraph 3 of Article 10), whilst for other States all profits of a partnership, whether distributed or not, are considered as business profits of the partners (Article 7). In many States, business profits of partnerships include, for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents,

interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings (in the above-mentioned examples: Articles 6, 11, 12, 14 or 15, respectively).

5. Finally the capital invested in a partnership or the alienation of a participation in a partnership may be treated, depending on the approach, under paragraph 2 of Articles 22 and 13 (permanent establishment) or paragraph 4 of Articles 22 and 13 (other movable property).

6. The concurrent application of different Articles of the Convention in the two Contracting States (or even the non-application of the Convention in one of them) may not only result in double taxation, but also in non-taxation. However, the practical application of double taxation conventions, whether or not based on the 1963 Draft Convention, and the discussions on the revision of the 1963 Draft Convention have shown that the opinions of the OECD Member countries differ too much and that it is extremely difficult to find a uniform solution which would be acceptable to all or even to the great majority of Member countries. The Convention does not, therefore, contain any special provisions relating to partnerships. Contracting States are however left free to examine the problems of partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate.

Improper Use of the Convention

7. The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, double taxation conventions being left aside, to exploit the differences in tax levels as between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter possible manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

8. Moreover, the extension of the network of double taxation conventions still reinforces the impact of such manoeuvres as they make it possible, through the creation of usually artificial legal constructions, to benefit both from the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions.

9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acted through a legal entity created in a State essentially to obtain treaty benefits which would not be available directly to such person. Another case would be one of an individual having in a Contracting State both his permanent home and all his economic interests, including a substantial participation in a company of that State, and who, essentially in order to sell the participation and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), transferred his permanent home to the other Contracting State, where such gains were subject to little or no tax.

10. Some of these situations are dealt with in the Convention, e.g. by the introduction of the concept of "beneficial owner" (in Articles 10, 11 and 12) and of special provisions, for the so-called artiste-companies (paragraph 2 of Article

17). Such problems are also mentioned in the Commentaries on Article 10 (paragraphs 17 and 22), Article 11 (paragraph 12), Article 12 (paragraph 7). It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.

Reservation on the Article

11. The *United States* reserves the right to tax its citizens and residents (with certain exceptions) without regard to the Convention.

Consultation Paper on Treaty Shopping – The Problem and Possible Solutions

Note: A consultation is not a poll. Please do not send multiple or duplicate submissions.

Consultations Document:

- Government Invites Comments on Possible Measures to Prevent Treaty Shopping (News Release 2013-102)
- Consultation Paper

How to Comment

The Government invites comments from stakeholders regarding any element of this paper by December 13, 2013.

Comments may be submitted to Treaty.Shopping-Chalandage.Fiscal@fin.gc.ca

Also, written comments can be forwarded to:

Treaty Shopping
Department of Finance
L'Esplanade Laurier
17th Floor, East Tower
140 O'Connor Street
Ottawa, Canada K1A 0G5

To add to the transparency of the consultation process, the Department of Finance will post submissions on the Department of Finance website, with the consent of the submitting party. We ask that, in providing your submission, you state whether you consent to posting your submission on the Department of Finance website. If you make a submission, please clearly indicate if you would like the Department of Finance to:

- Post your submission on the Department of Finance website; and
- Include your name and/or the name of the organization which you represent with your submission when posting it on the Department of Finance website.

We also request that submissions which are to be posted on the Departmental website be provided electronically in PDF format or in plain text.

The Department of Finance will not post submissions that do not clearly indicate a preference to be posted on our website.

Once received by the Department of Finance, all submissions will be subject to the Access to Information Act (ATI Act) and may be disclosed in accordance with its provisions. If a request pertaining to your submission is received under the ATI Act, you will be consulted under Section 27 of the ATI Act.

Summary of the Questions

Question 1 – *The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.*

Question 2 – *The Government invites stakeholders' comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping.*

Question 3 – *The Government invites stakeholders' views on whether a general approach is preferred over a relatively more specific and objective approach.*

Question 4 – *The Government invites stakeholders' views on whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.*

Question 5 – *The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration.*

Question 6 – *For stakeholders who favour a more specific approach over a main purpose approach, the Government invites input on the design of the conditions and the exceptions (e.g., the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach with a view to ensuring the measure is effective and applies in a reasonably straightforward manner with predictable outcomes.*

Question 7 – *The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.*

Treaty Shopping – The Problem and Possible Solutions

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Introduction

As indicated in Economic Action Plan 2013, the Government continues to actively negotiate and conclude tax treaties to reduce barriers to international trade and investment, combat tax evasion and avoidance, strengthen Canada's bilateral economic relationships, and create enhanced opportunities for Canadian businesses abroad. Tax treaties generally promote these economic objectives by establishing rules for the prevention of double taxation and reducing rates of withholding taxes imposed on cross-border payments. Canada now has more than 90 tax treaties in force, and more under negotiation, and is committed to maintaining an extensive and effective tax treaty network.

At the same time, insofar as another purpose of tax treaties is to prevent tax avoidance and evasion, it is important that safeguards exist to ensure that taxpayers cannot make improper use of Canada's tax treaties. Treaty shopping arises when, for example, a person who is not entitled to the benefits of a tax treaty with Canada uses an entity in a country with which Canada has concluded a tax treaty and, to obtain Canadian tax benefits, earns or realizes income sourced in Canada indirectly through that entity. As described in sections 1 and 5 below, treaty shopping defeats the purposes of Canada's bilateral tax treaties and poses risks to the Canadian tax base.

Distinguishing between acceptable uses of a tax treaty and treaty shopping can be difficult given the complexity of international transactions and the increasing sophistication of international tax planning. Nevertheless, there is both direct and circumstantial evidence that treaty shopping exists and that the unintended consequences of treaty shopping are significant. Many other countries are better positioned to address treaty shopping, either as a result of favourable judicial decisions or having taken more decisive steps to address treaty shopping in their domestic laws or tax treaties.

The intention of this consultation process is to examine a range of possible approaches to address the practice of treaty shopping into Canada. The purpose of this paper is to serve as the basis for a discussion aimed at reaching a workable solution to the problem of treaty shopping. In finding a solution to treaty shopping, the main goals are to ensure that Canada remains an attractive destination for foreign investors and that all of the purposes of Canada's tax treaties are achieved.

The first section of this paper defines treaty shopping. The second section sets out Canada's position on treaty shopping and the third section discusses recent judicial experience. The fourth section describes the evidence of treaty shopping and the fifth section explains unintended consequences of treaty shopping. The sixth section canvasses the possible approaches to preventing treaty shopping. The seventh section explores approaches for striking a balance between general and specific rules. The eighth section concludes with a description of the consultative process. Finally, the ninth section summarizes questions and issues on which the Government invites stakeholders' comments.

1. Treaty Shopping – The Hallmarks

"Treaty shopping" generally refers to a situation under which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity

that is entitled to such benefits in order to indirectly obtain those benefits.[1] Such practice is generally considered to be an "improper" use of tax treaties.[2]

The above definition covers a wide variety of arrangements, but generally Canada has found treaty shopping to occur where all of the following circumstances exist:[3]

- An entity ("intermediary entity"), resident in a country with which Canada has a tax treaty, claims the application of the tax treaty to obtain a reduction of Canadian tax otherwise payable on income earned in Canada;
- The intermediary entity is owned or controlled mainly by residents of another country which are not entitled to at least the same treaty benefits ("third country residents");
- The intermediary entity pays no or low taxes in its country of residence on the item of income earned in Canada (taking into account deductible amounts paid to third country residents[4] and other relevant aspects of the tax system in the country where the intermediary is resident); and
- The intermediary entity does not carry on real and substantial business activities (other than managing investment income) in its country of residence.

Where the combination of the circumstances listed above is observed, there is strong evidence that one of the main purposes of the existence of the intermediary entity is to receive the income for the benefit of third country residents (that is, to engage in treaty shopping).[5] Under these circumstances, Canada would be justified in denying tax treaty benefits. Such a use of intermediary (or "conduit") entities is generally considered to be an "improper" use of tax treaties, contrary to their object and purpose, because the benefits of the tax treaty are claimed by an entity lacking economic substance and a *bona fide* purpose, and accrue to a third country resident not entitled to claim treaty benefits directly. In general, the more substantial the commercial or economic presence of an entity in a jurisdiction, the less likely the entity is to be engaged in treaty shopping. In practice, the "impropriety" of a structure is closely linked to the artificiality of the tax structure and the intermediary's lack of economic substance.

2. Canada's Position on Treaty Shopping

Canada has, for many years, consistently expressed the position that it would challenge treaty shopping arrangements. Clear expressions to this effect were included in the 1995 technical explanation accompanying Article XXIX A (Limitation on Benefits) of the third protocol to the Canada-US Treaty (under this Article, only persons satisfying specific and objective tests are generally eligible for treaty benefits):

> "[...] Canada prefers to rely on general anti-avoidance rules to counter arrangements involving treaty-shopping through the United States. [...] Paragraph 7 [which states that the Article does not limit a state from applying its domestic anti-abuse rules] was added at Canada's request to confirm that the specific provisions of Article XXIX A and the fact that these provisions apply only for the purposes of the application of the Convention by the United States should not be construed so as to limit the right of each Contracting State to invoke applicable anti-abuse rules. Thus, for example, Canada remains free to apply such rules to counter abusive arrangements involving "treaty-shopping" through the United States [...]."[6]

Moreover, although not limited to treaty abuse in the nature of treaty shopping, the 2004 Budget clarified, by way of amendments to the general anti-avoidance rule ("GAAR") in subsection 245(4) of the *Income Tax Act* and the introduction of section 4.1 of the *Income Tax Conventions Interpretation Act*, the intended application of the GAAR to tax treaties.

Canada participates actively in the work of the OECD pertaining to the Model Tax Convention and supported the development of the OECD Commentary on the improper use of treaties (see section 1 of the Annex). In fact, Canada has included certain of the OECD-suggested approaches to addressing treaty shopping in its tax treaties. For example, entities that benefit from preferential tax regimes have been denied access to treaty benefits under many of Canada's treaties.[7] In addition, Canada has included a so-called main purpose test in 16 of its treaties and in particular in its most recent tax treaties.[8] As described further below, the main purpose test applies to deny access to tax treaty benefits where one of the main purposes of the transactions involved was to obtain such benefits. Moreover, Canada concluded a bilateral comprehensive limitation on benefits article in the Fifth Protocol to the Canada-US Treaty.

In addition, the Canada Revenue Agency (the CRA) has a long history of maintaining publicly that it would challenge treaty shopping[9] and, as discussed below, has challenged several treaty shopping cases in the courts. Thus, Canada has been taking steps to challenge treaty shopping for over two decades.

3. Canada's Judicial Experience

With one exception, Canadian court cases have not assisted the government in addressing treaty shopping in Canada. As discussed in more details below, Canadian courts have generally accepted that treaty shopping occurred in the cases before them, but did not find a clear tax treaty policy or legislative intent to deny the application of a tax treaty benefit to any particular treaty shopping arrangement.

Canada's position on treaty shopping is consistent with the Supreme Court of Canada's determination in *Crown Forest Industries*[10] that treaty shopping was contrary to the purpose of the Canada-US Treaty. Although the case was decided based on the meaning of a "resident of a contracting state" for purposes of the Treaty, Justice Iacobucci, in a unanimous decision, observed that the taxpayer's argument meant that a foreign corporation (in that case incorporated in the Bahamas) could be a resident of the United States for purposes of the Convention without having any US tax liability and that this possibility was "highly undesirable". In this context, he wrote the following on treaty shopping:

> "[...] "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.[11]

However, more than 10 years following the *Crown Forest Industries* decision, the leading Canadian treaty shopping case involving the GAAR was decided in favour of the taxpayer. In *MIL (Investments) S.A.*,[12] the corporate taxpayer was continued from Cayman Islands (a jurisdiction with which Canada does not have a tax treaty) to Luxembourg (a treaty country) shortly before it realized capital gains on the disposition of taxable Canadian property.[13] Upon its continuance to Luxembourg, the corporate taxpayer became a resident of Luxembourg for purposes of the Canada-Luxembourg Convention, positioning it to make a claim under the Convention to exempt the capital gain from tax in Canada. The Crown argued that this case

involved treaty shopping and, as such, represented an abuse of the provisions of the Convention that exempted the capital gain from tax in Canada. The Tax Court of Canada concluded that the GAAR was not applicable and that there was no inherent anti-abuse rule in the Convention. The Tax Court stated:

> "…I do not agree that Justice Iaccobucci's *obiter dicta* can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined."[14]

In a short decision, the Federal Court of Appeal dismissed the Crown's appeal in *MIL (Investments)* on the basis that it was unable to find an object or purpose of the exempting provision of the Convention whose abuse would justify a departure from the plain meaning of the words of the provision. This decision is a particularly strong statement by the Federal Court of Appeal, indicating that the courts in Canada require further legislative direction before finding that treaty shopping is an improper (and abusive) use of tax treaties.

In *Prevost Car Inc.*,[15] the CRA challenged a treaty shopping case on the basis that a conduit entity was not the "beneficial owner" of the Canadian-source income on which treaty benefits were sought. The case involved dividends paid on the shares of a Canadian resident corporation that were held by a Dutch corporation which in turn was owned by corporate shareholders in Sweden and the United Kingdom. The withholding tax rate on dividends paid to the Dutch holding company were lower than would have been the case had dividends been paid directly to the corporate shareholders in Sweden and the United Kingdom. Even though the terms of the shareholders agreement essentially required the Dutch holding company to pass through as dividends to its shareholders any dividends received from its Canadian subsidiary, the Tax Court found that the intermediary Dutch holding corporation was the beneficial owner of the dividends and the Federal Court of Appeal affirmed the Tax Court's interpretation of beneficial ownership.

The narrow meaning ascribed to beneficial owner in *Prevost Car Inc.* means that the beneficial ownership requirement in this context is not sufficient to deny treaty benefits to an intermediary entity. In particular, even though the intermediary foreign holding company in this case was effectively a direct conduit (i.e., it did not pay tax on dividends received, distributed substantially all of its income to third country residents who owned it, and had no employees or activities other than with respect to the ownership of shares of a subsidiary), it was not denied treaty benefits on the basis of beneficial ownership.

Similarly, the notion of beneficial owner was also argued by the Government in *Velcro Canada*[16] as the basis on which to deny treaty benefits in a treaty shopping case. In *Velcro Canada*, a corporation resident in the Netherlands Antilles, which would have been subject to a withholding tax rate in Canada of 25% on royalties paid by a Canadian company, incorporated an intermediary company in the Netherlands and essentially assigned to it the right to receive royalty payments from the Canadian company. The intermediary company in the Netherlands remitted 90% of the royalties received to its parent in the Netherland Antilles within 30 days, pursuant to a sub-licencing agreement between the Dutch intermediary and the Netherlands Antilles company. This was a classic "stepping stone" conduit structure.[17] The Government argued the case on the basis that the Dutch intermediary was not the beneficial owner of the royalties received. The Court followed the decision in *Prevost Car Inc*.

Collectively, these three cases indicate in relatively strong terms that the courts in Canada are not currently inclined to find against taxpayers in treaty shopping cases. In other words, the courts in Canada require clearer legislative direction to the effect that treaty shopping is an improper use of Canada's tax treaties.

The CRA has also discovered numerous other cases of treaty shopping that have been resolved out of court. Moreover, since the recent judicial decisions, the Income Tax Rulings Directorate of the CRA has received additional requests for Advance Tax Rulings in cases involving treaty shopping.

4. Evidence of Treaty Shopping

The above discussion regarding Canada's judicial experience described the use of treaty shopping arrangements in Canada, involving significant amounts of Canadian tax. However, these cases do not provide evidence of treaty shopping beyond the specific circumstances of the litigation and cannot be used to assess the extent of the existence of treaty shopping in the Canadian context. To attempt to assess the scale of treaty shopping, it is necessary to consider aggregate statistics on foreign direct investment (FDI).

In the aggregate statistics on FDI, it is difficult to distinguish indirect investment through intermediaries from direct investment, and even more difficult to separately identify cases involving indirect investment for tax planning purposes. Moreover, the use of intermediaries may involve tax planning other than treaty shopping. For example, intermediaries in low tax jurisdictions (or jurisdictions with preferential regimes) may be used to reduce or defer taxation in the country in which the ultimate beneficial owner is resident and not the source country, as in the case of treaty shopping.[18] Nevertheless, a comparison of FDI and trade data, and an understanding of the domestic tax and treaty policies of those countries that rank among the largest in terms of FDI in Canada provides circumstantial evidence that the scale of treaty shopping may be significant.

In general, unusually high levels of inbound and outbound FDI can be an indicator that a country commonly serves as a conduit investment country. Table 1 provides circumstantial evidence on the existence and use of conduit countries to indirectly route investment from the residence country of the investor, to the final destination (source) country of investment. This table builds on a table included in a recent study by Jack Mintz and Alfons Weichenrieder.[19] It compares the total stock of inbound and outbound FDI as a percentage of gross domestic product (GDP) across a number of countries. While not conclusive, ratios of FDI stocks to GDP that are several times the OECD average suggest that the particular country is used for conduit investment.

As indicated above, indirect investment is not always driven by treaty shopping; it may reflect other objectives of a multinational enterprise. For example, the top three countries identified in Table 1 do not have significant tax treaty networks. However, they do provide other significant tax benefits to investors. The remaining countries have significant tax treaty networks and many are understood to have domestic tax regimes that make them favoured intermediary jurisdictions for investment in other countries. Some of these conduit countries may be more popular in certain regions.

Table 1: Top 10 Countries with the Highest Ratio of Foreign Direct Investment Inbound and Outbound Stocks as a Percentage of GDP (Averaged over 2006 to 2010 for 159 countries)

Rank	Country	FDI Outbound Stock (%)	FDI Inbound Stock (%)	Sum of Inbound and Outbound Stocks (%)
1	British Virgin Islands	26,138.93	15,186.57	41,325.50
2	Cayman Islands	1,982.93	3,072.33	5,055.26

3	Liberia	522.59	573.78	1,096.36
4	Hong Kong	402.66	454.29	856.95
5	Iceland	325.32	247.42	572.74
6	Luxembourg	185.62	165.88	351.50
7	Belgium	168.76	171.59	340.35
8	Singapore	141.63	194.32	335.95
9	Switzerland	155.34	88.11	243.45
10	Netherlands	116.92	82.60	199.52
40	Canada	38.37	34.73	73.10
	OECD	62.02	49.02	111.04

Sources: UNCTAD statistical database, May 2013
** OECD computed as weighted average (by GDP); OECD membership as of 2013*

Indirect FDI flows in the geographical patterns of FDI from home countries to host countries[20] are becoming increasingly important. As international organizations have noted, various mechanisms are behind these increasing indirect FDI flows, including low or no tax jurisdictions and offshore financial centres as well as the use of special purpose entities (SPEs)[21] that are more prevalent in developed countries such as the Netherlands and Luxembourg.[22] In this respect, a recent OECD Report provided information on FDI positions (stock) held through SPEs. The OECD cited, for example, the fact that more than 80% of total inbound stock investments into the Netherlands for 2011 were investments through SPEs and that more than 75% of outbound stock investments from the Netherlands were made through SPEs. Similarly, more than 90% of both Luxembourg's inbound and outbound stock investments for 2011 were made through SPEs.[23] Although caution must be exercised in interpreting such numbers for the reasons set out above, the concentration of inbound and outbound FDI in these countries by SPEs, together with their extensive treaty networks and favourable domestic tax regimes, suggests that these countries may be used extensively for treaty shopping purposes.

Table 2 identifies the largest countries of origin for Canada's inbound FDI stock, and the rankings of these countries in terms of trade with Canada. The countries identified represent a mix of economies with which Canada has significant economic linkages, and countries which are common sources of indirect investment. For example, investors in the United States, the United Kingdom, Japan and China make significant investments in Canada. The appearance of these countries in the top ten FDI investing countries is unsurprising, given that there are significant economic linkages between these countries and Canada, as evidenced by the trade partner rank. However, other countries seem to rank higher in making FDI investments into Canada than the economic linkages suggested by the trade partner rank would warrant. For example, Luxembourg ranks only 72 on the trade partner rank, but number seven in terms of the source of investment in FDI stocks in Canada.[24] Other countries, such as the Netherlands and Switzerland, also show up in the top ten investor countries, suggesting that they play a role in conduit investments, although not all investments undertaken through multiple countries are driven by treaty shopping.

Table 2: Top 10 Countries Investing in Canada (averages 2006-2010)

Rank	Country	Stock of FDI Investment in Canada ($ billions)	Tade Partner Rank*
1	United States	292.69	1
2	Netherlands	46.16	12
3	United Kingdom	45.79	3
4	Switzerland	18.59	15
5	Brazil	14.35	13
6	Japan	13.30	4
7	Luxembourg	10.87	72
8	Germany	9.73	6
9	China	8.45	2
10	Australia	4.68	17

Source: Statistics Canada Cansim Table 376-0051
* Ranking of countries for which both FDI and trade data are available; Ranking determined as the sum total merchandise imports and merchandise exports.
Due to data availability, the average FDI calculation for China user the years 2007 to 2010.

A country with a high ranking in terms of inbound FDI stocks in Canada, even when paired with a low ranking on economic linkages demonstrated by trade partner rank, does not demonstrate the existence of treaty shopping. As established in section 1 above, Canada would consider treaty shopping to occur where certain circumstances exist in combination. It could, however, suggest that a significant volume of indirect investment is routed through such countries by ultimate beneficial owners making investments in Canada sourced from third countries (which Canadian statistics do not identify). The appearance of countries in Table 2, such as the Netherlands and Luxembourg, understood to be significant conduit investment locations as suggested in the discussion on FDI and SPEs data, combined with the experience of CRA auditors and the cases which have been taken to court, are indicative that treaty shopping has a significant role in inbound direct investment in Canada.

5. Unintended Consequences of Treaty Shopping

Where treaty shopping occurs, tax treaties concluded between Canada and its treaty partners can indirectly provide tax benefits to third country residents. While Canada is prepared to reduce the level of Canadian taxation imposed on residents of trading partners by concluding a bilateral tax treaty, Canada's intention is to extend benefits under that treaty only to residents of that country. For several reasons, it is inappropriate for residents of a country with which Canada does not have a tax treaty (or has a tax treaty but with less favourable terms) to indirectly access tax treaty benefits by treaty shopping through an intermediary resident in a country with favourable tax treaty terms.

First, if third country residents obtain reductions in Canadian taxes by treaty shopping into Canada, the benefits flow only in one direction as those third country residents enjoy Canadian tax relief on their indirect investments in Canada, but Canadian residents may not enjoy the same benefits on their investments in that third country.

Second, in cases of treaty shopping, the benefits of a tax treaty may flow to persons residing in a country with which Canada does not have a significant bilateral economic relationship or possibly to countries with which Canada had decided for other reasons that it did not wish to conclude a tax treaty. In these cases, treaty shopping effectively extends tax treaty benefits to residents of a third country without giving Canada the opportunity to negotiate terms that would reflect the tax system in that third country as well as Canada's bilateral relationship with it. This may also allow residents of that third country to enjoy Canadian tax reductions while remaining insulated from exchange of information provisions under Canada's tax treaties that enable the CRA to obtain information relevant to the administration and enforcement of the *Income Tax Act*.

Finally, when Canada intends to reduce Canadian taxation on non-residents (whether resident in a tax treaty country or not), it does so by amending the *Income Tax Act* and not indirectly by accepting treaty shopping practices.[25]

The use of Canada's tax treaties for treaty shopping purposes undermines the bilateral nature of a tax treaty. Absent anti-treaty shopping safeguards, Canada's ability to appropriately constrain tax treaty benefits within a particular bilateral relationship is compromised, undermining Canada's ability to conclude tax treaties with terms that correspond to and reflect each particular economic relationship between Canada and its tax treaty partners.

6. Possible Approaches to Preventing Treaty Shopping

6.1 Overview and tax policy objectives

As indicated above, Canada's recent attempts to address treaty shopping in the Courts have been unsuccessful. Thus, notwithstanding the policy and administrative statements and actions on the part of the Department of Finance and the CRA, recent judicial experience in Canada suggests that the CRA requires clearer legislative authority to successfully challenge treaty shopping arrangements.

There are a wide range of approaches to preventing treaty shopping. The threshold question for countries is whether treaty shopping rules should be included in domestic tax laws or in tax treaties. In addition, regardless of whether a country adopts a domestic law or treaty based approach, it must also be determined whether to adopt a general anti-treaty shopping rule or a more specific anti-treaty shopping rule. Each approach has pros and cons and, as a practical matter, it may be necessary to combine different approaches and types of rules.

Key considerations with respect to each of the main approaches and types of rules are discussed briefly in this section of the paper. In particular, in evaluating alternative approaches and types of rules, consideration must be given to the following tax policy objectives:

1. Effectiveness – would the approach target treaty shopping with the appropriate degree of precision or would it produce outcomes that may be under-inclusive (i.e., would not adequately prevent treaty shopping) or over-inclusive (i.e., would undermine Canada's treaty network and create a barrier to foreign investment in Canada with adverse effects on economic efficiency, growth, and competitiveness), and can it be implemented in a timely manner?

2. Certainty and simplicity for taxpayers – would the approach produce predictable outcomes and be reasonably straightforward to understand and to apply in practice?

3. Ease of administration for the CRA – would the approach be relatively easy for the CRA to administer?

6.2 Domestic tax rules or treaty-based rules

As indicated above, the threshold question is whether treaty shopping rules should be included in Canada's domestic tax laws or whether Canada should continue to negotiate treaty-based rules. Because of the nature of tax treaties as bilateral agreements, it could be asserted that the solution resides in the on-going negotiation (and re-negotiation) of tax treaties to include in each of them appropriate safeguards against treaty shopping. However, the speed with which the tax policy objectives could be achieved under a treaty-based approach would depend largely on the resources dedicated to treaty negotiations and the availability and receptiveness of Canada's treaty partners to negotiate. As a practical matter, amending every treaty in Canada's tax treaty network that does not have an anti-treaty shopping measure would likely take decades.

One possible response to the concern about the time it would take to re-negotiate substantially all of Canada's tax treaties is that only a small number of tax treaties represent most of the problem. Thus, it could be asserted that successful re-negotiations with those countries would significantly curtail treaty shopping. However, even if it were possible to re-negotiate Canada's treaties with certain countries where conduit entities are common – a difficult task given that these countries may not wish to re-negotiate – other conduit countries may emerge. Accordingly, a treaty-based approach, on its own, would likely be ineffective as it would not serve as a timely response to the treaty shopping problem facing Canada today.

In contrast, if Canada were to adopt a domestic law approach, amendments could be implemented in a timely manner. Domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD and the United Nations (the "UN");[26] both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping.[27] For clarity, if a domestic law approach were adopted, it would provide that the domestic law provisions prevail over tax treaties; however, it should be recognized that Canada's intention would be to clarify and codify its position concerning treaty shopping in a manner consistent with the OECD and UN Model Commentaries as well as the laws and practices of several other countries.[28]

In addition to the significant benefit that a domestic law approach could be implemented and effective in less time than a treaty-based approach, the fact that it would also have immediate effect across Canada's entire tax treaty network would facilitate a greater consistency in practice than would unfold if Canada were to rely exclusively on treaty-based solutions.

Although a treaty-based approach would potentially allow for more comprehensive provisions compared to a domestic law approach, which provisions may be constrained in order to avoid a conflict with existing treaty obligations, a combination of both approaches could also be considered. This combination approach would enable the CRA to address treaty shopping arrangements upon enactment of the domestic rules and also enable the

Government to consider more comprehensive provisions to determining eligibility for treaty benefits in the course of negotiations with particular countries. (See also the discussion in section 7.3 below.)

Q.1 The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.

6.3 General or specific anti-treaty shopping rules

In broad terms, the approaches available to address treaty shopping range from a general anti-treaty shopping rule to more specific anti-treaty shopping rules. The OECD Commentary sets out various approaches that countries have used to address treaty shopping. Although the OECD contemplates the possibility that countries may implement domestic anti-abuse rules, it has traditionally limited its suggested approaches to those which countries might consider in bilateral treaty negotiations. Nevertheless, certain of the approaches identified could be considered for implementation in domestic tax laws. The following types of rules are generally described in the Commentary to Article 1 of the OECD Model Convention: [29]

- The *look-through approach* disallows treaty benefits to a company owned or controlled, directly or indirectly, by persons who are not residents of a contracting state;
- The *subject-to-tax approach* provides that treaty benefits in the country of source are granted only if the income in question is subject to tax in the country of residence; and
- The *channel approach* disallows treaty benefits in cases where an intermediary company receives what would be treaty-protected income if more than 50% of that income is paid to satisfy claims (deductible amounts) of a person not resident in the country of the intermediary company and who has, directly or indirectly, a substantial interest in (or exercises management or control over) the company.

The Commentary indicates that these solutions are of a general nature and need to be accompanied by specific provisions to ensure that treaty benefits will be granted in *bona fide* cases. This recognizes that these specific anti-treaty shopping rules may be over-inclusive and, accordingly, require some exceptions in order to ensure the measure is appropriately targeted to treaty shopping. Such exceptions could include: [30]

- a general *bona fide* provision – where the company can establish that its principal purpose is motivated by business reasons and not to obtain tax benefits under the Convention;
- a business activity provision – where the company is engaged in substantive business operations in the residence state and the income on which treaty benefits is sought is connected with such operations;
- an amount of tax provision – where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident;
- a stock exchange provision – where the principal class of shares of the company is registered on an approved stock exchange in a contracting state; and
- an alternative relief provision – where the third country residents owning the intermediary company are resident in countries that have tax conventions with the contracting state from which relief from taxation is claimed and those conventions provide no less tax relief than that claimed under the particular convention (also referred to as a derivative benefits provision).

The OECD Commentary also sets out an approach for states wishing to address treaty shopping in a comprehensive way. This approach is essentially a US-style limitation of benefits (LOB) article, similar to Article XXIX A of the Canada-US Treaty. Under this approach, only persons satisfying specific and objective tests are eligible for treaty benefits. The premise underlying this approach is that if any of the objective tests for eligibility are satisfied, the requisite treaty shopping motive is not present and treaty benefits should be granted. [31] Although more targeted and certain in application, this LOB approach can also be over-inclusive and generally contains a provision enabling contracting states to grant treaty benefits on a discretionary basis in appropriate circumstances. At the same time, this comprehensive and mechanical approach to dealing with treaty shopping can also be under-inclusive and, accordingly, domestic law measures may still be required to address treaty shopping cases. [32]

The OECD Commentary also discusses a general anti-abuse rule that applies only to specific types of income. This approach would deny treaty benefits that restrict source country taxation in respect of dividends, interest, and royalties (and other income) in cases where the main purpose or one of the main purposes of any person (e.g., a conduit entity) concerned with the creation or assignment of an interest in property (e.g., shares, debt-claims, or rights) is to take advantage of the treaty provision by means of that creation or assignment. As indicated above, Canada has included this general rule in several tax treaties.

Aside from special treaty rules that address, for example, preferential tax regimes, most countries that deal with the problem of treaty shopping in their tax treaties use a general rule (i.e., a provision denying tax treaty benefits where transactions have been entered into for the main purpose of obtaining these benefits), such as the main purpose test described above. [33] However, some countries (e.g., Japan and the United States) prefer to address the issue with specific and comprehensive rules governing limitations on benefits.

Q.2 The Government invites stakeholders' comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping.

6.4 The use of general or specific approaches – considerations in the Canadian context

The Government recognizes the difficult trade-offs in choosing between general and specific approaches to preventing treaty shopping. General approaches seem less complex – particularly in comparison to the specific and comprehensive rule-based approach of the comprehensive LOB article –

yet they explicitly authorize tax administrations and the courts to deny treaty benefits in treaty shopping cases. However, general approaches may produce less certain outcomes in some cases (compared to a comprehensive LOB article) and, accordingly, may expose businesses to some compliance risks. General approaches risk being both over-inclusive (depending on how they are applied by tax authorities) and under-inclusive (if taxpayers can support a tax filing position based on a purpose test or a general exception). The burden on tax authorities may also be significant in terms of developing guidance, administering ruling requests, and carrying out audit and enforcement activities.

Notwithstanding the challenges with general approaches, there are several attractions. For example, Canada has already adopted certain general approaches in its tax treaties, as discussed above, and therefore has some familiarity with them. Moreover, general approaches, whether in the form of a main purpose rule or a more specific anti-conduit rule, are consistent with what the OECD considers abusive; therefore, the implementation of such a rule in Canada's domestic law should not be in conflict with treaty obligations. As indicated above, the ability to implement a general anti-treaty shopping rule in domestic laws would enable Canada to begin addressing treaty shopping much sooner than would be possible under a treaty-based approach, an important consideration given the situation in Canada today.

Conversely, adopting a more specific rule would generally have the advantage of greater certainty for businesses but may produce more inappropriate outcomes, absent the exercise of discretionary authority.

Q.3 The Government invites stakeholders' views on whether a general approach is preferred over a relatively more specific and objective approach.

7. Striking a Balance Between General and Specific Rules

7.1 Considerations regarding effectiveness and certainty

As indicated above, Canada has implemented a main purpose test in 16 tax treaties, including in many recent treaties.[34] In principle, this approach requires the CRA to make a factual determination as to whether the main purpose (or one of the main purposes) of certain creations or assignments of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefits of a particular tax treaty. As indicated above, the OECD contemplates the use of a main purpose test in the context of specific types of income (e.g., dividends, interest, royalties, and other income); however, it would be necessary to consider whether a main purpose test, if enacted in Canada's domestic laws, should apply to other treaty provisions. For example, where tax treaties contain more favourable terms under the Capital Gains Article than under domestic law, it would be important to ensure that those treaties could not be used by third country residents to avoid paying Canadian tax arising on the disposition of taxable Canadian property.

The factual determination required under a main purpose test is similar to that required to make an "avoidance transaction" determination under the GAAR – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. There are also several other provisions in the *Income Tax Act* that contain a purpose test and require a determination of whether a main purpose of a transaction (or series of transactions) was to achieve a particular tax benefit.[35] Thus, a main purpose test is relatively familiar to both Canada's treaty partners and Canadian tax advisors. On this basis, a main purpose test, if implemented in Canada's domestic laws, could strike a reasonable balance between effectiveness and certainty.

As indicated in section 6.4, another view is that a main purpose test involves a meaningful element of uncertainty, both for taxpayers and the government. Under this view, even though a main purpose test can be considered a relatively objective fact-finding rule, ascertaining a taxpayer's purpose in carrying out a particular transaction has an element of subjectivity**.** There is a risk that taxpayers may exploit this subjectivity and self-assess treaty benefits in cases that in fact are motivated by treaty shopping. From the Government's perspective, such an outcome would be undesirable.

Q.4 The Government invites stakeholders' views on whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.

7.2 Dealing with the difficult cases

If there are concerns that the effectiveness and certainty objectives may not be achieved under a main purpose test, another general approach is to implement in Canada's domestic laws an anti-treaty shopping rule that is more specific. Such a rule would set out objective conditions which, if satisfied, would indicate the presence of treaty shopping. For example, such a rule could deny tax treaty benefits to an entity (a conduit) where:

1) the entity is owned or controlled, directly or indirectly, by residents of one or more third countries;

2) the entity pays, in the country in which it is resident, no or low taxes on the item of income earned in Canada (taking into account deductible amounts paid to third country residents and other relevant aspects of the tax system in the country where the intermediary is resident);

3) the entity is not engaged in substantive business operations in its country of residence (other than managing investment income); and

4) the third country residents referred to in (1) or (2) are not all resident in a country with which Canada has a tax treaty, and that treaty provides at least as much tax relief on the particular item of income as the particular tax treaty.

This approach contains elements from each of the look-through approach, the subject-to-tax approach, and the channel approach discussed in the OECD Commentary on Article 1. It also contains exceptions for entities meeting a substance test and entities controlled by third country residents which would have enjoyed similar tax treaty benefits (a so-called "derivative benefits test"). The Government recognizes that additional legislative or administrative guidance may be required in connection with each of these provisions; however, this approach has the benefit of expressing more clearly than a main purpose test what constitutes treaty shopping.[36] In addition, it would be possible to provide the Minister of National Revenue with the authority to grant treaty relief in appropriate cases.

The Government recognizes that there is a wide range of circumstances in which intermediary entities are used that do not involve treaty shopping.

For taxpayers in those circumstances, objective rules could produce predictable and appropriate outcomes. However, a move to more specific and objective rules also involves some risks for the Government in that it may provide taxpayers with a "road-map" for creating factual conditions necessary to avoid the anti-treaty shopping rule. Thus, in order to maintain effectiveness, the exceptions to any specific and objective test must be designed such that they cannot be easily or artificially satisfied. To achieve effectiveness, this practical reality may involve tightening the conditions and placing greater reliance on a discretionary authority of the Minister of National Revenue to grant treaty benefits in appropriate circumstances.

Q.5 The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration.

Q.6 For stakeholders who favour a more specific approach over a main purpose approach, the Government invites input on the design of the conditions and the exceptions (e.g., the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach with a view to ensuring the measure is effective and applies in a reasonably straightforward manner with predictable outcomes.

7.3 The interaction between domestic law and treaty-based approaches

If Canada were to adopt a domestic law approach, the question arises as to whether such domestic law provisions should apply in the case of tax treaties containing more comprehensive anti-treaty shopping provisions, such as Article XXIX-A (Limitation on Benefits) of the Canada-U.S. Tax Treaty. On the one hand, depending on the formulation of either a general or specific anti-treaty shopping rule under domestic law, it may be that the domestic law rule complements the treaty-based anti-treaty shopping rule.[37] On the other hand, on the basis that a US-style LOB rule is a comprehensive rule under which only persons satisfying specific and objective tests are eligible for treaty benefits, it may be inappropriate to impose additional rules in such circumstances.

Q.7 The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.

8. Consultative Process

As stated in the Introduction, the intention of this consultation is to examine a range of possible approaches to address the practice of treaty shopping into Canada. The purpose of this consultation is to serve as the basis for a discussion aimed at reaching a workable solution to the problem of treaty shopping.

The Government will use the responses from this consultation to evaluate whether new rules would have the potential to address the issue of treaty shopping.

How to Comment

The Government invites comments from stakeholders regarding any element of this paper by December 13, 2013.

Comments may be submitted to Treaty.Shopping-Chalandage.Fiscal@fin.gc.ca

Also, written comments can be forwarded to:

Treaty Shopping
Department of Finance
L'Esplanade Laurier
17th Floor, East Tower
140 O'Connor Street
Ottawa, Canada K1A 0G5

To add to the transparency of the consultation process, the Department of Finance will post submissions on the Department of Finance website, with the consent of the submitting party. We ask that, in providing your submission, you state whether you consent to posting your submission on the Department of Finance website. If you make a submission, please clearly indicate if you would like the Department of Finance to:

- Post your submission on the Department of Finance website; and
- Include your name and/or the name of the organization which you represent with your submission when posting it on the Department of Finance website.

We also request that submissions which are to be posted on the Departmental website be provided electronically in PDF format or in plain text.

The Department of Finance will not post submissions that do not clearly indicate a preference to be posted on our website.

Once received by the Department of Finance, all submissions will be subject to the Access to Information Act (ATI Act) and may be disclosed in accordance with its provisions. If a request pertaining to your submission is received under the ATI Act, you will be consulted under Section 27 of the ATI Act.

9. Summary of the Questions

Question 1 – *The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.*

Question 2 – *The Government invites stakeholders' comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping.*

Question 3 – *The Government invites stakeholders' views on whether a general approach is preferred over a relatively more specific and objective approach.*

Question 4 – *The Government invites stakeholders' views on whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.*

Question 5 – *The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration.*

Question 6 – *For stakeholders who favour a more specific approach over a main purpose approach, the Government invites input on the design of the conditions and the exceptions (e.g., the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach with a view to ensuring the measure is effective and applies in a reasonably straightforward manner with predictable outcomes.*

Question 7 – *The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.*

ANNEX

OECD and Other Countries Position on Treaty Shopping

1 – OECD Position on Improper Use of Tax Treaties

In January 2003, the OECD issued extensive revisions to the Commentary to the OECD Model which addresses the relationship between tax treaties and domestic anti-avoidance rules and problems concerning the improper use (or abuse) of tax treaties.

Under the heading "Improper use of the Convention", the 2003 OECD Commentary on Article 1 states:

> 8. It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions.
>
> 9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.
>
> 9.1 This raises two fundamental questions that are discussed in the following paragraphs:
>
> - whether the benefits of tax conventions must be granted when transactions constitute an abuse of the provisions of these conventions are entered into (see paragraphs 9.2 and following below); and
> - whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions (see paragraphs 22 and following below).
>
> 9.2 For many States, the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the second question above. As indicated in paragraph 22.1 below, the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.
>
> 9.3 Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions entered into with the view of obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*).
>
> 9.4 Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.
>
> 9.5 It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.
>
> 9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.

[...]

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict.

Treaty shopping was, in the mind of the OECD, an improper use of tax treaties at least as far back as 1986, as evidenced by the Conduit Report. The Report said:

D. Main characteristics of "conduit configurations"

6. Through the configurations described above, the conduit company takes advantage of the treaty provisions under its own name in the State of source; economically, however, the benefit goes to persons not entitled to use that treaty. A net tax advantage results because little or no taxation occurs in the State(s) of conduit.

The advantage arises in the source country. As its tax laws deal adequately with the situation (it generally taxes all non-residents including the conduit company), the problem is created exclusively by the treaty itself and therefore can only be dealt with under the treaty.

7. This situation is unsatisfactory in several ways:

a) treaty benefits negotiated between two states are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices altered;

b) Income flowing internationally may be exempted from tax altogether or be subject to inadequate taxation in a way unintended by the contracting states. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal taxing regime of that State;

c) The State of residence of the ultimate beneficiary has little incentive to enter into a tax treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the state of Source without the need for the State of Residence to provide reciprocal benefits.

Finally, the Committee on Fiscal Affairs of the OECD is currently considering a wide-ranging project to develop a comprehensive action plan to address several issues relating to "base erosion and profit shifting" (BEPS). One of the issues identified as contributing to BEPS in the 2013 OECD background report on BEPS is treaty shopping.

2 – UN Model Commentary Concerning Specific and General Legislative Anti-abuse Rules in Domestic Law

In 2011, significant revisions were made to the UN Model Commentary concerning the relationship between domestic law and treaties in the context of specific and general anti-abuse rules found in domestic law. This commentary is substantially the same as the OECD Commentary, although it contains a more complete and clearer discussion of the relationship between domestic tax rules and treaty rules. The following is an excerpt of the commentary dealing with general legislative anti-abuse rules found in domestic law:

20. Some countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific rules or judicial doctrines.

21. As is the case for specific anti-abuse rules found in domestic law, the main issue that arises with respect to the application of such general anti-abuse rules to improper uses of a treaty is possible conflicts with the provisions of the treaty. To the extent that the application of such general rules is restricted to cases of abuse, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in paragraphs 22 and 22.1 of the Commentary on Article 1 of the OECD Model Convention and with which the Committee agrees:

> 22. Other forms of abuse of tax treaties (*e.g.* the use of a base company) and possible ways to deal with them, including substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties [...].
>
> 22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict [...].

22. Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude that "[...] States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into."
(1) [Paragraph 9.4 of the Commentary on Article 1 of the OECD Model Convention]

23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle" (2) [Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention]:

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

24. The members of the Committee endorse that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

25. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

- a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and
- obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.

26. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.

27. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

3 – Other Countries' Experience Dealing With Treaty Shopping

Canada is not the only country that is concerned with treaty shopping. Many countries have taken legislative or administrative steps to address treaty shopping or have successfully challenged treaty shopping in their domestic courts. The following are very brief summaries of some of the approaches understood to be used in these countries to address treaty shopping.[38]

The **United States** was one of the first countries to raise an objection to treaty shopping and it remains the most forceful in combating it. The United States' domestic tax law and tax treaties contain robust measures to protect their treaties from abusive tax planning. These measures include specific anti-conduit rules and regulations in United States' domestic law, as well as a tax treaty policy that requires the inclusion of a comprehensive Limitation on Benefits provision (the "LOB")) in all United States' tax treaties. The United States' courts also have developed various judicial doctrines (economic substance, business purpose, and sham) that can apply in a tax treaty context to deny an intermediary benefits under a U.S. tax treaty.

The **United Kingdom** has chosen to take a more general approach and has included a main purpose test in the dividends, interest, and royalties articles of more than 60 tax treaties**.** For example, paragraph 5 of Article 11 of the 2008 United Kingdom - Netherlands tax treaty reads as follows:

> 5. No relief shall be available under this Article if it was the main purpose or one of the main purposes of any person concerned with the assignment of the interest, or with the creation or assignment of the debt-claim in respect of which the interest is paid, or with the establishment, acquisition or maintenance of the company that is the beneficial owner of the interest and the conduct of its operations, to take advantage of this Article. In any case where a Contracting State intends to apply this paragraph, its competent authority shall in advance consult with the competent authority of the other Contracting State.

Recently, the U.K. introduced special limitation clauses in its treaties with Bahrain and Hong Kong to protect U.K. taxes on interest income.

Germany has chosen a domestic legislative remedy to prevent treaty shopping and in so doing has implemented an anti-treaty shopping rule.[39] According to Germany's anti-treaty-shopping rule (as amended by Germany in January 2012 to comply with EU law), German withholding tax relief can be claimed only to the extent that:

> (1) the foreign company's shareholders (all of them in the chain of ownership) would have been entitled to a refund or exemption had they received the income directly (the "shareholder test"); and
>
> (2) either :
>
>> (a) the foreign company's gross receipts for the year is derived from its own active business activities ("active business test"); or
>>
>> (b) (i) there are economic or other significant non-tax reasons for the interposition of the foreign company ("business purpose test"), and (ii) The foreign company has adequate business substance to engage in its business and participates in general commerce (the "substance test").

The German Ministry of Finance has also published a circular dealing with the interpretation of the anti-treaty shopping rule.[40]

France won a major treaty shopping case at the highest court (*le Conseil d'État*) based on the notion of "*fraude à la loi*".[41] *Fraude à la loi* refers to any action undertaken for the sole purpose of avoiding tax in a way not previously envisioned by the legislator. The theory behind the concept *fraude à la loi* is similar to an economic substance-over-form approach.

In **Australia**, the domestic general anti-avoidance rule applies in treaty cases whether or not its application amounts to a treaty override. This is the same as in Canada except that the general anti-avoidance rule in Australia does not contain a misuse or abuse exception. Australia's GAAR applies if the dominant purpose of the scheme was to obtain the tax benefit. The Commissioner expressed the view in a Draft Taxation Determination that "[w]here an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structuring arrangement, this may be a scheme or a part of a scheme which otherwise satisfies the terms of Part IVA, and any tax benefit obtained in relation to such a scheme may be cancelled". [42]

China has a general anti-avoidance rule which applies to tax treaty abuse. Under China's GAAR, the absence of a reasonable business purpose is the core of the rule. Moreover, China's State Administration of Taxation issued in 2009 a circular (Circular 601) that provides a definition of the concept of "beneficial owner", the result of which is to prevent non-residents from treaty shopping in the context of Chinese-source dividends, interest, and royalties.[43] Since circulars and other administrative positions in China are considered to have a higher status than those in Canada, China has effectively introduced a relatively specific anti-treaty shopping rule in the form of a definition of beneficial owner. According to Circular 601, "beneficial owner" is essentially defined as a person who:

> 1) owns or has control over the Chinese-sourced income, or over the rights or assets that may give rise to Chinese-sourced income;
>
> 2) is engaged in substantial business activities;
>
> 3) is not an agent; and
>
> 4) is not a conduit company (defined as a company established for the purposes of avoiding taxes).

The circular further provides factors under which a person would not be considered to be the beneficial owner (negative factors). The emphasis of these factors is on whether the person claiming the tax treaty benefit is carrying on substantial business activities in the treaty country, and the burden of establishing this lies on that person.

---

[1] According to the OECD Glossary of Tax Terms, "treaty shopping" refers to "[a]n analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident in either of the treaty countries establishes an entity in one of the treaty countries to obtain treaty benefits." See also Larking, IBFD International Tax Glossary, 5th ed. (2005).

[2] See section 1 of the Annex which sets out the OECD's position on the improper use of tax treaties. Also, paragraph 47 of the Commentary on Article 1 of the United Nations Model Convention clearly provides that treaty shopping is an improper use of tax treaties.

[3] Paragraph 4 of the OECD Report *Double Taxation Convention and The Use of Conduit Companies* (1986), for example, sets out similar circumstances.

[4] The direct conduit structure used in treaty shopping schemes usually involves an intermediary entity that is subject to little or no tax on the receipt of treaty-protected income. "Stepping stone conduit" structures involve an intermediary entity that is subject to tax but is able to claim an offsetting deduction in respect of amounts owing to residents of a third country where little or no tax is paid on the income.

[5] It is important to note that other situations, such as the creation of special rights or the assignment of property in an attempt to qualify income for treaty benefits in another person's hands, may also constitute treaty shopping.

[6] Technical Explanation to the 1995 Canada-U.S. protocol regarding Article XXIX-A (Limitation on Benefits), paragraphs 1 and 7. Even after the 2007 Protocol to the Canada-US Treaty when Canada began to apply the limitation on benefits article, Canada preserved its right to apply its domestic rules to counter abusive arrangements involving treaty shopping.

[7] See paragraph 21.1 of the Commentary on Article 1 of the OECD Model Convention. Such rule has been included in over 40 Canadian tax treaties.

[8] See paragraph 21.4 of the OECD Commentary on Article 1 of the OECD Model Convention and Canada's tax treaties with: Hong Kong (2012); Poland (2012); New Zealand (2012); Colombia (2008); Mexico (2006); Oman (2004); Peru (2001); Uzbekistan (1999); Chile (1998); Kazakhstan (1996); Lithuania (1996); Ukraine (1996); Estonia (1995); Latvia (1995); and United Kingdom (1978).

[9] For example, in answering the question "Does Revenue Canada believe that 'treaty shopping' is subject to the general anti-avoidance rule" at the 1993 Corporate Management Tax Conference, CRA said: "… where a non-resident of Canada enters into a series of transactions designed primarily to secure an exemption or reduction from Canadian tax under an income tax convention Canada has with another country, the Department would seek to apply the general anti-avoidance rule to deny any tax benefit such transactions would otherwise produce…". In 2006, the CRA stated at the seminar of the International Fiscal Association (Canadian Branch) that it would challenge payments to an intermediary recipient if it did not have an office, employees, activities, or significant other assets and was required to remit the payments to a third party (see Canadian Tax Highlights, Volume 20, Number 3, March 2012). See also Income Tax Technical News no. 35, dated February 26, 2007.

[10] 95 DTC 5389.

[11] Paragraph 52 of the decision.

[12] 2006 TCC 460 (Aff'd 2007 DTC 5437 (Federal Court of Appeal)).

[13] A non resident of Canada is taxable in Canada on, among other things, capital gains arising on the disposition of taxable Canadian property, subject to the provisions of an applicable tax treaty.

[14] See paragraph 72 of the decision.

[15] 2009 D.T.C. 5053.

[16] 2012 D.T.C. 1100.

[17] See footnote 4 above and paragraph 4 of the OECD Report Double Taxation Convention and The Use of Conduit Companies (adopted by the OECD Council on 27 November 1986).

[18] This statement refers to outbound international tax planning. The nature of outbound international tax planning varies depending on the tax system in the country in which the investor is resident. Outbound and inbound international tax planning often intersect to influence the choice of the country in which an intermediary might be established. In some contexts, this may be referred to as outbound treaty shopping; however, treaty shopping usually refers to inbound tax planning and the consequences of this practice on the source country's tax base. For clarity, this consultation paper is primarily concerned with treaty shopping inbound to Canada.

[19] Jack M. Mintz and Alfons J. Weichenrieder, *The Indirect Side of Direct Investment Multinational Company Finance and Taxation,* CESifo Book Series, Cambridge Mass. MIT Press, 2010, Table 2.1, p. 34. That table used data only in respect of countries that have established special conduit regimes and covered the period of 2001-2005. The top ten countries in that table were, in order: Luxembourg, Hong Kong (China), Singapore, Iceland, Netherlands, Belgium, Ireland, Lesotho, Switzerland and Bulgaria.

[20] A home country is roughly equivalent to the residence country of the ultimate beneficial owner, while the host country would be the source country.

[21] According to the OECD, SPEs are entities with no or few employees, little or no physical presence in the host economy, whose assets and liabilities represent investments in or from other countries, and whose core business consists of group financing or holding activities (OECD background report on "Base Erosion and Profit Shifting" (BEPS), Chapter 2–*How big a problem is BEPS? An overview of the available data*, p. 18).

[22] See Box I.1 of: United Nations Conference on Trade and Development (2012), *World Investment Report,* pp. 7 and 8.

[23] 2013 OECD background report on "*Base Erosion and Profit Shifting*" (BEPS), Chapter 2, at p. 18:

> "For example, total inward stock investments into the Netherlands for 2011 were equal to USD 3 207 billion. Of this amount, investments through SPEs amounted to USD 2 625 billion. On the other hand, outward stock investments from the Netherlands were equal to USD 4 002 billion, with about USD 3 023 billion being made through SPEs. Similarly, in the case of Luxembourg, total inward stock investments for 2011 were equal to USD 2 129 billion, with USD 1 987 billion being made through SPEs. On the other hand, outward stock investments from Luxembourg were equal to USD 2 140 billion, with about USD 1 945 billion being made through SPEs." See also Box I.1 of the United Nations *World Investment Report* referred to in footnote 22.

[24] We also note that Luxembourg's stock of FDI in Canada in 2011 was more than twice the average shown in Table 2 for the period 2006-2010.

[25] For example, effective in 2008, Canada amended the *Income Tax Act* to eliminate withholding tax on interest earned by all non-residents in Canada in respect of most arm's length debts.

[26] See sections 1 and 2 of the Annex. For example, paragraph 9.4 of the Commentary to Article 1 of the OECD Model Convention states that countries do not have to grant the benefit of a double taxation convention where arrangements that constitute an abuse of the convention have been entered into and any such denial of treaty benefits may be achieved under either a domestic law or treaty-based approach.

[27] Subject to the caveat in paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention that "…it is not to be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above." In addition, paragraph 9.5 sets out the guiding principle that "…the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

[28] For example, the following countries have domestic treaty shopping rules or statutory, judicial or administrative anti-avoidance rules that their courts or tax administrations have applied to counter treaty shopping: China, France, Germany, United Kingdom and United States. See section 3 of the Annex.

[29] See paragraphs 13 to 26 of the OECD Model Commentary to Article 1.

[30] Paragraph 19 of the OECD Model Commentary on Article 1.

[31] These specific and objective tests are similar in principle to certain of the exceptions discussed above in the context of some general anti-treaty shopping approaches which are likely to be over-inclusive. However, countries using objective rules in LOB articles to determine eligibility for treaty benefits would also tend to provide more specific guidance on the interpretation of those rules in other authoritative sources. This is the case in the US where in practice taxpayers and practitioners refer to the US Model Convention and other treaties for specific and technical guidance in addition to the technical explanation for any particular treaty.

[32] For example, income paid to certain stepping stone conduits (see footnote 4 above and paragraph 4 of the OECD Report on Conduit Companies) may not be denied treaty benefits under a comprehensive LOB rule if, for example, the income satisfies the active trade or business provision of the LOB rule.

[33] There are currently over 300 tax treaties which have a main purpose test provision.

[34] For example, paragraph 7 of Article 10 (and paragraph 9 of Article 11 and paragraph 7 of Article 12) of the Canada-Hong Kong tax treaty reads as follows:

> "7. A resident of a Party shall not be entitled to any benefits provided under this Article in respect of a dividend if **one of the main purposes** of any person concerned with an assignment or transfer of the dividend, or with the creation, assignment, acquisition or transfer of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the dividend, is for that resident to obtain the benefits of this Article."

[35] For example, subsection 69(11) of the *Income Tax Act* requires a determination of whether one of the main purposes of the series of transactions is to obtain the benefit of tax attributes of a non-affiliated person. Also, subsection 256(8) of the *Income Tax Act* requires a determination of whether one of the main purposes of the acquisition of a right is to avoid the application of certain rules that would apply had the right been exercised.

[36] As noted earlier (see footnote 5) treaty shopping can also arise through the creation of special rights or assignment of property. These cases would also need to be considered in the context of a more specific rule.

[37] For example, as indicated above, it is possible that certain stepping stone conduit structures may not be denied treaty benefits under a comprehensive LOB rule on the basis that the intermediary satisfies an active trade or business exception whereas such structures may be subject to an anti-treaty shopping rule under domestic law. In fact, United States domestic law contains detailed anti-conduit rules to further support its comprehensive LOB policy (see section 3 of the Annex).

[38] For further details, see Cahiers de Droit Fiscal International, Vol. 95a, *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, International Fiscal Association, 2010 Rome Congress, 890 pages.

[39] Section 50d para. 3 of the German Income Tax Act (Einkommensteuergesetz – EStG).

[40] See Ulrich Ränsch and Alexandra John, § 50d (3) EStG Entitlement to Tax Relief Available to Foreign Companies – Unofficial Translation of the Federal Ministry of Finance Circular Dated 24 January 2012 and Explanatory Notes, Intertax, Volume 40, Issue 6 - 7, p. 431 to 438.

[41] Decision of the Conseil d'État *Bank of Scotland* (CE Dec. 20, 2006, No. 283314).

[42] Paragraph 19 of TD 2009/D17 on the Australian Taxation Office (Legal Database) Website. See also TD 2010/20ECATO.

[43] Guoshuihan [2009] No. 601 (issued by the State Administration of Taxation on October 27, 2009).

Court File No. 2014-4359(IT)G

TAX COURT OF CANADA

BETWEEN:

ALTA ENERGY LUXEMBOURG S.A. R.L.

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

TRANSCRIPT OF PROCEEDINGS
HEARD BEFORE THE HONOURABLE JUSTICE HOGAN
held at the Tax Court of Canada,
180 Queen Street West, Courtroom 6A, Toronto, Ontario
on Wednesday, June 13, 2018 at 9:32 a.m.

VOLUME 3

APPEARANCES:

Warren J.A. Mitchell Matthew G. Williams E. Rebecca Potter	for the Appellant
Christopher Bartlett Patricia Lee	for the Respondent

Also Present:

Kathleen Harrill	Court Registrar
Sandra Brereton	Court Reporter

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1 of triangles and circles. Are you familiar with the purpose
2 of -- or who they are?
3 A. Not in any level of detail. I know that
4 that's Joe Greenberg and his group.
5 JUSTICE HOGAN: Just for simplification
6 purposes, the whole purpose is to allow conduit treatment
7 for the U.S. investors on that side of the chart.
8 THE WITNESS: Correct.
9 BY MR. MITCHELL:
10 Q. On the right-hand side of the chart
11 there are Blackstone capital partners, two Blackstone
12 capital partners. It says Cayman; is that correct?
13 A. At inception those were Delaware
14 partnerships, but at this point when Canada had been
15 identified as the investment -- investee jurisdiction, those
16 were converted.
17 JUSTICE HOGAN: So you moved? Or you
18 dissolved the old partnerships and moved them into the
19 Caymans?
20 THE WITNESS: No, we didn't. In our fund
21 agreement, so when we talk about initially when we raise a
22 fund, there's not a particular investment in mind at that
23 point in time.
24 So the main fund vehicle for purposes of
25 having a legal entity that memorializes our arrangement with
26 our limited partners is generally a Delaware partnership.
27 It has nothing in it other than a legal contract with our
28 limited partners. In that document we are allowed to form

1 what we call alternative investment vehicles or AIVs, which
2 can be located in any jurisdiction so long as they don't
3 present a particular tax problem.
4 JUSTICE HOGAN: So am I correct in assuming
5 then in the top partnership which is Delaware, that's where
6 you have your cash calls. The cash would come in and then
7 get routed through the Caymans?
8 THE WITNESS: No.
9 JUSTICE HOGAN: Or it would direct -- in
10 other words, you just direct the investors to make their
11 investments in the Caymans.
12 THE WITNESS: So we have the legal right and
13 we have power of attorney from all the limited partners to
14 form Cayman partnerships or other partnerships on their
15 behalf, and then call the capital directly into those
16 partnerships. And that's the -- it has mirror agreement to
17 the main fund. So all of the terms that cover the main fund
18 then govern the Cayman fund.
19 JUSTICE HOGAN: Thank you.
20 BY MR. MITCHELL:
21 Q. Can you -- going to those funds, can you
22 outline what the terms to the investor are? I put in a
23 million dollars, what's the deal?
24 A. Well, the deal is is that we will take
25 your -- we'll take your money at the right -- at the
26 appropriate time.
27 Q. That was no surprise.
28 A. We will -- typically in the offering

1 change.
2 So if the world stopped in June of 2011, the
3 diagram we have here would be representative of the
4 structure?
5 A. Yes, that's correct.
6 Q. Now, when it became apparent that the
7 investment was going to be in Canada, what changes did that
8 invoke? What did you do because of that?
9 A. Well, the first thing we did, based on
10 prior practice and rules that we're well familiar with in
11 the United States, is that we moved the fund vehicles from
12 being the Delaware main fund vehicles to being alternative
13 investment vehicles in Canada.
14 Q. Let me stop you there and deal with the
15 --
16 A. Sorry, in the Caymans, not Canada.
17 Q. Let me deal with there, and I should
18 have got this before, the bottom square or the bottom
19 rectangle in the diagram, Alta Energy Partners Canada
20 Limited, what was that formed for?
21 A. For purpose of holding assets in the
22 Duvernay -- in Canada.
23 Q. And that would be how the world would be
24 at the end of June 2011, that would have been in place?
25 A. Yes.
26 JUSTICE HOGAN: Just one question. You said
27 that you could make your cash calls through the Cayman, but
28 presumably there was cash calls made through the Delaware

1 partnership at the outset when the structure was first set
2 up?
3 THE WITNESS: No. None.
4 JUSTICE HOGAN: None.
5 THE WITNESS: None.
6 JUSTICE HOGAN: So from day one when money
7 flowed to Canada it always went through the Cayman
8 structure.
9 THE WITNESS: Yes.
10 JUSTICE HOGAN: Thank you.
11 BY MR. MITCHELL:
12 Q. Sorry, I interrupted you to put the
13 Canadian company in, but please go on. We now know that the
14 investments in the United States, what did that invoke?
15 A. So initially it invoked utilizing our
16 Cayman alternative investment vehicles as the pooling
17 vehicle for the capital to this particular investment. And
18 then it initiated a process whereby we engaged with Canadian
19 counsel, legal, regulatory, tax to inform us as to the
20 optimal structure to invest in Canadian assets.
21 Q. Could you turn to page --
22 JUSTICE HOGAN: Just one quick question that
23 -- before I'll allow you to go there, counsel. What's the
24 advantage of using a Cayman partnership? It is a
25 partnership or a corporate in the Caymans? I know it's
26 disregarded, but was it a limited partnership that you were
27 using?
28 THE WITNESS: I don't want to say