Canadian Appeal Court Narrows Foreign Affiliate Antiavoidance Rule in *Lehigh*

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The Canadian Federal Court of Appeal (FCA) on April 23 issued a judgment in *Lehigh Cement Limited*[1] that comes as a relief to Canadian-based multinationals. The FCA rejected the Tax Court of Canada's (TCC) broad reading[2] of an antiavoidance rule that the government has tried to use to effectively deny taxpayer benefits, including the tax-free receipt of some distributions by foreign subsidiaries, provided under Canada's foreign affiliate (FA) system.

Canadian FA status generally arises from the ownership of 10 percent or more of any class of stock. The antiavoidance rule in section 95(6)(b) of the Income Tax Act (Canada) can deny FA status by deeming that shares of a nonresident corporation not issued if a tax reduction is alleged to be the principal purpose of the issue.

The Canada Revenue Agency's long-standing position (upheld by the TCC) has been that the rule can be invoked in any case in which the use of an FA gives rise to overall Canadian tax results that the CRA considers ''unacceptable.''

However, the FCA effectively concluded (as has long been the view of tax practitioners) that the rule should only apply when either FA status is artificially created or, in relation to the adverse aspects of the system involving attribution of passive foreign income, when ''controlled foreign affiliate'' status is artificially avoided. The provision should not be read as some sort of general prohibition or antiavoidance rule against tax planning with FAs.

The FCA's decision in favor of the taxpayer agrees with that of the TCC, which had found that even though, in its view, the taxpayer's arrangements were within the scope of the rule, they lacked the requisite reduction of tax alleged by the government.

The issue before the court was whether the taxpayer (Lehigh) could deduct dividends from an affiliated U.S. limited liability company paid out of interest from a loan made by the latter, as part of a corporate restructuring, to another U.S. member of the Belgian-owned group in light of the section 95(6)(b) antiavoidance rule.[3]

The issue can be considered in the context of the following background.

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[1] *The Queen v. Lehigh Cement Limited*, 2014 FCA 103, and a companion decision in *The Queen v. CBR Alberta Limited*, 2014 FCA 103.

[2] *Lehigh Cement Limited v. The Queen*. This decision and a companion decision in *CBR Alberta Limited v. The Queen* are cited as 2013 TCC 176. CBR was a wholly owned Canadian subsidiary of Lehigh, and each transaction ascribed herein to Lehigh was in fact undertaken as to 99 percent by Lehigh and as to 1 percent by CBR. *See* Nathan Boidman ''The Troubling Effects for Canadian MNEs of the *Lehigh* Decision,'' *Tax Notes Int'l*, June 17, 2013, p. 1211; and Steve Suarez, ''Crown Appeals Loss in Canadian Outbound Planning Case,'' *Tax Notes Int'l*, Oct. 7, 2013, p. 26.

[3] U.S. IRC section 894(c) was enacted in August 1997 to terminate treaty benefits associated with such structures.

Background

Canada's Partial Territorial System

Canada has a form of territorial system for Canadian multinationals and their investment in foreign operating corporations[4] that exempts (from Canadian tax) direct or indirect dividends from such corporations if the following conditions are met:

- the foreign corporation must be based in a country with which Canada has a tax treaty or tax information exchange agreement;
- the Canadian multinational enterprise must own at least 10 percent of the shares of any class of stock of the foreign corporation or at least 1 percent with 10 percent owned by the group (so that the foreign corporation qualifies as an FA vis-à-vis the Canadian MNE); and
- the dividend must stem from active business profits of the foreign corporation.

This is known as the ''exempt surplus'' system.[5]

The Antiavoidance Rule

According to section 95(6)(b) of the ITA, in dealing with the FA rules, shares issued by a corporation and/or the acquisition or disposition of shares of a corporation can be ignored if their issuance, acquisition, or disposition is principally for tax avoidance purposes. However, notwithstanding its broad language,[6] tax practitioners have long thought that the rule has been enacted for only two reasons.

First, the rule protects the integrity of a separate set of rules[7] that attribute to a relevant Canadian MNE the passive income of those FAs that are controlled, in specified ways, by Canadians or affiliated parties or a combination thereof (a controlled foreign affiliate, or CFA). In this case, section 95(6) seems intended to prevent decontrolling CFAs by issuing or selling voting shares to friendly foreign parties. That would make the attribution rule in section 91 inapplicable.

Second, the rule was later amended to protect the integrity of another set of rules, under section 95(2)(a)(ii), that recharacterize certain inter-foreign group financing and licensing income as active business income so as not to be subject to attribution as passive income.[8] In this case, section 95(6) seems intended to prevent artificially creating FA status by having, say, preferred shares issued by nonresident corporations that were not otherwise FAs of Canadian parties and to whom there would be loans or licensing of property. The purpose of that would be to render the income recharacterization rule of section 95(2)(a)(ii) applicable to income derived from such loans or licenses and avoid passive income attribution.

In that context, conceptually there seems to be no relationship between the territoriality/exempt surplus system rule and the section 95(6)(b) antiavoidance rule.

The exempt surplus system is of broad economic policy effect and is intended to promote the international competitiveness of Canada's MNEs. It rests on the three pillars described above and should not be undermined by a vaguely worded antiavoidance rule that is widely thought to be aimed at narrow mischiefs. But that is exactly what the CRA tried to do.

The Facts in *Lehigh*

In *Lehigh* — involving transactions in the 1996-1997 tax years — the government sought to invoke section 95(6)(b) to deny the basic exemption for dividends meeting the three basic territorial-related tests described above because it believed that a foreign controlled Canadian subsidiary (namely Lehigh, which was controlled by a Belgian group) was being used to provide funds, through its own non-Canadian subsidiary (the LLC) that qualified as a FA, to a foreign sister operating company (namely a U.S. corporation owned by the Belgian group) in a fashion that was eroding Lehigh's Canadian income base.[9]

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[4]This assumes a corporation that is not resident in Canada, which, from the standpoint of corporate law, in general means a non-Canadian corporation that is not managed and controlled in Canada — per section 250(4) et seq. of the ITA, RSC 1985, c.1 (5th Supplement), as amended.

[5]*See*, *inter alia*, sections 90, 95, and 113 of the ITA and Part 5900 of the Income Tax Regulations made thereunder.

[6]Section 95(6)(b) reads as follows:

> For the purposes of this subdivision (other than section 90) . . . (b) where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can be reasonably considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be are deemed not to have been issued.

Note that section 95(6)(a) deals with a similar antiavoidance rule where there are rights to acquire shares.

[7]These are the controlled foreign affiliate/foreign accrual property income rules of sections 91-95 of the ITA.

[8]In the years at issue before the court (1996-1997), that rule (section 95(2)(a)(ii)) applied to payments to an FA by either another FA or, as relevant in *Lehigh*, a foreign corporation related to the Canadian shareholder of the recipient FA. To counter the arrangement in *Lehigh*, the rule was later amended to only apply to inter-FA payments.

[9]As noted in note 8 *supra*, amendments since the mid-1990s have eliminated the Canadian benefits of such (foreign sister operating company) arrangements. Furthermore, such arrangements would now attract a punitive tax regime, at the point implemented, under the controversial new FA dumping rules of section 212.3.

Lehigh borrowed funds ($100 million)[10] and deducted interest paid thereon against its Canadian-source profits. It invested the borrowed funds in the capital of a wholly owned U.S. LLC, which on-lent them to a sister U.S. operating company. The LLC then paid up, as dividends, its interest income to Lehigh, its Canadian parent, which relied on section 95(2)(a)(ii) and the exempt surplus rules to pay no tax in Canada on the arrangement, notwithstanding the deductibility of the borrowing costs in both Canada and the U.S. To see the overall tax effects, note that the U.S. tax cast was a 10 percent withholding tax under the Canada-U.S. tax treaty, as it then was, and under U.S. law before the enactment of IRC section 894(c) in August 1997.[11]

The government sought to apply section 95(6)(b) to deem the LLC shares not issued so that the LLC could not be an FA of Lehigh and so that the dividends the LLC paid could not qualify for the exempt surplus system. The taxpayer prevailed before the TCC but at a potential cost to Canadian MNEs.

The TCC Judgment

Although the Tax Court of Canada rejected the government's claim, it unfortunately (and, with respect, wrongly) did not do so by rejecting the government's wide reading of the basic ambit of section 95(6)(b). Instead, the court agreed with the government that section 95(6)(b) could apply beyond the two situations suggested above. However, it found that the rule shouldn't apply in this case because no Canadian tax was avoided: The Canadian results would have been the same had the Canadian company provided the funds to its sister U.S. company by a straight preferred share investment rather than through the LLC arrangement.[12]

That result was an interpretation that would not provide taxpayers with the means of cutting off section 95(6)(b) challenges by reference to the basic role played by an issue of or acquisition or disposition of shares by a FA, as would be the case if the court had adopted the long-standing views of tax practitioners.[13] Instead, it meant that taxpayers would have to show, by comparative analysis of alternative arrangements, that impugned arrangements do not raise tax reduction. This was overall a very unfortunate result. Fortunately, however, the FCA revised that.

The FCA Judgment

The FCA set the tone for its decision early in the judgment when it stated[14] that in the Tax Court the parties had debated whether ''paragraph 95(6)(b) should be interpreted broadly as the Crown contended or narrowly as the taxpayers contended.''[15]

The judgment then marches inexorably to the conclusion — already noted at the onset — that the answer is a narrow interpretation.

The FCA showed its full hand when it wrote in the context of explaining the potential benefits of FA status and adverse effects of CFA status, ''And often the Canadian taxpayer can easily manipulate that status to get those tax savings''[16] and ''To address the Canadian taxpayers' ability to manipulate the ownership status of non-resident corporations, Parliament enacted paragraph 95(6)(b).''[17]

There it is: precisely what tax practitioners have always contended and what the CRA stubbornly had rejected and refused to recognize.

The balance of the judgment serves to elaborate on and confirm this basic and firm view — that the provision is not to be used as a general tax avoidance tool but as a precise instrument for very precise issues, namely, attempts to create FA status where none would otherwise exist and de-control what would otherwise be CFAs.

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[10]As noted in note 2 *supra*, each transaction ascribed herein to Lehigh was actually entered into by both Lehigh (99 percent) and its special purpose Canadian subsidiary, CBR (1 percent).

[11]*See supra* note 3.

[12]In this respect the court noted that the tax difference between the LLC arrangement and a direct preferred share investment was in the U.S. The former saw interest expense reduce the U.S. taxable income of the U.S. operating company, while the latter would not have involved interest deductions against the U.S. taxable income base.

[13]Those views, as put forward by the taxpayer, are discussed in some detail in the judgment. The TCC considered a similar issue involving section 95(6)(b) in *Univar Canada Ltd. v. The Queen*, 2005 TCC 723; however, the TCC decided on grounds that did not require a determination respecting the scope of the rule and

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therefore none was made. The uncertainties that flowed from the Tax Court's view of the ambit and the need to look for comparative transactions that provide exclusion from the rule may be seen in pending litigation before the Tax Court in *Imperial Tobacco Canada Limited* and in *Lincoln Canadian Holdings ULC* involving claims by the government that section 95(6)(b) should apply to the type of foreign sister company preferred share investment as the Tax Court used in *Lehigh* to decide the case in favor of the taxpayer. *See Imperial Tobacco Canada Limited v. The Queen*, 2012 CTC 135 and 2013 TCC 144, two decisions on preliminary motions in this as yet undecided litigation; and *Lincoln*, 2013-468 (IT)G.

[14]Para. 4 of the judgment.

[15]In paragraph 5, the FCA noted the contrary conclusion to which the TCC had arrived as follows:

> The Tax Court allowed the taxpayers' appeals from the reassessments. While it agreed with the Crown concerning the breadth of paragraph 95(6)(b), it found that the paragraph did not apply to the taxpayers in those circumstances because there was no tax that would have been otherwise payable.

[16]Para. 19 of the judgment.

[17]Para. 20 of the judgment.

Section 95(6)(b) most certainly is not a tool to ignore a wholly owned FA such as in *Lehigh*, regardless of the motives that prompt its establishment.

To ground its view, the FCA embarked on an interpretative process laid down by the Supreme Court in October 2005 in its first decision on Canada's statutory general antiavoidance rule, namely a search for a unified view of the text, context, and purpose of the statutory provision under examination.[18]

And the focus of this exercise (which the court said is to ''not supplant or qualify the words of paragraph 95(2)(b) by creating 'unexpressed exceptions derived from [our] view of the object and purpose of the provision' or by resorting to tendentious reasoning''[19]) is set forth as follows:

> The taxpayers submit paragraph 95(6)(b) focuses on the principal purpose of the particular acquisition or disposition of the shares, not the principal purpose of the series of transactions of which the acquisition or disposition form a part. It is meant to remedy a situation where a taxpayer attempts to manipulate the ownership status of a non-resident corporation for the principal purpose of gaining a tax advantage from the ownership status. It is not meant to remedy a situation where a taxpayer engages in a series of transactions that achieve any other favourable tax result.[20]

The court concluded in favor of that taxpayer submission in the following words: ''Overall, though, our task is to discern the meaning of the provisions' text using all of the objective clues available to us.''[21] It added, ''Doing this, following the above principles, I accept the taxpayers' interpretation of paragraph 95(6)(b).''[22] According to the court, this is because the statutory words ''are precise and unequivocal.''[23] The provision looks for the direct purpose/effect of acquiring or disposing of shares, ''not the principal purpose of the series of transactions of which the acquisition or disposition form a part. There is no basis for this court to read in those extra words.''[24]

The court then found[25] context to support its textual reading of the provision. It put particular emphasis on:

- the implication that enactment of other antiavoidance rules that involve FAs is consistent with a narrow reading of section 95(6)(b);[26] and
- ''the architecture of the Act,'' which sees section 95(6)(b) located in and for purposes of the specific rules for ''Shareholders of Corporations Not Resident in Canada'' (subdivision i of Division B of the ITA) and not ''in a more general part of the Act such as Part XVI ('Tax Avoidance').''[27]

The court concluded this (contextual) factor with two points. First, it noted that because taxpayers can ''easily manipulate'' FA status (and the benefits that flow therefrom) ''by acquiring or disposing of shares,'' the provisions of section 95(6)(b) are ''the fix [that] fits the problem.'' And ''it would take clearer wording to lead to the conclusion that the fix in paragraph 95(6)(b) is aimed at a broader problem.''[28]

Second, the court stated that:

> From the foregoing analysis then, it seems to me that the species of tax avoidance addressed by paragraph 95(6)(b) is the manipulation of share ownership of the non-resident corporation to meet or fail the relevant tests for foreign affiliate, controlled foreign affiliate or related corporation status in subdivision i of Division B of Part 1 of the Act.[29]

The court then found support for its textually and contextually based position in the realm of the ''underlying purpose of the provision'' (as referred to in paragraph 57 of the judgment).

This aspect of the inquiry sees a very interesting dynamic: The CRA asserting a wide discretion to strike down tax planning it considers ''unacceptable'' and the court pushing back to a more appropriate rule of law instead of administrative fiat.

The court noted[30] that some interpretations of statutory provisions ''are consistent with the broad themes of the Act and the legal principles governing its administration. Others not so much.'' It is in that context that the court made the following remarkable observations and comments:

- The government believes it can use section 95(6)(b) ''where a taxpayer engaged in what the Minister considers to be abusive tax planning involving foreign corporations,'' and it can do so ''even if the non-resident corporation has obtained foreign affiliate status without any artificial manipulation of share ownership.''[31]

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[18]*See* paras. 37 et seq. of the judgment; and *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, [2005] 2 S.C.R. 601.

[19]Para. 42 of the judgment.

[20]Para. 35 of the judgment.

[21]Para. 44 of the judgment.

[22]Para. 45 of the judgment.

[23]Para. 46 of the judgment.

[24]Para. 46 of the judgment.

[25]Paras. 48-56 of the judgment.

[26]Para. 52 of the judgment.

[27]Para. 54 of the judgment.

[28]Para. 55 of the judgment.

[29]Para. 56 of the judgment.

[30]Para. 61 of the judgment.

[31]Para. 62 of the judgment.

- The government shows some restraint and says, according to the court, ''that paragraph 95(6)(b) will be applied only where the tax avoidance is unacceptable.''[32]
- The court, however, took a dim view of the government's ''acceptability'' standard:

  > Unacceptability is in the eyes of the beholder. It can shift depending upon one's subjective judgment and mood at the time. Using it, as the Crown suggests, to restrain the indiscriminate use of paragraph 95(6)(b) creates the spectre of similarly-situated taxpayers being treated differently for no objective reason. This would violate the principle that, absent clear legislative wording, the same legal principles should apply to all taxpayers: *Bronfman Trust v. the Queen*, [1987] 1. S.C.R. 32, at page 46.[33]

- The court then illustrated the latter violation in relation to an everyday garden-variety borrowing to fund a foreign subsidiary[34] and the fact that section 96(5)(b) contains on its face no ''limiting factor'' (as is seen, the court said, in Canada's section 245 GAAR[35]) and it leads to the conclusion that:

  > Absent clear wording, I would be loath to interpret paragraph 95(6)(b) in a way that gives the Minister such an unlimited and ill-defined discretion — a standardless sweep — as to whether or not tax is owing, limited only by the view of unacceptability. It would be contrary to fundamental principle. It would also promote inconsistency and arbitrary application, the bane of consistency, predictability and fairness.[36]

Concluding Comment

The FCA concluded with the finding:

> that paragraph 95(6)(b) is targeted at those whose principal purpose for acquiring or disposing of shares in a non-resident corporation is to meet or fail the relevant tests for foreign affiliate, controlled foreign affiliate or related-corporation status with a view to avoiding, reducing or deferring Canadian tax.[37]

That clearly lifts the cloud of uncertainty placed over Canadian-based multinationals by the lower court's decision. It is therefore a welcome development, although it is not known at this juncture if the government will seek leave to appeal to the Supreme Court. ◆

[32]Para. 63 of the judgment.

[33]Para. 64 of the judgment.

[34]Para. 67 of the judgment.

[35]The limiting factor referred to by the court in paragraph 66 is that Canada's section 245 GAAR requires the government to show that a taxpayer has either misused a provision of the law or has abused the law as a whole.

(Footnote continued in next column.)

[36]Para. 67 of the judgment.

[37]Para. 68 of the judgment.