DECEMBER 14, 2021

Top Court Blesses Treaty-Shopping Arrangement: The *Alta Energy* Decision

Authors: Michael N. Kandev, Taj Kudhail, Sammy Cheaib, Marc Pietro Allard, John J. Lennard and Michael H. Lubetsky

The Supreme Court of Canada (SCC) recently rendered its eagerly awaited decision in *Canada v Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49 (*Alta Energy*). Six of the nine justices held that the Canadian statutory general anti-avoidance rule (GAAR) did not apply to deny treaty benefits under the *Canada-Luxembourg Tax Treaty* (Treaty) in an apparent treaty-shopping scenario. The decision, rendered on November 26, 2021, will likely be a leading authority on this controversial issue both in Canada and internationally. It may also influence the interpretation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI).

In the context of the decision, which we summarize below, we provide our insights on the effect of *Alta Energy* on the interpretation of tax treaties and on the use and application of the GAAR in Canada.

Background

Alta Energy concerned Alta Energy Partners Canada Ltd. (Alta Canada), a Canadian corporation that held interests in Canadian resource properties in the Duvernay shale oil formation in Northern Alberta. Alta Canada shares were initially held by a U.S. subsidiary (Alta US) of a large U.S.-based private equity group. In 2012, as part of an internal reorganization, the shares in Alta Canada were sold to Alta Energy Luxembourg S.A.R.L. (the Taxpayer), an entity resident in Luxembourg. Though this sale was subject to tax in Canada, Alta US took the position, which the Canada Revenue Agency accepted, that the value of its shares in Alta Canada at the time of the reorganization was equal to its cost in the shares so that no capital gain was realized. Less than a year later, the Taxpayer sold its shares in Alta Canada and realized a gain of nearly US$400 million. This gain would have been subject to capital gains tax in Canada absent a specific tax treaty exemption. The Taxpayer took the position that the gain was not taxable in Canada, relying on article 13(4) of the Treaty, which provides that gains derived from the disposition of shares whose value is derived principally from immovable property situated in Canada can be taxed in Canada unless a business is carried on "in" the immovable property (Business Property Exemption). Over 40 of Canada's tax treaties contain a Business Property Exemption, though it is notably absent from Canada's treaty with the United States as well as the *Model Tax Convention* (Model Treaty) of the Organisation for Economic Co-operation and Development (OECD).

The Canadian tax authorities reassessed the Taxpayer on the basis that the sale of the Alta Energy shares did not qualify for the Business Property Exemption, or, alternatively, that the GAAR would apply to deny the benefit of the Business Property Exemption. The Tax Court of Canada held in favour of the Taxpayer on both grounds. On appeal only of the GAAR issue, the Federal Court of Appeal also ruled in favour of the Taxpayer. The government was granted leave to appeal this decision to the SCC.

The SCC Decision

For the GAAR to apply, a taxpayer must have obtained a "tax benefit" by entering into an "avoidance transaction" in a manner that "misused or abused" domestic tax legislation or a tax treaty. In this case, the Taxpayer conceded that it had obtained a tax benefit by engaging in an avoidance transaction. Consequently, the application of the GAAR turned on whether the Taxpayer had misused or abused a provision of the Treaty. The determination of misuse or abuse involves a two-step process: first, a court must assess the object, spirit and purpose of the provision(s) that a taxpayer is alleged to have misused or abused; second, it must determine whether the Taxpayer frustrated that object, spirit or purpose. The SCC has repeatedly held that the question of misuse or abuse requires consideration of the specific provision(s) in question and not broad fiscal policy principles. The government alleged that the Taxpayer had misused or abused the Treaty's provisions on the determination of residence (articles 1 and 4) as well as the Business Property Exemption (article 13(4)).

On both of these issues, the government took the position that a general policy underlying all treaties is to allocate taxing rights among contracting states on the basis of "economic allegiance," so that even if a taxpayer technically qualified as a resident of a contracting state under a treaty, it would frustrate the treaty's underlying policy for that taxpayer to access treaty benefits if it did not have sufficient economic allegiance to that state. Consequently, the government argued, the Taxpayer did not have "sufficient substantive economic connections" to Luxembourg to be considered a resident under the Treaty or to claim the Business Property Exemption: it was simply a "conduit corporation" set up as part of a treaty-shopping arrangement used to obtain a benefit under the Treaty, which would not otherwise be available. Accordingly, the government asserted that the Taxpayer's arrangements abused the Treaty's provisions concerning residence and the Business Property Exemption, and its treaty benefits should be denied.

A six-person majority of the Court, in a judgment delivered by Justice Suzanne Côté, rejected the government's arguments. The majority noted that in interpreting tax treaties, it must consider the ordinary meaning of the treaty's text in its context and in light of its purpose, and added that it must do so with a view to implementing the common intention of the treaty parties.

With respect to treaty residence, the majority held that the object, spirit and purpose of articles 1 and 4 are to allow all persons that are residents under the laws of one or both of the contracting states to claim benefits under the Treaty if their residence status could expose them to full tax liability in that contracting state. Residence for treaty purposes should be determined in accordance with the laws of the contracting state in which residence is claimed. In this respect, Luxembourg's domestic law is consistent with the international norm of treating corporations as being resident in the country in which they have their legal seat or central management. The majority opined that if the parties to the Treaty had intended to deviate from this well‑established notion of residence, its drafters would have explicitly signalled this intention. Moreover, the inclusion of article 28(3) in the Treaty, which denies treaty benefits to certain Luxembourg holding companies, suggests that when negotiating the Treaty, Canada and Luxembourg specifically considered the question of what categories of Luxembourg-resident corporations should be denied access to treaty benefits.

With respect to the Business Property Exemption, the majority indicated that the Treaty's object, spirit and purpose are to foster international investment in Canada by exempting residents of Luxembourg from Canadian capital gains on immovable property used in carrying on their business (or on shares that principally derive their value from such immovable property). In enacting article 13(4), the drafters intended to deviate from the Model Treaty, with Canada in effect giving up its right to tax certain transactions by Luxembourg residents in exchange for the economic opportunities that the Business Property Exemption would promote in Canada. The majority noted that the use of Luxembourg conduit corporations was well-known and foreseen at the time the Treaty was entered into, and that, subject to article 28(3) of the Treaty, Canada made a deliberate choice not to exclude conduit corporations from treaty benefits.

The three-person minority judgment, co-authored by Justice Malcolm Rowe and Justice Sheilah Martin, endorsed the government's view that the object, spirit and purpose of the relevant provisions of the Treaty were to assign taxing rights to the state with the closest economic connection to the taxpayer's income. That purpose had clearly been frustrated by the Taxpayer, since it had no genuine economic connection to Luxembourg and was "a mere conduit interposed in Luxembourg for residents of third‑party states to avail themselves of a tax exemption under the Treaty." The minority judgment criticized the majority's view that the government of Canada would deliberately agree to a treaty that created "the conditions for unlimited tax avoidance" by means of Luxembourg conduit corporations.

Our Insights

The judgment provides rich analysis of both the GAAR and the interpretation of tax treaties. We are reassured by the majority's cautionary preface that, although one may consider treaty-shopping in tax havens to be immoral, the application of the GAAR should not be a "value judgment." Rather, for the GAAR to apply, a taxpayer must obtain a tax benefit from an avoidance transaction that frustrates the object, spirit and purpose of one or more specific tax provisions. The GAAR does not entitle the government or a court to rewrite tax statutes or tax treaties to achieve a desired result. Justice Côté likewise reiterated the well-known distinction between tax avoidance and tax evasion, noting that tax avoidance should not be conflated with abuse.

With respect to the interpretation of the Treaty, the majority focused on the joint and common intentions of the contracting states and acknowledged that tax treaties are intended to stimulate investments in contracting states (for instance, by providing relief against double taxation) as well as to allocate taxing rights among them.

A threshold matter not squarely addressed by the majority is the inherent difficulty with applying the GAAR to the Treaty. Following the allegedly "clarifying" amendment to the GAAR enacted in 2005 (retroactive to 1988), Canadian domestic tax legislation, including the special statute that Canada uses to enact treaty overrides, uncontrovertibly provides that the GAAR applies to Canada's tax treaties. Nonetheless, the application of the GAAR to tax treaties raises different considerations than its use in the domestic context: in determining whether there is abuse of a tax treaty, what must be sought is the common intention of contracting states, each acting in its own self-interest in the "give and take" of treaty negotiation. An additional layer of complexity results from the fact that, as a practical matter, the governments' positions (and concessions) in treaty negotiations are not generally made public, and there is often little direct evidence of the common intention of the parties beyond general statements of purpose. However, as noted in the majority judgment, Luxembourg has at least since 2003 publicly expressed reservations about the application of domestic anti-abuse rules to its tax treaties absent an express provision in the relevant treaty. It can be presumed that Luxembourg held this view while negotiating the Treaty. It is therefore difficult to reconcile the unilateral application of the GAAR to the Treaty against the expressed contrary intention of Luxembourg. Given this tension, the Luxembourg government's lack of intervention in the proceedings in *Alta Energy* may be surprising to some observers.

Indeed, the issue of foreseeability featured prominently in the majority's reasoning. The majority focused heavily on the point that the alleged misuse and abuse that the Taxpayer made of the Treaty was, in fact, specifically contemplated when the Treaty was negotiated. Luxembourg was at the time "well-known as an international tax haven," and the use of Luxembourg conduit corporations to facilitate inbound investment was a common practice. The majority noted that Canada had options available to limit treaty benefits to such conduit corporations (and, in fact, had included such options in other tax treaties concluded in the same period), but specifically and consciously chose not to require them in the Treaty. Consequently, the use of such a conduit corporation can hardly constitute a misuse or abuse of the Treaty. Prior to *Alta Energy*, in determining whether a taxpayer had abused a tax provision, courts had not typically focused on whether the taxpayer's transaction or arrangement was foreseen (or foreseeable) at the time that provision was enacted. It does seem intuitive that a taxpayer should generally not be held to abuse a tax provision by engaging in a transaction that was foreseen but not addressed by the legislator. We surmise that as a result of *Alta Energy*, arguments about the foreseeability of avoidance transactions may become more prevalent in future GAAR cases.

The SCC majority's reasoning also confirmed that the determination of the object, spirit and purpose of a tax provision must be assessed with reference to the period when it was enacted. In this regard, the majority noted that at the time the Treaty was entered into, Canadian international policy aimed to stimulate foreign investment in Canada, which partly involved making the Canadian tax system more favourable to international investors. The majority recognized that in granting tax benefits to Luxembourg residents under the Treaty, Canada chose to sacrifice higher tax revenues in exchange for the economic benefits spurred by foreign investments. Canadian treaty negotiators had no illusions about the nature of Luxembourg's economy and domestic taxation laws: they were aware that Luxembourg did not have significant endogenous wealth and that multinational corporations operated through corporations resident in Luxembourg in order to take advantage of its favourable tax environment. Little concern was shown regarding treaty-shopping in those years; indeed, Canada tolerated or even encouraged treaty-shopping if it would ultimately lead to greater investment in Canada. For this reason, the minority's view that Canada could not have intended to allow benefits under the Treaty to extend to residents of Luxembourg without substantial economic connections thereto is, with due respect, ahistorical.

The minority suggested that treaty-shopping is abusive when taxing rights are allocated on the basis of economic allegiance and conduit entities claim tax benefits despite the absence of any "genuine economic connection" with the state of residence. In this respect, the minority's reasoning appears to be heavily influenced by the ongoing global initiatives led by the OECD against tax avoidance by multinational companies. In particular, the minority emphasized the government's unilateral right to invoke the GAAR to fight aggressive international tax planning, and interpreted the Treaty, in effect, as guaranteeing Canada's right to tax a transaction that has a greater economic connection to Canada than to the residence of the person claiming the treaty benefit. The majority and minority decisions of the SCC thus represent two competing visions of Canada's tax treaties and their interaction with the GAAR.

Finally, an important open question is how *Alta Energy* will affect the application of the MLI, and more specifically whether the outcome in this case would have been different under the MLI rather than the GAAR. As our bulletin explains, the MLI contains a principal purpose test (the PPT), which operates to deny treaty benefits when one of the principal purposes of an arrangement or transaction is to obtain treaty benefits in a way that is not in accordance with the object and purpose of the relevant treaty provisions. As argued elsewhere,[1] the PPT bears substantial resemblance to the GAAR, especially in respect of the abuse analysis. Because of these similarities, the SCC's holding that the arrangements entered into by the Taxpayer were in accordance with the object and purpose of the relevant Treaty provisions may be pertinent to the analysis of when the PPT may apply to deny treaty benefits. It remains to be seen whether as a result of *Alta Energy*, the Canadian government will actively pursue the inclusion of a limitation on benefits provision in key treaties, such as the one contained in the Canada-U.S. tax treaty, which seeks to prevent treaty-shopping and the use of conduit entities by setting out objective tests to ensure that the person claiming treaty benefits has a proper nexus to the contracting jurisdiction.

[1] Michael N. Kandev and John J. Lennard, "The OECD Multilateral Instrument: A Canadian Perspective on the Principal Purpose Test" (2020) *Bulletin for International Taxation* 54.

Key Contacts: Michael N. Kandev and R. Ian Crosbie