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In this article, the authors discuss the Canadian Federal Court of Appeal's judgment in *Alta Energy*, focusing on its effect on Canada's application of general antiabuse rules against contested treaty benefit claims and the OECD multilateral instrument's principal purpose test on perceived treaty shopping.

On February 12 the Canadian Federal Court of Appeal (FCA) rendered its judgment in *Alta Energy Luxembourg SARL v. The Queen*, 2020 FCA 43, affirming the decision of the Tax Court of Canada (TCC) that treaty benefits claimed by a Luxembourg company on the sale of shares of a Canadian oil and gas company were not abusive under Canada's domestic general antiavoidance rule.

Alta Energy was decided just as Canada formally embarked on a new era of international coordination with the coming into force of the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI).[1] The case thus has dual significance: On the one hand, it may dampen the Canadian government's confidence in the application of the GAAR to defeat treaty benefit claims it regards as abusive; on the other hand, it should provide guidance on how the principal purpose test (PPT) that is the centerpiece of the MLI should be applied to perceived treaty-shopping cases. This article comments on the case in light of those factors.

The Facts

In 2011 Alta Energy Partners LLC (Alta LLC), a joint venture of Alta Resources LLC and an affiliate of The Blackstone Group, incorporated Alta Energy Partners Canada (Alta Canada) as a wholly owned Canadian subsidiary to develop a working interest in Alberta's Duvernay shale formation. The working interest consisted of various licenses and leases issued by the Alberta government to explore, drill, and extract shale oil and gas from an area of the formation.

To mitigate some tax consequences resulting from the original holding structure, a reorganization was undertaken in April 2012 under which affiliates of Alta Resources and Blackstone established Alta Energy Canada Partnership, a partnership formed under the laws of Alberta, and its Luxembourg corporate subsidiary, Alta Energy Luxembourg SARL (Alta Lux). The shares of Alta Canada were then transferred to Alta Lux in a taxable transaction that did not give rise to a gain. Meanwhile, Alta

[1] Canada ratified the MLI on August 29, 2019. It became effective for Canada's tax treaties with many other ratifying countries for withholding taxes on January 1, 2020, and for other taxes (including capital gains taxes) for tax years beginning on or after June 1, 2020.

Canada continued to exploit some of the licenses and leases under the working interest by drilling wells while continuing to set aside others for future exploration and development.

Almost 18 months later, in September 2013, Alta Lux sold its shares of Alta Canada to Chevron Canada Ltd., with which it had no dealings in April 2012, and realized a gain of approximately C $382 million. While Canada generally does not tax foreign persons on gains from disposing of corporate securities, gains from the divestiture of shares of a Canadian corporation that derive their value principally from Canadian real property or Canadian resource property are subject to tax, except when the shares disposed of are listed on specified stock exchanges.

Because the working interest constituted Canadian resource property under the Income Tax Act (Canada), the sale by Alta Lux would have been taxed in Canada, absent an exemption under the 1999 Canada-Luxembourg tax treaty. Alta Lux took the position that the shares were exempt under treaty article 13(4) as so-called excluded property (the excluded property exception), which exempts shares of companies whose Canadian real or resource property consists of property in which the business of the company was carried on.

The TCC Judgment

At trial, the Minister of National Revenue (MNR) challenged the taxpayer's treaty exemption claim on both treaty and GAAR grounds. It made various technical arguments in an attempt to limit the excluded property exception under the treaty. It argued that property such as the working interest, which consisted of numerous licenses, should be evaluated asset by asset and that for property to qualify under the exception, it must be under active exploitation, rather than merely held for future exploitation or development. The MNR also questioned whether an intangible asset such as a resource license could ever qualify under the excluded property exception because it cannot be physically occupied for carrying on business.

The TCC instead adopted a purposive interpretation of article 13(4) in concluding that the excluded property exception applied to the working interest. It found that the object of the exception was to encourage foreign investment in the Canadian real estate and resource sectors, then reasoned that the treaty negotiators would have intended for a resource property to fall within the exception when developed in accordance with industry best practices. The court accepted the taxpayer's argument that its process for developing the working interest — acquiring a sufficient number of licenses to secure access to a large part of the formation and then drilling on selected sections to establish the best way to drill and stimulate production over the entire area of the working interest — was consistent with industry best practices. Thus, the gain on the sale of Alta Canada's shares was exempt from Canadian tax under the treaty.

The TCC then considered whether the GAAR could apply to the treaty benefits claim. Alta Lux admitted that the reorganization satisfied the first two components of the GAAR analysis insofar as it constituted an avoidance transaction from which the taxpayer derived a tax benefit. Therefore, the only question before the TCC was whether the reorganization constituted an abuse of the treaty.

The MNR argued that the misuse or abuse resulted from the fact that Alta Lux, although a resident of Luxembourg for treaty purposes, was created and became the owner of the shares, by its own admission, for no purpose other than avoiding Canadian tax on the gain from the sale of the shares. It noted that the company also paid no tax in Luxembourg as a result of the sale of the shares. Thus, the MNR claimed that the reorganization abused the treaty, whose rationale and purpose is to prevent or reduce double taxation, as set out in the preamble. Finally, it also argued that the reorganization amounted to treaty shopping, which it argued was by default an abuse of the treaty under the GAAR.

The TCC quickly disposed of the MNR's argument centered on the preamble, commenting that the focus should be on determining the rationale of the specific treaty provisions at issue, principally article 13(4), rather than the treaty as a whole. According to the court, the rationale for that provision was that both parties intended to strike a bargain whereby the right to tax gains on the disposition of specific property connected with immovable property in which business is carried on in one state was ceded in exchange for stimulating foreign investment by residents of the other state. Because Alta Lux's sale of the Alta Canada shares fell within the scope of that rationale, it was not an abusive transaction under the GAAR.

Finally, the TCC dismissed the MNR's argument that the reorganization was abusive because it was treaty shopping. It concluded that treaty shopping, merely because it involves tax planning to use treaty terms to reduce the tax otherwise payable on a transaction, is not per se abusive under the GAAR. It also cited the example of the limitation on benefits provision in the Canada-U.S. tax treaty as an example of a comprehensive anti-treaty-shopping provision.

The FCA Judgment

On appeal, the government pursued only the GAAR argument. The FCA unanimously upheld the TCC's decision that the GAAR did not apply to deny the claim for treaty benefits. The decision once again turned on the interpretation given to the rationale for the excluded property exception in the treaty.

The MNR repeated its argument that the reorganization was abusive as contrary to the rationale of article 13(4) of the treaty and as treaty shopping. Essentially, the MNR's argument amounted to an attack on the interposition of a special-purpose Luxembourg company to hold and sell the shares of Alta Canada. The FCA interpreted the MNR as arguing that article 13(4) was intended, and should be read down, to benefit only taxpayers who are Luxembourg investors and not merely any Luxembourg residents, entities that have the potential to realize income in Luxembourg, and entities that have commercial or economic ties with Luxembourg.

The FCA rejected all those limitations on the basis that they were without support in the text, context, and purpose of the treaty provision. It found that the rationale for the provision was embodied in the words of the provision itself. On that basis, the FCA held that the application of the excluded property exception to the sale of shares of Alta Canada was not abusive under the GAAR.

Finally, the FCA considered the MNR's suggestion that the GAAR should limit taxpayer behavior that amounts to treaty shopping. The FCA cited the TCC's reasoning in *MIL (Investments) SA v. The Queen,* 2006 TCC 460, *aff'd* 2007 FCA 236, in which Justice Ronald Bell commented that there is nothing inherently proper or improper in selecting one foreign regime over another; doing so is relevant for determining whether there is an avoidance transaction under the GAAR, but not for whether there is abusive tax avoidance.

Commentary

As noted, *Alta Energy* is important for both the application of Canada's domestic GAAR and the MLI PPT to cases of perceived treaty shopping.

Regarding the GAAR, *Alta Energy* was seen as the government's second kick at the can after its loss over a decade ago in Canada's first treaty-shopping case, *MIL*. The terse FCA decision rendered from the bench in *MIL* seemed to open the door for a new treaty-shopping case to be brought through the courts. That case was *Alta Energy*, and, unfortunately for the Canadian government, it was a resounding defeat. This time the FCA provided lengthy reasons that forcefully rebutted the government's various abuse arguments under the GAAR.[2] That is a bitter pill for the government to swallow, and the MNR has filed its application for leave to appeal to the Supreme Court of Canada.[3] If the Court refuses to hear the MNR's appeal,[4] it may be expected, in light of the FCA siding with the taxpayer in *MIL* and *Alta Energy*, that in future the Canadian tax authorities will be hesitant to apply the GAAR to perceived treaty abuse situations.

The more interesting question now is what prospective impact *Alta Energy* could have on the interpretation of the PPT as it applies to Canada's covered tax agreements under the MLI.[5] The PPT, found in MLI article 7(1) , is a general anti-treaty-

[2]For additional commentary regarding capital gains tax planning in light of the decision in *Alta Energy* and the entry into force of the MLI, see Steve Suarez, "How the MLI Will Change Capital Gains Taxation in Canada," *Tax Notes Int'l*, May 11, 2020, p. 657.

[3]SCC Docket 39113. The Court's decision on the application for leave is pending.

[4]Which seems likely, in light of the alignment among the three FCA justices, discussed *infra*.

[5]*See generally* Michael Kandev and John Lennard, "The OECD Multilateral Instrument: A Canadian Perspective on the Principal Purpose Test," 74(1) *Bull. Int'l Tax'n* 54 (2020).

abuse provision that may deny a treaty benefit to a party that engages in an arrangement or transaction[6] for a principal purpose of obtaining that benefit, unless the benefit is in accordance with the object and purpose of the treaty. In our view, *Alta Energy* provides interesting insights for those looking to divine the PPT's effect on alleged treaty-shopping situations involving Canada.

Alta Energy is relevant because the GAAR and the PPT share the same structure: the requirement that a tax benefit result from a transaction or series that has an avoidance purpose, and the question of whether the benefit is consistent with or frustrates the object and purpose of the relevant treaty provisions.

The main difference between the GAAR and the PPT is that the PPT applies if "one of the principal purposes" of the arrangement or transaction is to obtain the treaty benefit, while the GAAR is triggered only if the transaction or series has been undertaken or arranged primarily for nontax purposes. Further, an important practical difference between the two is that the PPT seems to require only that the tax authority establish that obtaining the treaty benefit was one of the principal purposes of the taxpayer's transaction, while requiring the taxpayer to establish that granting the treaty benefit would be in accordance with the object and purpose of the relevant treaty provision. That is the obverse of how the GAAR operates and seems inconsistent with common sense that would see the taxpayer seek to demolish the government's factual assumptions, including those regarding its tax avoidance purpose, and the government argue that the treaty benefit is inconsistent with the treaty's object, with which it is presumed be familiar.

Regarding the apparent taxpayer burden to prove that its avoidance transactions were in accordance with the object and purpose of the treaty provisions relied on, the FCA's decision in *Alta Energy* provides a welcome confirmation that the object and purpose of the treaty provisions at issue were reflected in their wording. The holding should be portable to an application of the PPT, and a taxpayer should be able to invoke it to the effect that a treaty benefit it claimed based on the provisions' clear wording is in accordance with the provisions' object and purpose.

The remaining question is whether the abuse analysis, such as the one in *Alta Energy* under the GAAR, would be altered by the preamble added to covered tax agreements in MLI article 6, which reads:

> Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).

As a preliminary matter, regarding the interpretative role that preamble plays, one observer has said:

> Although expressed to be "preamble text," the exact status of this provision is unclear because of the relationship between the MLI and CTAs [covered tax agreements]. The MLI modifies CTAs to the extent the parties agree. . . .
>
> The MLI is, therefore, not part of the context of a CTA within article 31(2) of the Vienna Convention (1969). Similarly, it is not a subsequent agreement made by the parties in connection with the conclusion of a CTA within article 31(3)(a) of the Vienna Convention (1969). In consequence, article 6(1) of the MLI preamble text is not a preamble to a CTA. It is far from clear on what basis the preamble text might be relevant to the interpretation of those provisions of the CTA that are unmodified by the MLI. The penultimate paragraph of the preamble to the MLI explains the reason for article 6(1). The status of article 6(1) in relation to the MLI itself is unclear, as it is neither a preamble to the MLI itself, nor does it impose specific rights and obligations on the contracting states to a CTA.

[6] Regarding the interpretation of the expression "arrangement or transaction" in the PPT, see Kandev and Lennard, "Interpreting the Expression 'Arrangement or Transaction' in the Principal Purpose Test of the MLI," 106 *Wolters Kluwer Int'l Tax* 1 (June 2019), arguing that the meaning of the term is narrower than that of the series test used for GAAR purposes.

> Exceptionally, it may be preamble-like to the extent of modification of a CTA by the MLI. Thus, it forms part of the context in interpreting the provisions of the MLI that modify a CTA, including the mandatory article 7(1) and other provisions that parties may select.[7]

Against the above backdrop, Justice Robert Hogan's holding in *Alta Energy* that the preamble to the treaty is too vague to be an interpretative aid is particularly relevant:

> A tax treaty is a multi-purpose legal instrument. The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty, this statement remains vague regarding the application of specific articles of the Treaty. Under the GAAR analysis, the Court must identify the rationale underlying Article 1, 4 and 13, not a vague policy supporting a general approach to the interpretation of the Treaty as a whole.

Indeed, it seems unlikely that a Canadian court will find that the expanded preamble of MLI article 6 allows it to read anti-treaty-shopping limitations into the residence article or any other provision of a covered tax agreement.

To Hogan's point, that preamble remains too vague. First, the new language refers to not "creating opportunities for non-taxation or reduced taxation," but tax treaties often intentionally offer those kinds of opportunities. Second, the preamble refers to avoidance but, not insignificantly, does not qualify that notion by reference to abuse. Finally, the new wording singles out "treaty-shopping arrangements" as a form of avoidance that is presumably to be discouraged. While treaty shopping has become an increasingly pejorative notion, it remains a term of variable content, and whether it is abusive is often in the eye of the beholder.

To illustrate that point, compare two scenarios. Suppose a Cayman resident individual owns shares in a Canadian resource company through a single-purpose Cayman holding company, which signs a contract to sell the shares of the Canadian company. Before the deal closes, the Cayman company is continued to Luxembourg and ultimately a treaty exemption is claimed. One can reasonably argue that that is abusive treaty shopping that should be prevented.

Now suppose a Cayman resident individual sets up a family office company in Luxembourg with 30 employees, including investment professionals specializing in public markets, funds, real estate, and direct investments, as well as back-office staff handling accounting, tax compliance, and IT support. If that Luxembourg company acquires shares in a Canadian resource company, then sells them at a gain and claims the treaty exemption, few would say that is treaty shopping, and there would probably be consensus that it is not abusive behavior by any stretch of the imagination.

Consistent with Hogan's holding in *Alta Energy*, one observer comments:

> In the author's view, the only article that this language may have any bearing on is article 4 (fiscal domicile). However, there is nothing in the definition of residence for treaty purposes in that article that helps to explain when a person who otherwise meets the definition of a resident of a contracting state should or should not be denied treaty benefits as a result of treaty shopping. The author agrees with Justice Hogan that if preventing treaty shopping is the objective, then a US-style limitation on benefits (LOB) that grants benefits only to qualifying residents would give effect to the stated purpose in the preamble to article 6(1) of the MLI.[8]

We cannot agree more.[9] ■

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[7] Jonathan Schwarz, "The Impact of the New Preamble on the Interpretation of Old and New Treaties and on the Policy of Abuse Prevention," 74(4/5) *Bull. Int'l Tax'n* 174, at 176 (2020)

[8] *Id.*

[9] *See* Kandev, "Taxpayer Wins Treaty Shopping Challenge in *Alta Energy Luxembourg*," 47 *TM Int'l J.* 572 (Sept. 14, 2018).