Treaty-Shopping Consultation

The 2013 federal budget announced the government's intention to consult on measures to protect Canada's tax treaties against treaty shopping and yet preserve a business tax environment conducive to foreign investment.

Treaty shopping exists if a resident of one country (the residence country) derives income or capital gains from another country (the source country) and accesses a tax treaty between the source country and a third country that offers a more generous tax treatment than the tax treatment otherwise applicable. For example, the resident country may not have a tax treaty with the source country, or the treaty between the resident country and the source country may offer less generous tax treatment than the tax treaty between the source country and the third country.

The budget says that the government remains concerned that treaty shopping poses significant risks to the Canadian tax base, despite the conclusion in the December 2008 final report of the government-mandated Advisory Panel on Canada's International Tax System that treaty shopping is not inherently objectionable and that "businesses should be able to organize their affairs to obtain access to treaty benefits." The budget notes that the government has been largely unsuccessful in its court challenges of treaty-shopping cases. In the first decision on point, MIL (Investments) SA (2006 TCC 208, aff'd. 2007 FCA 236), the TCC clearly suggested that in isolation, treaty shopping to minimize tax is not abusive under Canada's GAAR. The government also failed in Prévost Car Inc. (2009 FCA 57) and Velcro Canada Inc. (2012 TCC 57) in its argument that treaty-reduced withholding rates on dividends and royalties, respectively, should be denied because the recipient was not the payments' beneficial owner. The budget points out that other countries are also concerned with treaty shopping, and several have either implemented provisions in their domestic law to combat such practices or have launched successful court challenges. Indeed, largely under the OECD's influence, both OECD member and non-member countries have been challenging treaty-shopping structures with varying degrees of success. Consultation on a topic as controversial as treaty shopping is very welcome: it provides stakeholders with an opportunity to comment on any possible measures. However, elements of the budget announcement may cause concern.

First, the government prefaces its discussion with the statement that "Canada enters into bilateral tax treaties with other countries for the purposes of supporting cross-border trade and investment, and preventing international tax evasion and avoidance." The controversial statement that tax treaties are intended to prevent international tax avoidance--not just tax evasion--without any qualification that the avoidance is abusive of clear tax policy is taken verbatim from paragraph 7 of the OECD model treaty commentary on article 1. If a treaty does not contain a specific anti-treaty-shopping provision, arguably as a general matter the treaty does not aim to prevent tax avoidance: thus, the Canadian government should not use the OECD commentary without qualification, particularly in light of the holding in MIL and the advisory panel's conclusions.
Second, the 2013 budget states that treaty shopping effectively extends tax treaty benefits to third-country residents "in circumstances that were not contemplated when the tax treaty was entered into and without any reciprocal benefits accruing to Canadian investors or to Canada." Treaty shopping is not a new tax-planning technique: most of Canada's tax treaties were entered into without the inclusion of any anti-shopping provisions--except in some rare situations--even though Canada had full knowledge that tax-planning structures existed. In contrast to that Canadian treaty policy, the longstanding US approach has been to include limitation-on-benefits (LOB) provisions in US treaties precisely in order to prevent treaty shopping.

Third, it is not clear whether the announced consultation can overcome two fundamental hurdles to a coherent stance on treaty shopping. Most countries deplore the loss of revenue created by inbound treaty shopping by non-residents but are seemingly not troubled by their resident investors' outbound treaty shopping. Moreover, if revenue loss from treaty shopping results in material economic benefit to the source country, it may be seen as merely the cost of attracting highly mobile capital from nontreaty countries, including capital-rich tax havens. These factors may explain the advisory panel's conclusion and its reluctance to recommend anti-treaty-shopping initiatives.

It remains to be seen whether Canada will adopt domestic rules (like Germany) or treaty LOB provisions (like the United States) to curb treaty shopping, or whether instead it will continue case-by-case challenges of perceived abusive situations under the existing law.

Michael Kandev

Davies Ward Phillips and Vineberg LLP, Montreal