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AGGRESSIVE INTERNATIONAL TAX PLANNING BY MULTINATIONAL CORPORATIONS: THE CANADIAN CONTEXT AND POSSIBLE RESPONSES*†

Brian J. Arnold and James R. Wilson

SUMMARY

Aggressive international tax planning by multinational corporations has lately fallen under intense political scrutiny. U.S. politicians have called out some American multinationals, including Apple, Amazon, Starbucks and Google, for relocating profits abroad to avoid American taxes. More recently, politicians accused Burger King of being unpatriotic for its own purported "tax inversion" maneuver, in which it would acquire Canada's Tim Hortons and shift the head office from Florida to Ontario, benefitting from the lower northern tax rates. The Chicago-based Walgreens pharmacy chain recently backed off a "tax inversion" plan to relocate to Switzerland (the former headquarters of Alliance Boots, a company acquired by Walgreens), apparently having assessed the political risk as too high.

This sort of aggressive international tax planning by multinational corporations was what G20 members had committed to fighting against when they endorsed the OECD's "action plan" against base erosion and profit shifting (BEPS). Canada has been vigilant about improving its tax framework to prevent non-resident corporations from eroding the Canadian tax base, having enacted thin-capitalization rules and, more recently, foreign-affiliate-dumping rules, as well as proposing anti-treaty-shopping measures. But despite Canada's commitment to the OECD's BEPS Action Plan, the Canadian government has been reluctant to follow through on implementing rules that might affect its own resident corporations and their international competitiveness.

This is most notably visible in the generous participation exemption for dividends from foreign affiliates, the absence of rules restricting the deductibility of interest expenses incurred to earn exempt dividends from foreign affiliates.

Canada may be reluctant to fully follow through on all aspects of the OECD's BEPS Action Plan. As the examples of Apple, Amazon, Google and Starbucks demonstrate, the American government has so far been unable to bring itself to take any meaningful action against aggressive international planning by U.S.-resident corporations. Were Canada to enact and enforce rules that clamped down on aggressive international tax planning by its own resident corporations, it would only put Canadian firms at a competitive disadvantage relative to American (or other international) rivals. Until the United States is willing and able to take the lead on aggressive international tax planning by multi-national corporations, the reality is that smaller countries, including Canada, should be cautious about making changes to its international tax rules that are dependent on other countries making similar changes.

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PLANIFICATION FISCALE INTERNATIONALE ABUSIVE DES SOCIÉTÉS MULTINATIONALES : LE CONTEXTE CANADIEN ET LES RÉPONSES POSSIBLES*†

Brian J. Arnold et James R. Wilson

SUMMARY

La planification fiscale internationale abusive des sociétés multinationales a récemment fait l'objet d'un rigoureux examen par la classe politique. Des politiciens américains ont interpellé des multinationales américaines, dont Apple, Amazon, Starbucks et Google, à propos de la relocalisation des profits à l'étranger pour éviter d'avoir à payer des impôts aux États-Unis. Plus récemment, des politiciens ont accusé Burger King de manque de patriotisme pour sa prétendue manœuvre d'« inversion fiscale », dans le cadre de laquelle l'entreprise ferait l'acquisition de la firme canadienne Tim Hortons et délocaliserait le siège social de la Floride à l'Ontario afin de bénéficier des taux d'imposition moins élevés de son voisin du nord. La chaîne de pharmacies Walgreens de Chicago a récemment renoncé à son plan de relocalisation de son siège social en Suisse (où était situé l'ancien siège social d'Alliance Boots, une entreprise achetée par Walgreens), ayant apparemment jugé que le risque politique était trop grand.

C'est ce type de gestion fiscale abusive adopté par des multinationales que les membres du G20 s'étaient engagés à combattre lorsqu'ils ont approuvé le « plan d'action » de l'OCDE contre l'érosion de la base d'imposition et le transfert de bénéfices (BEPS). Le Canada a fait preuve de vigilance à l'égard de l'amélioration de son cadre fiscal afin de prévenir l'érosion par des entreprises non résidentes de l'assiette d'imposition, ayant adopté des dispositions relatives à la capitalisation restreinte ainsi que, récemment, des règlements contre le dumping par des sociétés étrangères affiliées, et ayant proposé des mesures contre le chalandage fiscal. Toutefois, en dépit de l'engagement du Canada envers le plan d'action BEPS de l'OCDE, le gouvernement canadien s'est montré hésitant à donner suite à la mise en application de règlements qui pourraient nuire à ses propres entreprises résidentes et à leur compétitivité internationale.

Cela est illustré particulièrement par la généreuse exemption de participation pour les dividendes provenant de sociétés étrangères affiliées et l'absence de mesures restreignant la déductibilité des frais d'intérêts engagés pour gagner des dividendes exemptés de sociétés étrangères affiliées.

Le Canada pourrait se montrer hésitant à donner suite à tous les aspects du plan d'action BEPS de l'OCDE. Comme le démontrent les exemples d'Apple, d'Amazon, de Google et de Starbucks, le gouvernement américain a été jusqu'à présent incapable de se résoudre à adopter des mesures significatives à l'égard de la planification internationale abusive des sociétés résidentes aux É.-U. Si le Canada devait adopter et mettre en application des règlements qui restreindraient la planification fiscale internationale abusive de ses propres entreprises résidentes, il mettrait les sociétés canadiennes en situation de désavantage concurrentiel par rapport à leurs rivales américaines (ou internationales). Jusqu'à ce que les États-Unis soient prêts à ouvrir la voie dans le domaine de la planification fiscale internationale abusive des sociétés multinationales et désireux et capables de le faire, le fait est que les pays plus petits, comme le Canada, devraient faire preuve de prudence pour ce qui est de l'adoption de changements de leurs règles fiscales internationales qui dépendent de l'adoption de changements similaires par d'autres pays.

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INTRODUCTION

Tax planning by multinational corporations is a commonplace feature of commercial life. The proliferation of income tax systems and the increase in tax rates during the 20th century made it necessary for multinationals to engage in defensive tax planning to eliminate double taxation and reduce excessive taxation by source countries.[1] The process of globalization in the late 20th century eliminated most of the barriers to cross-border trade and investment and made tax a much more important factor in the location of foreign investment. It also increased international competition between multinational enterprises. Several other factors led to an increasing emphasis on international tax planning. Due to technological advances, travel and communications became easier; the Internet made it possible for enterprises to do business in a country without having any physical presence there; the liberalization of the international financial system and development of new financial instruments allowed multinationals to change the source, character and timing of income with little effort or expense; and the growth in the number of tax treaties facilitated international tax planning, including by the increased opportunities for treaty shopping.

At the same time, many countries adopted international tax systems that encouraged their multinational enterprises to invest offshore in pursuit of international competitiveness. Several capital-exporting countries adopted exemption systems for active business income earned offshore and for dividends paid by foreign subsidiaries to their resident parent corporations. Most countries with imputation regimes for the taxation of corporations and shareholders abandoned those regimes, in part because they discriminated against foreign investment by resident corporations and against foreign investment in resident corporations. Withholding taxes on dividends and interest have been reduced or eliminated entirely. Access to the attractive tax-planning opportunities offered by tax havens became easier, and many high-tax countries began to offer preferential tax regimes to compete with tax havens.

While countries were using their tax systems to promote the international competitiveness of their multinationals, they were also trying to protect their domestic tax bases. For example, several countries adopted thin-capitalization rules, controlled-foreign-corporation rules and exit taxes, and attempted to develop a more robust approach to transfer pricing. In the late 1990s through the OECD's Harmful Tax Competition project,[2] an attempt was made to deal with tax havens and the harmful preferential tax regimes of high-tax countries. The project failed with respect to its primary goal and was transformed into an initiative to enhance the exchange of tax information between treaty partners and to eliminate bank secrecy; this initiative has been largely successful.

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1 We use the terms "source country" and "residence country" to refer respectively to the country in which income is earned or derived and the country in which the taxpayer that earns or derives the income is resident.

2 OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

In retrospect, it was only a question of time before the pressures on countries' tax revenues led to additional efforts to protect their domestic tax bases from the tax-planning strategies of multinationals; these efforts gained momentum during the financial crisis of 2008. In 2011, the OECD launched its project against base erosion and profit shifting (BEPS). This project received a shot in the arm when the tax-planning techniques used by several U.S. multinationals, including Apple, Amazon, Starbucks and Google, came under intense criticism by politicians. The OECD's BEPS initiative and, in particular, the BEPS Action Plan, was endorsed at the 2013 meeting of the G20 nations.[3] In March 2014, the OECD issued public discussion drafts dealing with the digital economy, hybrid mismatch arrangements and treaty abuse.[4] In addition to the OECD BEPS initiative, several OECD member countries, including Canada, have taken unilateral action against aggressive international tax planning by multinationals. For example, Canada announced a consultation exercise on BEPS in the Feb. 11, 2014 federal budget and released for discussion the essential elements of a proposed rule to address treaty shopping.

This paper examines the problem of aggressive international tax planning by multinational corporations from the perspective of the Canadian tax system. Following this introduction, the paper provides a brief overview of the OECD's BEPS initiative and the relevant aspects of the Canadian tax system. The next section deals with the distinction between tax evasion and tax avoidance and the distinction between legitimate and illegitimate tax avoidance. These distinctions are crucial to an understanding of the problem of aggressive international tax planning and the development of appropriate responses to that problem. The balance of the paper focuses on international tax avoidance by multinational corporations.

A key part of our paper analyzes some common types of international tax planning utilized by Canadian-based multinationals to make investments outside Canada and by foreign-based multinationals investing in Canada. After describing these planning strategies, we discuss the structural features of the Canadian tax system that allow them to work effectively. We conclude by identifying and analyzing several existing and proposed measures to counteract the problem of aggressive international tax planning by multinational corporations.

This paper has modest objectives. It is intended to situate the OECD's BEPS project in the context of the Canadian tax system and to provide some background information about the treatment of aggressive international tax planning under the existing Canadian tax rules so that readers can better understand and appreciate the potential effects of the BEPS project from a Canadian perspective. However, this paper does not present an evaluation of the BEPS action plans in general or their potential impact on the Canadian tax system; such an evaluation would be pure speculation at this point. In addition, the paper does not purport to provide a comprehensive academic tax policy analysis of either the international aspects of the Canadian tax system or the BEPS proposals. Although such an analysis might be useful, especially for Canadian tax-policy officials, the paper is already too long. Nevertheless, we have included some brief comments about the tax-policy basis for the BEPS proposals and we have not been

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[3] OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), available at www.oecd.org/ctp.

[4] OECD, Public Discussion Draft, "BEPS Action 1: Address the Tax Challenges of the Digital Economy," March 24, 2014; OECD, Public Discussion Draft, "BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements," March 19, 2014; and OECD, Public Discussion Draft, "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances," March 14, 2014, all available at www.oecd.org/ctp.

able to resist the temptation to make occasional comments about the tax policy underlying certain aspects of the Canadian rules. These comments are not supported by comprehensive analysis and extensive references to the relevant literature; however, some readers may find these comments interesting. Finally, the paper does not provide a detailed history of the Canadian international tax system[5] although it does make selective references to the evolution of certain aspects of that system.

One of the issues targeted by the OECD's BEPS project is the digital economy or electronic commerce, which presents serious challenges to the fundamental principles underlying the international tax system because it allows enterprises to conduct extensive business in a country without having any physical presence there. Traditionally, source countries are not entitled to tax income from the sale of goods or the performance of services by non-residents unless the sales take place or the services are performed in the source country and the non-residents have some significant presence in the source country, such as a permanent establishment or fixed base. Therefore, dealing with the issues presented by electronic commerce requires significant changes in the fundamental rules governing international taxation. In our view, the problems or challenges caused by electronic commerce are not primarily a result of aggressive international tax planning by multinational corporations. As a result, we do not deal with the taxation of income from cross-border electronic commerce in this paper.[6]

At the outset, it should be acknowledged that the problem dealt with in this paper is not a new one. International tax planning has been a standard part of business practice for decades, and inevitably, governments have responded with various types of rules to protect their tax base. Therefore, it is important to see the current situation as just the most recent manifestation of the tension between multinational corporations and national tax authorities. In the past, however, tax authorities responded to international tax avoidance primarily with unilateral anti-avoidance measures in their domestic law or in their bilateral tax treaties. In contrast, multinational enterprises engage in tax planning on an international or multinational basis. In our view, any effective response to the problem of international tax avoidance requires co-ordinated action by national tax authorities. The OECD BEPS project represents an attempt to formulate harmonized action by the member countries of the OECD against international tax avoidance. It remains to be seen if the project will succeed. On the one hand, the failure of the OECD's previous attempt to deal with harmful tax competition makes us skeptical about the BEPS project. On the other hand, the support of the G20 and the apparent success of the OECD-led efforts to improve exchange of tax information among all countries, including tax havens, suggest that things may be different today.

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5 Such detailed history is available elsewhere for interested readers. See, for example Brian J. Arnold, "The Canadian International Tax System: Review and Reform" 43, 5 *Canadian Tax Journal* (1995): 1792-1818; and J. Scott Wilkie et al., "The Foreign Affiliate System in View and Review," in T*ax Planning for Canada-U.S. and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:27-55, with respect to the history of the treatment of foreign-source income.

6 We admit that we do not see any reasonable means whereby source countries can effectively tax income derived from electronic commerce by non-residents. See Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in *The Taxation of Business Profits Under Tax Treaties*, ed. Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt (Toronto: Canadian Tax Foundation, 2004) 55-108. OECD, BEPS Action 1, 10, 14.

THE OECD BASE-EROSION AND PROFIT-SHIFTING PROJECT

The major events in the OECD's BEPS initiative are well known and are summarized briefly here as background to the subsequent discussion.

The final declaration of the meeting of the G20 finance ministers in June 2012 emphasized "the need to prevent base erosion and profit shifting." The BEPS initiative was a natural outgrowth of the OECD's work on exchange of information as a tool to combat international tax avoidance. In February 2013, the OECD responded to the G20's concerns by issuing a short note, "Addressing Base Erosion and Profit Shifting," that identified several areas for action and deadlines for the implementation of responses. The G20 finance ministers meeting in February 2013 welcomed the OECD report and strongly supported the initiative in the following terms:

> We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July.

On July 19, 2013 the OECD released its detailed "Action Plan on Base Erosion and Profit Shifting" (OECD Action Plan). This action plan sets out an ambitious agenda with tight deadlines; it consists of the following actions:

1. develop rules to allow countries to impose direct and indirect taxation on electronic commerce (the digital economy);
2. develop treaty provisions and recommendations for domestic rules to deal with hybrid-mismatch arrangements involving the use of hybrid financial instruments and entities;
3. develop proposals to strengthen controlled-foreign-corporation rules;
4. develop recommendations to deal with base erosion through interest and other financing expenses;
5. develop more effective countermeasures for harmful tax practices;
6. develop treaty anti-abuse provisions and recommendations for the adoption of domestic anti-abuse rules;
7. revise the definition of permanent establishment (PE) in the OECD Model Treaty to prevent the use of commissionnaire and other arrangements to avoid PE status;
8. revise transfer-pricing rules to ensure that transfer pricing cannot be used for base-erosion and profit-shifting purposes;[7]
9. develop methodologies for the collection and analysis of data concerning BEPS and for the evaluation of the effectiveness of measures to counteract BEPS;
10. develop measures to require the disclosure of aggressive tax-planning arrangements;
11. improve transfer-pricing documentation;
12. improve the treaty process for the resolution of disputes, including arbitration; and
13. develop a multilateral treaty to implement BEPS countermeasures and to amend bilateral treaties.

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[7] The concern with transfer pricing encompasses three separate actions in the BEPS Action Plan.

The OECD's BEPS Action Plan is obviously an ambitious one even taking into account the fact that the OECD had been working on some of the issues, such as hybrid-mismatch arrangements and transfer pricing, before the announcement of the BEPS project. It is even more ambitious considering the timeframe for the delivery of the OECD's recommendations. Only the work on the transfer-pricing aspects of financial instruments, part of the work on harmful tax practices,[8] and the development of a multilateral treaty will take more than two years. With respect to the other issues, OECD recommendations are due by September 2014 or September 2015. To meet the September 2014 deadline, the OECD has committed to consult with the public before finalizing its recommendations. Public consultations on the three discussion drafts issued in March 2014 will take place in April and May and the reports will be finalized in June and presented to the G20 in September.

The tight timing of the BEPS project emphasizes the importance of the work to the OECD and the G20. However, it also raises concerns about the quality of the work. Although the OECD's Centre for Tax Policy and Administration is staffed with highly qualified people, it is a rather lean organization without any excess resources. It might be preferable for the OECD to take more time and ensure that the work is done thoroughly. After all, it took over 10 years for the OECD to finalize the work on the attribution of profits to PEs under Article 7 of the OECD Model Treaty — a project that was narrower in scope and less controversial.

At this stage, several initial points may be noted about the BEPS project. First, it is significant that the project has gained widespread support from the G20, which includes Brazil, Russia, India, China and South Africa (the so-called BRICS), as well as from developing countries.[9] One crucial question is whether the widespread support for BEPS in principle will continue when the project calls for co-ordinated action by these nations on specific issues. Second, co-ordinated action by the member countries of the OECD and the BRICS is essential for the success of any action to combat aggressive tax planning by multinational enterprises. Multinationals operate and engage in tax planning on a worldwide basis. Unilateral action by countries, even countries with the largest economies, such as the United States, is likely either to prove ineffective or to inflict serious damage on the domestic economy. Third, the bad publicity generated by the attacks of politicians in Europe and the United States against multinationals has generated a public perception that multinational corporations are engaged in tax-avoidance activities that are probably illegal, and certainly immoral; multinationals have been put on their back feet.[10] Fourth, as noted above, for the most part these issues are not new; they have plagued the international tax regime for more than 25 years. Countries have tried time and again to take unilateral action and put provisions in their tax treaties against international tax avoidance. Finally, as Hugh Ault has noted, BEPS represents an opportunity to make progress in designing (or more accurately, redesigning) an international tax regime that has become a bit tired;[11] even if only some of the items on the list for remodeling are achieved, life will be improved at the margin.

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[8] The action plan does not specify which part.

[9] United Nations Committee of Experts on International Cooperation in Tax Matters, available at www.un.org/esa/ffd.

[10] It is notable that the public reaction in Canada has not been as strong as it has in Europe and the United States.

[11] Hugh J. Ault, "Some Reflections on the OECD and the Sources of International Tax Principles," *Tax Notes International* 70, 12 (June 17, 2013): 1195-1201.

The tax-policy considerations underlying the OECD's BEPS initiative are superficially clear.[12] Aggressive international tax avoidance by multinational enterprises produces several harmful consequences for national tax systems. First, it reduces government tax revenues and increases the cost to the government of ensuring compliance with the tax rules by multinational enterprises. Second, it undermines the perceived integrity of the tax system and may have a deleterious effect on tax compliance generally. Third, it undermines the fairness of national tax systems because taxpayers, other than multinational corporations, must bear a greater share of the tax burden. Fourth, small- and medium-sized enterprises may not be able to take advantage of the same international tax-planning opportunities as can multinational enterprises and may therefore be placed at a competitive disadvantage. Fifth, to the extent that opportunities for aggressive tax planning are greater in the international context than in the domestic context, distortions in the location of investment may result.

However, the tax-policy analysis of BEPS for any particular country is much more subtle and difficult than the foregoing list of consequences may suggest. The tax systems of many capital-exporting countries are fundamentally characterized by concerns about the international competitiveness of their resident multinational corporations. These countries have consistently taken domestic measures over the past two or three decades to enhance the competitive position of their resident multinational corporations, or at the least have avoided taking measures that would place their multinationals at a competitive disadvantage. Thus, many countries, including Canada, can be expected to have a schizophrenic attitude to BEPS. On the one hand, they want to protect their domestic tax bases from the aggressive tax-planning strategies of foreign-based multinationals. On the other hand, they have no interest in preventing their own resident multinationals from eroding the tax base of other countries (i.e., making them pay more foreign tax).

From a particular country's perspective, therefore, the ideal result from the BEPS project is for other countries to take action to require their multinational corporations to pay more foreign tax, while it does little or nothing with respect to its resident multinationals so that they gain a competitive advantage. This explains in simple terms why co-ordinated action is so important and so difficult. Part of the difficulty relates to the widely varying interests of the OECD member countries. Net-capital-importing countries have different interests from net-capital-exporting countries. In addition, some OECD members such as Belgium, Ireland, Luxembourg and the Netherlands have significant interests both from a public perspective (tax revenue, investment, employment) and a private-sector perspective (professional firms and financial institutions) in facilitating international tax planning by multinational enterprises and maintaining the status quo.

Given the uncertainty in the tax-policy analysis, it seems unlikely that Canada would conclude that it should lead the charge on BEPS by taking strong unilateral action without waiting to see what other countries, especially the United States, do. Thus far, as a member of the OECD, the Canadian government has been cautiously supportive of the BEPS project and has also launched a domestic consultation exercise with respect to BEPS as part of the Feb. 11, 2014 federal budget.[13]

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[12] See OECD, Action Plan on *Base Erosion*, 8.

[13] The proposal in the 2014 federal budget to amend the Income Tax Conventions Interpretation Act to add an anti-treaty-shopping rule, which is discussed in detail below, cannot be considered as Canadian action pursuant to or in support of the OECD's BEPS project because the government would likely have taken action against treaty shopping even in the absence of BEPS. Furthermore, the proposed anti-treaty-shopping rule in the budget is inconsistent with the anti-treaty-shopping rules proposed in the OECD's BEPS Action 6.

AN OVERVIEW OF THE INTERNATIONAL ASPECTS OF THE CANADIAN TAX SYSTEM

Introduction

This part of the paper provides a broad overview of the structure of the international tax rules of the Canadian federal income tax system applicable to multinational enterprises. It describes the rules applicable to Canadian-resident multinationals earning foreign source income and non-resident multinationals earning Canadian source income, as well as the provisions of Canadian tax treaties. In order to provide some context for the subsequent discussion of common tax-planning arrangements, the focus is on the structure of the Canadian rules rather than on their technical details. Our goal is to consider whether aggressive international tax planning is enabled by the fundamental structure of the Canadian system or by deficiencies in the detailed rules.

Canadian-resident Corporations Earning Foreign Source Income (the Outbound Dimension)

In general terms, there are three patterns for the taxation of foreign source income:

1. Foreign source income can be subject to Canadian tax as it is earned with a credit against Canadian tax for any foreign tax on the income;
2. Foreign source income can be exempt from Canadian tax; and
3. Canadian tax on foreign source income can be deferred until the income is remitted or repatriated to Canadian residents and then taxed with a credit for any foreign withholding tax on the dividend and for the foreign corporate tax on the income out of which the dividend is paid.

As will be seen, all three patterns are found in the Canadian tax system depending on the type of taxpayer, the legal structure of the foreign investment (branch or subsidiary) and the type of income.

In general, Canada taxes its residents, individuals, corporations and other entities on their worldwide income and provides a credit for foreign tax on foreign source income to eliminate international double taxation. Corporations are considered to be resident in Canada if they are incorporated in Canada or if their central management and control are located in Canada. This pattern of taxation (current Canadian tax with a foreign tax credit) applies to foreign source business income earned by Canadian corporations through a foreign branch and also to foreign non-business income, which includes passive investment-type income and capital gains.

Most foreign source income derived by multinationals is earned indirectly through foreign corporations rather than directly through foreign branches. Foreign source income earned by foreign affiliates of Canadian-resident corporations is not subject to current Canadian tax (i.e., as the income is earned by the foreign affiliate) unless the foreign-accrual-property-income (FAPI) rules apply, as discussed below, because the foreign affiliates are treated as separate taxable entities.

A foreign affiliate of a Canadian-resident corporation is generally a non-resident corporation in which the Canadian corporation owns directly or indirectly 10 per cent or more of the shares of any class. Even when a foreign affiliate pays dividends to its Canadian parent corporation, the dividends are exempt from Canadian tax if they are paid out of the "exempt surplus" of the foreign affiliate.[14] In general terms, exempt surplus is active business income earned by a foreign affiliate if the foreign affiliate is resident in a "designated treaty country"[15] and the income is earned in Canada or a designated treaty country.

The amount of certain capital gains realized by a foreign affiliate from the disposition of shares in other foreign affiliates, partnerships and certain receivables and other amounts related to such shares and partnership interests is included in the affiliate's "hybrid surplus." Dividends paid out of hybrid surplus are included in the recipient shareholder's income with a credit for the foreign taxes attributable to the gains.[16]

Other income earned by a foreign affiliate, such as active business income earned in a country other than a designated treaty country, any income earned by a foreign affiliate not resident in a designated treaty country, and passive investment-type income, is included in the foreign affiliate's "taxable surplus" and is taxable when dividends out of such surplus are received by a Canadian corporation, with credits for any foreign withholding taxes on the dividends and any underlying foreign tax paid by the foreign affiliate related to the taxable surplus.[17] Any other dividends paid by a foreign affiliate are dividends out of "pre-acquisition surplus"; they are exempt from Canadian tax but reduce the adjusted cost base of the shares of the foreign affiliate to the Canadian corporation.[18]

In practice, this combined credit/exemption system for dividends from foreign affiliates operates as a complete exemption system, since dividends out of hybrid surplus and taxable surplus are not repatriated to Canada unless there is sufficient foreign tax to completely offset any Canadian tax. Moreover, dividends are deemed to be paid out of a foreign affiliate's exempt surplus before its hybrid surplus and taxable surplus.

The treatment of capital gains from the disposition of shares of a foreign affiliate is inextricably linked to the taxation of dividends from the foreign affiliate. Although capital gains realized by a Canadian corporation on the sale of the shares of a foreign affiliate are taxable, an election is available under Section 93 to convert all or part of the gain into a deemed dividend; as a result, if the foreign affiliate has sufficient exempt surplus, the dividend may be exempt from Canadian tax. The Section 93 election also applies to capital gains realized by one foreign affiliate from the disposition of the shares of another foreign affiliate of the same taxpayer.

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[14] Such dividends are included in the shareholder's income under section 90, but are deductible in computing taxable income under paragraph 113(1)(a).

[15] A designated treaty country is defined in Regulation 5907(11), in general, to be a country with which Canada has entered into a bilateral tax treaty or tax-information-exchange agreement.

[16] Paragraph 113(1)(a.1).

[17] The credits take the form of deductions in computing taxable income under paragraphs 113(1)(b) and (c). The deductions are grossed up to reflect the amount of before-tax income out of which the dividends are paid.

[18] Paragraph 113(1)(d) and subsection 92(2).

Under the FAPI rules, any passive income and certain limited types of business income (generally, income derived from sources in Canada and from certain related-party transactions) earned by a "controlled foreign affiliate" (CFA) are taxed in the hands of the Canadian-resident shareholders of the CFA (both individuals and corporations) when the income is earned by the CFA. The income inclusion is not deferred until dividends are distributed to the Canadian corporation. A credit is allowed against Canadian tax for any foreign tax paid in respect of the FAPI, including any foreign withholding tax if the amount is distributed in the future. A CFA is a foreign affiliate that is controlled by a group of five or fewer residents of Canada. For this purpose, control means legal control — generally, the ownership of more than 50 per cent of the voting shares of the foreign affiliate. The FAPI rules apply only to CFAs, whereas the exemption system for dividends from foreign affiliates applies to foreign corporations in which a Canadian corporation owns at least 10 per cent of the shares of any class.

The FAPI rules are necessary to prevent the abuse of, or to protect the integrity of, the combined exemption/credit system for dividends. In the absence of the FAPI rules, passive and other mobile income could be diverted by a Canadian-resident corporation to its CFAs in low-tax countries and repatriated to Canada in the form of exempt dividends.

The final important structural aspect of the outbound dimension of the international tax system is the deductibility of expenses. In principle, expenses incurred to earn income that is exempt from Canadian tax should not be deductible. Thus, expenses incurred by Canadian corporations to earn exempt dividends from foreign affiliates should not be deductible.[19] However, under the current law, expenses such as interest and other financing expenses incurred to acquire shares of foreign affiliates are deductible even if the dividends from the affiliate are exempt from Canadian tax. A similar problem occurs with respect to research and development expenses incurred by Canadian corporations that relate to intellectual property that is transferred to a foreign affiliate.

Non-resident Corporations Earning Canadian Source Income (the Inbound Dimension)

Traditionally, Canada has exercised broad jurisdiction to tax non-residents on their income derived from Canada. Non-residents carrying on business in Canada are taxable on their income from the business. For this purpose, carrying on business has a very broad meaning; it includes producing, growing, mining, manufacturing, creating, fabricating, improving, packing, preserving and constructing anything in Canada, offering anything for sale in Canada, and an adventure or concern in the nature of trade carried on in Canada.[20] However, as noted below, this broad taxation of non-residents in respect of business income is given up under Canada's tax treaties for non-residents that do not carry on business through a permanent establishment in Canada.

[19] In principle, even expenses incurred to earn dividends that are taxable with a credit for foreign tax should not be deductible until the dividends are received, and the expenses should be allocated to the foreign income for purposes of the limitation on the foreign tax credit. In general, the foreign tax credit is limited to the Canadian tax on the foreign source income. If the expenses are allocated to and reduce the foreign source income, the amount of the foreign tax credit will be reduced.

[20] Section 253 and subsection 248(1), the definition of "business."

Under Part XIII of the Income Tax Act, Canada imposes a withholding tax of 25 per cent on the gross amount of a broad range of payments made by residents of Canada to non-residents, including dividends, interest, rents and royalties. However, since withholding taxes are often borne by the payer as a contractual matter, several exemptions from withholding tax are available. For example, copyright royalties in respect of cultural and artistic work, interest paid or guaranteed by the government, and interest paid to an arm's-length non-resident are exempt from withholding tax. In addition, as discussed below, the 25 per cent rate of withholding tax under Part XIII on dividends, interest and royalties is reduced pursuant to Canada's bilateral tax treaties.

Non-residents are subject to Canadian tax only on capital gains in respect of "taxable Canadian property," which is defined to include the following:

- immovable property located in Canada,
- property of a business carried on in Canada,
- shares of a corporation, other than shares listed on a designated stock exchange, if more than 50 per cent of the value of the shares is derived from immovable property located in Canada, Canadian resource properties or timber-resource properties,
- shares of a corporation listed on a designated stock exchange if non-resident and non-arm's-length persons owned 25 per cent or more of the shares at any time in the five-year period before the disposition and more than 50 per cent of the value of the shares is derived from immovable property located in Canada, Canadian resource properties or timber-resource properties,[21]
- Canadian resource property,
- timber-resource property, and
- options in respect of property described above.[22]

Canada's Tax Treaties

As of early 2014, Canada had a large network of 92 bilateral tax treaties. By way of comparison, at the same time the United States and Australia had only 65 and 45 treaties respectively. Canada's tax-treaty network includes treaties with Canada's major trading partners and many minor trading partners. It also includes treaties with several well-known tax havens, such as Barbados, Ireland, Luxembourg, the Netherlands, Hong Kong, Singapore, Malta and Cyprus.

Canada's large tax-treaty network is attributable in large part to the exempt surplus system for dividends from foreign affiliates. As noted above, the exemption for dividends from foreign affiliates is available only for dividends paid by foreign affiliates that are resident in a designated treaty country. When this system was adopted in 1972, Canada had only 16 tax treaties and the government committed to expanding the treaty network. Therefore, the policy of negotiating a treaty with any country in which Canadian corporations have significant active business investments appears to be driving the growth of the Canadian treaty network.

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[21] Shares of a mutual fund corporation and units of a mutual fund trust are also included even if the shares or units are not listed on a designated stock exchange.

[22] Subsection 248(1), the definition of "taxable Canadian property."

Canadian tax treaties generally follow the OECD model, which is appropriate since Canada is a member of the OECD. However, Canadian tax treaties depart from the provisions of the OECD model in some important respects. For example, in the non-discrimination article of its treaties, Canada does not agree to the national treatment provided by the OECD model, but provides most-favoured-nation treatment only. Thus, Canada agrees to treat residents of any particular treaty partner no less favourably than the residents of any other treaty partner, but does not agree to treat them as favourably as it treats Canadian residents. Also, Canada does not agree to exclusive residence-country taxation of royalties, as provided in Article 12 of the OECD model.

With respect to the taxation of non-residents on Canadian source income, Canada generally agrees to a five per cent rate of withholding tax on direct dividends and 15 per cent on other dividends, and a 10 per cent rate on interest and royalties. Many Canadian tax treaties provide for higher rates of withholding on dividends, interest and royalties but, presumably, these higher rates reflect the positions of the treaty partners. It is important to remember that the provisions of any of Canada's tax treaties reflect the results of negotiations between Canada and the other contracting state. As a result, Canada may be required to agree to provisions that are not representative of its position but are necessary in order to obtain the other country's agreement to other provisions of the treaty that are important to Canada.

With respect to capital gains, Canada's practice is to follow Article 13 of the OECD model, with the following differences:

- the treatment of land-rich companies is usually extended to interests in partnerships and trusts;[23]
- Canada insists on the right to tax capital gains in respect of taxable Canadian property realized by residents of the other country if they were previously resident in Canada at any time in the past five or six years (a so-called "trailing tax");
- because of Canada's exit tax on taxpayers ceasing to be resident, Canada tries to get the other country to agree to give its new resident a step-up in the cost of the property to its fair market value in order to avoid any double taxation when the taxpayer disposes of the property; and
- Canada often includes a provision to facilitate cross-border reorganizations of corporations and other entities.

With respect to aggressive tax planning through the use of tax treaties, Canada's position has been inconsistent. Until the mid-1990s little concern about treaty abuse is discernible. In the Third Protocol to the Canada-United States treaty, Canada declined the reciprocal application of the limitation-on-benefits provision that the United States had insisted on. Instead, Canada indicated that it preferred to rely on the general anti-avoidance rule (GAAR) to deal with the problem of treaty abuse. The GAAR was amended in 2004 retroactively to 1988 to make it applicable to abuses of tax treaties. At the same time, the Income Tax Conventions

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[23] The OECD Public Discussion Draft BEPS Action 6 recommends that Article 13(4) of the OECD Model Convention should be extended to interests in entities other than corporations.

Interpretation Act was amended to clarify that the provisions of a tax treaty cannot be applied to override the GAAR.[24] There is also an explicit treaty override with respect to subsection 94(3) dealing with non-resident trusts.[25] There is no explicit treaty override for other specific anti-avoidance rules in the Income Tax Act.

Canada's more recent treaties have included specific anti-avoidance rules in articles 10, 11 and 12 dealing with dividends, interest and royalties.[26] These provisions deny the benefits of the particular article if a main purpose of the creation or assignment of the share, debt or rights is to take advantage of the article. In addition, several treaties contain provisions that deny the benefits of the treaty with respect to an entity resident in a country that is beneficially owned or controlled by residents of another country if the tax on the entity's income is substantially lower than it would have been if the entity was owned or controlled by residents of the country in which the entity is resident. In 2007, Canada agreed to the reciprocal application of the detailed limitation-on-benefits provision in the Fifth Protocol to the Canada-United States treaty. Finally, the recent treaty with Hong Kong contains a provision that indicates that nothing in the treaty shall be construed to prevent the application of any domestic anti-avoidance rules.[27]

As a result of adverse decisions in several recent treaty-shopping cases, in October 2013 the Department of Finance issued a consultation paper dealing with treaty shopping and then announced a new anti-treaty-shopping measure in the 2014 budget. The proposed rule, which is discussed below, takes the form of a one-of-the-main-purposes test and will override all of Canada's tax treaties.[28]

THE DISTINCTION BETWEEN TAX EVASION AND TAX AVOIDANCE AND VARIOUS TYPES OF TAX AVOIDANCE

As noted in the introduction, this paper deals with tax avoidance; it does not deal with tax evasion.[29] However, it is important to understand the difference between the two concepts. Sometimes they are confused, as in the recent discussions about aggressive international tax planning by multinational corporations such as Starbucks, Google, Amazon and Apple. Politicians and journalists have sometimes accused these multinationals of engaging in immoral and illegal conduct. These accusations often resonate with the public, but they are usually misleading. In our experience, public corporations are extremely cautious about ensuring that their tax-planning transactions are within the law.

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[24] Section 4.1 of the Income Tax Conventions Interpretation Act.

[25] Section 4.3 of the Income Tax Conventions Interpretation Act.

[26] Sixteen treaties contain this type of provision.

[27] Article 26(2) of the Canada-Hong Kong treaty.

[28] See Ministry of Finance, Budget, February 11, 2014, "Supplementary Information — Annex 2," available at www.fin.gc.ca.

[29] Tax evasion refers to the use of illegal means to reduce or avoid tax liability.

At the outset, it is important to note that morality is irrelevant to this discussion of aggressive international tax planning by multinationals. Although individuals may have a moral obligation to contribute to the society of which they are a part and from which they derive benefits, corporations are artificial persons and legal fictions; they do not pay tax and therefore it is meaningless to consider whether they have a moral obligation to pay tax. Furthermore, it is well established that the obligation to pay tax is imposed by law and that there is no obligation on any taxpayer to pay more tax than the law requires. This principle finds expression in Canadian tax law in the Duke of Westminster[30] principle that a taxpayer is entitled to arrange its affairs to minimize the amount of tax payable. This principle is deeply entrenched. It is explicitly recognized by the Canada Revenue Agency (CRA) and is included in its Taxpayers Bill of Rights. It is also a foundational principle in most other countries' tax systems.

Tax evasion is a serious criminal offence that may result in prosecution and substantial penalties.[31] The hallmark of tax evasion is intentional behaviour designed to reduce a person's tax liability through non-disclosure or misrepresentation. The CRA describes tax evasion as follows:

> Tax evasion is the commission or omission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law, or a conspiracy to commit such an offence. This may be accomplished by the deliberate omission of revenue, fraudulent claiming of expenses or allowances, and the deliberate misrepresentation, concealment or withholding of material facts.[32]

This definition of tax evasion has been endorsed by the courts on several occasions. The essence of tax evasion is intentional fraud, deceit, misrepresentation or non-disclosure.

The distinction between tax evasion and tax avoidance has been graphically described as the "thickness of a cell wall." This description is not particularly useful; it has no predictive value because it reflects the consequences of the distinction rather than the factors that lead to a conclusion of tax evasion or avoidance. Tax avoidance involves lawful actions or transactions effected by a taxpayer that, if effective for tax purposes, reduce the taxpayer's tax liability. Once again, the adjective "lawful" is conclusory and unhelpful in distinguishing between tax evasion and tax avoidance. The key factor in making the distinction between tax evasion and tax avoidance is that, as noted above, the former involves fraud, deceit, misrepresentation or nondisclosure, whereas the latter does not. If a taxpayer fully discloses all of the material facts, it is inconceivable that the taxpayer could be convicted of tax evasion.

Although tax avoidance is not illegal, it may become the target of legislative or judicial limits because it is regarded as aggressive. Unlike the boundary between tax evasion and tax avoidance, however, the line between "unacceptable" tax avoidance — recently, often called "aggressive" tax avoidance — and "acceptable" tax avoidance — sometimes referred to as tax mitigation — is elusive. Lord Walker noted that a "simple tripartite classification of tax

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[30] *CIR v. Duke of Westminster* [1936] AC 1 (HL).

[31] Sections 163 and 239.

[32] Information Circular IC 73-10R2, April 24, 1978 (archived).

evasion — illegal and criminal; tax avoidance — legal but unacceptable; tax mitigation — legal and acceptable ... is too crude an analysis to promote understanding of what is a fairly complex subject."[33] For some, drawing the line in a particular case is more aptly described as an exercise in intuition rather than legal reasoning.[34]

The terms used to describe the difference between acceptable and unacceptable tax avoidance — artificial, abusive, aggressive, impermissible, illegitimate — are invariably conclusive. They do not provide any standards by which different types of tax avoidance transactions can be judged. The term "unacceptable" tax avoidance means that some tax avoidance transactions are not successful or do not "work" because they are subject to a statutory anti-avoidance rule or a judicial anti-avoidance doctrine. In general, unacceptable tax-avoidance transactions are transactions that result in tax benefits that are not intended by the legislature and are not within the purpose of the tax legislation. As the U.K. Tax Law Review Committee noted in its 1997 report:

> We think it impossible to define the expression "tax avoidance" in any truly satisfactory manner ... So far as we have needed some broad framework within which to conduct our discussion of tax avoidance activity, we have regarded tax avoidance (in contra-distinction to legitimate tax mitigation or planning) as action taken to reduce or defer tax liabilities in a way that Parliament plainly did not intend or could not possibly have intended had the matter been put to it.[35]

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33 Lord Walker, "Ramsay 25 Years On: Some Reflections on Tax Avoidance," *Law Quarterly Review* (2004): 416.

34 In that connection, the oft-quoted description of Justice Stewart of the U.S. Supreme Court comes to mind. In a case dealing with the application to a particular film of a state censorship law that prohibited the exhibition of films that constituted "hard pornography," Justice Stewart observed that while he found the precise meaning of the term "hard pornography" elusive, he knew hard pornography when he saw it and the particular film was not it. In its 1997 Report on Tax Avoidance, the U.K. Tax Law Review Commission (TLRC) of the Institute for Fiscal Studies succinctly stated: "[O]ne person's tax avoidance may be another person's prudent and sensible tax planning." (Institute for Fiscal Studies, *The Tax Law Review Committee Report on Tax Avoidance*, November 1997 (KKS Printing: 1997), 3 (hereafter "TLRC, 1997 Report.") As the TLRC stated in its 2009 Report, trying to distinguish between "acceptable" and "unacceptable" tax avoidance leaves unanswered the basic question: "Acceptable to whom?" (hereafter "TLRC, 2009 Report.") M. Littlewood, "The Privy Council and the Australasian Anti-Avoidance Rules," *British Tax Review* 2 (2007): 175-205, refers to the difficulty of drawing the line between abusive tax avoidance and acceptable tax mitigation as follows:

> All in all, to describe the distinction between avoidance and mitigation as "vague" is to understate the problem, for it suggests that there is general agreement as to roughly where the line lies and that the disagreement is only as to marginal cases. But none of their Lordships appear to have regarded any of the cases as marginal. It is difficult, therefore, to extract from them any guidance as to where the line lies.

A similar comment might be made with respect to the GAAR decisions of the Supreme Court of Canada.

35 TLRC, 1997 Report, ix. To similar effect, in *IRC v. Willoughby* [1997] STC 995, at 1004, the House of Lords described tax avoidance as "a course of action designed to conflict with or defeat the evident intention of Parliament." Chapter 5 of the TLRC, 1997 Report sets out for illustrative purposes a draft general anti-avoidance rule. The purpose of the rule was described as follows: "[T]he purpose of this rule is to deter or counteract transactions that are designed to avoid tax in a way that conflicts with or defeats the evident intention of Parliament. This rule should be applied in a manner that is consistent with that purpose." This may be read as an attempt to describe "unacceptable" tax avoidance — the target or mischief at which the draft rule was aimed. To buttress the point, the draft rule defined "protected transactions" as a category of transactions that was to be excluded from the application of the draft rule. "Protected transactions" included a transaction that satisfied one or more of the following tests: (i) it can reasonably be regarded as encouraged by legislation, (ii) it falls within an exception or exclusion provided in other anti-avoidance provisions, or (iii) it otherwise does not conflict with or defeat the purpose of the legislation. The relationship to specific anti-avoidance rules is interesting in that the drafters seemed to envisage that the draft rule should fill gaps or loopholes in more specific legislation, except where there is a relevant safe harbour expressly provided in that legislation.

In Canada, judicial anti-avoidance doctrines have not been very effective in dealing with aggressive tax avoidance.[36] Canadian courts adhere rigorously to the legal form of transactions (rather than considering their economic substance) and often interpret the provisions of tax legislation literally. These two features of the case law tend to facilitate tax avoidance. Unlike U.S. courts, Canadian courts do not strike down tax-avoidance transactions that lack a business purpose. Canadian courts do disregard sham transactions, but the sham-transaction doctrine has been applied quite narrowly. A sham transaction is a transaction that is intended to give the appearance of rights and obligations different from the actual rights and obligations created by the parties.[37] The Supreme Court of Canada has reiterated on several occasions that, absent a sham, window dressing, or other vitiating circumstances, a taxpayer is free to engage in transactions to avoid tax.[38] This freedom is, of course, subject to any specific statutory anti-avoidance rules and the general anti-avoidance rule.

The Income Tax Act is replete with specific anti-avoidance rules, some of which are aimed at aggressive international tax-avoidance transactions and are discussed in more detail below. Examples of such rules include:

- Thin-capitalization rules
- Foreign-affiliate debt-dumping rules
- Back-to-back financing arrangements
- Controlled-foreign-corporation rules
- Foreign-investment-entity rules
- Transfer-pricing rules

Despite the broad range of specific anti-avoidance rules, they cannot provide a complete response to the problem of aggressive tax planning. Such rules often provide taxpayers with a road map to avoid the application of the specific rules, and the government is always playing catch-up as taxpayers and their advisers devise more inventive ways of avoiding tax.

Therefore, many countries, including Canada, have adopted a general anti-avoidance rule (GAAR) to control aggressive tax avoidance. The Canadian GAAR was adopted in 1988 and features a two-part test for aggressive tax avoidance:

- There must be a transaction that either results in a tax benefit or is part of a series that results in a tax benefit and the primary purpose of the transaction was to obtain a tax benefit, and
- The transaction or series of transactions must result in a misuse of the relevant statutory provisions or treaty or an abuse having regard to those provisions read as a whole.

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[36] A discussion of the judicial anti-avoidance doctrines applicable in Canada is beyond the scope of this paper; see generally Arnold and Wilson, infra note 59.

[37] *Snook v. London & West Riding Investments Ltd.* [1967] 2 QB 786 (CA). The U.K. definition of sham was endorsed by the Supreme Court of Canada in *MNR v. Cameron* [1972] CTC 380 (SCC).

[38] *Shell Canada Limited v. The Queen* [1999] 3 SCR 622.

The crucial part of the GAAR is the misuse or abuse test, which the Supreme Court has interpreted to mean simply abuse.[39] Further, the court has held that an abuse occurs only if a transaction frustrates or defeats the purpose of the provisions of the tax legislation that are relied on by the taxpayer; and a transaction frustrates or defeats the purpose of the legislative provisions if it is not in accordance with the object, spirit and purpose of those provisions.

The jurisprudence on the GAAR is still in its infancy. The Supreme Court has decided only four cases, one of which was a four-three decision, and it is difficult to make any firm judgment about how effective the GAAR might be in controlling aggressive international tax avoidance.

In summary, in this paper we use the term "aggressive tax avoidance" to describe tax avoidance that national tax authorities or international organizations such as the OECD might consider to be objectionable because it frustrates or defeats the "object, spirit or purpose" or "underlying rationale" of the relevant domestic tax law or bilateral tax treaty. In short, it means tax avoidance that a country might challenge in its courts under its existing law or take legislative action to curb.[40] It is critical to note, however, that not all tax avoidance is problematic — presumably even to the OECD and national governments. This point is often lost in the public debate on aggressive tax avoidance. As noted above, in most countries, including Canada, a basic tax principle is that taxpayers are permitted to arrange their affairs so as to minimize their tax burden. However, a companion principle is that there is a category of tax avoidance that should be prohibited. As noted above, the problem is drawing a line between "acceptable" tax avoidance and "unacceptable" tax avoidance — to balance taxpayers' need for a reasonable degree of certainty and predictability in planning their affairs and the government's need to protect its tax base.

COMMON TYPES OF INTERNATIONAL TAX PLANNING

Introduction

In this part of the paper, we consider common types of international tax planning by multinational enterprises that some might regard as "aggressive" tax avoidance. Because it results in the erosion of domestic tax bases or the shifting of profits, international tax planning that might be regarded as aggressive tax avoidance can take many forms. Some planning can be surprisingly simple and may involve a single related-party transaction. Most tax planning, however, is complex, in part because the planning must navigate the competing commercial, legal and tax objectives of the relevant participants. The basic underpinning of tax planning is

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[39] According to the Supreme Court, it is impossible to misuse the provisions of the Income Tax Act without abusing them.

[40] Reference is made in Canada, House of Commons, Report of the Standing Committee on Finance, "Tax Evasion and the Use of Tax Havens," May 2013, 41st Parliament, First Session, to the testimony of a CRA official who described aggressive tax avoidance as domestic and international tax minimization that complies with the letter of the law but not its object and spirit. The difficulty with this description, of course, is that the object, spirit, purpose ("underlying rationale") of a relevant Canadian tax provision is sometimes elusive. The underlying rationale of a provision is never explicit in the legislation itself and may not be apparent even from extrinsic aids.

to exploit differences, gaps and asymmetries in the relevant domestic legal and tax systems that create opportunities to reduce, defer or eliminate the multinational enterprise's overall tax liability. Many of these asymmetries arise from the fact that, historically, domestic tax rules and bilateral tax treaties have focused primarily on the avoidance of double taxation rather than on preventing base erosion and profit shifting or addressing circumstances where a particular item of income is not taxed anywhere (commonly referred to as "double non-taxation" or "stateless income").[41]

In general, international tax planning is designed to achieve one or more of the four elements identified in the OECD's BEPS Action Plan:[42] reduction of both corporate tax and withholding tax in the source country, reduction of tax on any intermediary entities that receive amounts from the entities in the source country, and reduction of tax on the ultimate parent.[43] The basic objectives are readily apparent: to arrange the affairs of a multinational group of companies such that profits are earned where they are taxed at the lowest possible rates and expenses are incurred where their deduction yields the greatest tax relief. In that connection, there are several key aspects of domestic tax rules and bilateral tax treaties that inform international tax planning, including:

- jurisdiction to tax (normally based on an entity basis, with each entity subject to tax as a separate entity on a worldwide or territorial basis),
- transfer pricing (each country taxes its share of the profits of related corporations based on an arm's-length allocation),
- the treatment of cross-border intercorporate dividends (many countries, including Canada, provide a participation exemption for such dividends),
- the treatment of capital gains,
- financing expenses (interest on debt financing is generally deductible on a pre-tax basis), and
- anti-avoidance rules (including specific and general anti-avoidance rules contained in domestic tax law and bilateral tax treaties).

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41 In OECD Report, *Addressing Base Erosion and Profit Shifting* (2012), the OECD observed: "[C]orporations have urged bilateral and multilateral co-operation among countries to address differences in tax rules that result in double taxation, while simultaneously exploiting differences that result in double non-taxation." See also Edward D. Kleinbard, "Stateless Income," *Florida Tax Review* 11 (2011): 699.

42 Ibid.

43 Ibid. The OECD summarizes the objectives of most aggressive international tax plans:

> In practice any structure aimed at BEPS will need to incorporate a number of co-ordinated strategies, which often can be broken down into four elements: (i) minimization of taxation in a foreign operating or source country (which is often a medium- to high-tax jurisdiction) either by shifting gross profits via trading structures or reducing net profit by maximizing deductions at the level of the payer, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient (which can be achieved via low tax jurisdictions, preferential regimes or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built up via intra group arrangements, as well as (iv) no current taxation at the low-taxed profits (achieved via the first three steps) at the level of the ultimate parent.

Three general observations should be noted. First, most countries, including Canada, apply different tax treatment to corporate debt and equity. Interest on debt is deductible by the debtor for tax purposes but dividends on shares (equity) are not. This distinction creates a strong preference for multinationals to use debt financing to reduce tax in the source countries in which their subsidiaries carry on business, and also in the residence country where the ultimate parent or an intermediary is resident. Moreover, although interest is generally taxable to the recipient, dividends received by resident corporations from their foreign subsidiaries are often exempt from residence-country tax.

Second, some international tax planning does not exploit the domestic tax rules or bilateral tax treaties of a particular country so much as the manner in which those rules interact and intersect with those of one or more other countries. As succinctly noted in the OECD's BEPS Report "[O]ften it is not any particular country's tax rule that creates the opportunity for BEPS, but rather the way the rules of several countries interact."[44] The result is that international tax planning may result in claims in multiple countries for interest or other deductions or foreign tax credits. For this reason, the OECD argues that only a co-ordinated response by national governments will be effective in curbing aggressive international tax planning. Further, as the OECD Report *Addressing Base Erosion and Profit Shifting* notes, unilateral responses by countries raise the very real risk of "… undermining the consensus-based framework for establishing jurisdiction to tax and addressing double taxation which exists today."[45]

Third, the anti-avoidance rules of most countries primarily target aggressive tax planning in the domestic context rather than in the international context. These rules include specific anti-avoidance rules, controlled-foreign-company ("CFC") rules, thin-capitalization rules, anti-hybrid rules and anti-base erosion rules, and in some countries (such as Canada), a general anti-avoidance rule. These domestic anti-avoidance rules have their limitations, as discussed below, and in many countries, including Canada, the efficacy of a GAAR in curbing international tax planning is far from clear.

As a final point, for the most part it is assumed that the international planning described below "works" technically under the relevant domestic tax laws and bilateral tax treaties (i.e., it complies with that law and those treaties). In that connection, the OECD report on BEPS acknowledges that much of what it regards as aggressive international tax planning involves "technically legal arrangements and transactions." Thus, it is unlikely that such planning can be addressed effectively by more aggressive tax audits and reassessments by national tax authorities. Consequently, the specific actions proposed by the OECD's *Action Plan on BEPS*[46] are focused on legislative action — specifically, amendments to domestic tax law and tax treaties, rather than on more aggressive tax audits. Increased vigilance in tax audits and

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[44] OECD Report, *Addressing Base Erosion*, 44. For examples of corporate-loss strategies that involve the use of losses and the creation of artificial losses for such use, see OECD, *Addressing Tax Risks Involving Bank Losses* (2010) and OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (2011). In this report, the OECD identified arrangements in which multinational enterprises shift profits to a loss-making group member, use the same loss multiple times, and create artificial losses. Examples include arrangements in which derivative contracts are used to shift losses from one group company in a low-tax country to another group company in a high-tax country. In another arrangement, long and short positions in index-linked securities are used to effectively transfer unusable losses from one group member to another.

[45] Ibid. at 48.

[46] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), http://www.oecd.org/ctp/BEPSActionPlan.pdf.

reassessment activity, where sanctioned by existing tax laws, is encouraged by the OECD — with the caution that any increase in reassessment activity to curb international tax planning should always be based on a reasoned and balanced interpretation and application of the relevant tax law.

The following case studies are intended to illustrate the types of international tax planning that multinationals commonly engage in. We have selected three case studies to examine in the body of the paper: an inbound transaction, in which the objective is to reduce source-country tax; an outbound transaction, in which the objective is to reduce residence-country tax; and a financing arrangement designed to reduce both source-country and residence-country tax. The purpose of these case studies is to identify the ways in which the tax planning takes advantage of aspects of domestic law and tax treaties; it will then be possible to discuss options for revising domestic laws and tax treaties to control aggressive international tax planning. We do not discuss how the various BEPS actions might affect the Canadian tax consequences of the transactions in the case studies, since at this stage that would involve too much speculation.

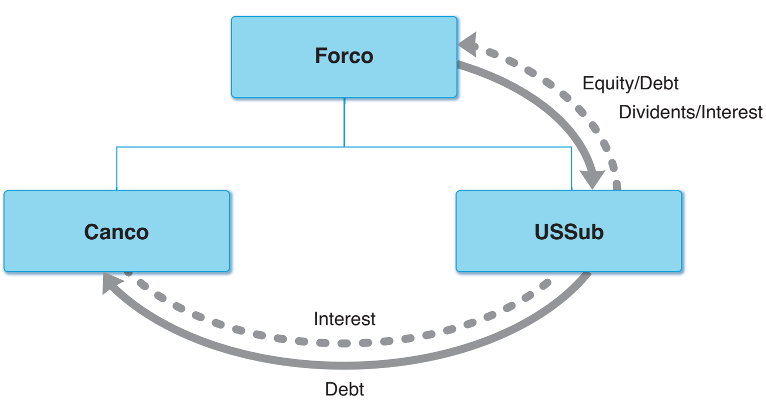
CASE STUDIES — COMMON INTERNATIONAL TAX-PLANNING ARRANGEMENTS

Case Study 1 — Inbound Treaty Shopping

FACTS

Forco is a corporation that is a non-resident of Canada. It has two direct wholly owned subsidiaries: Canco, a Canadian-resident corporation and USco, a U.S.-resident corporation. Forco holds a debt obligation issued by Canco that bears interest subject to Canadian withholding tax under Part XIII of the Income Tax Act.

Forco transfers the debt obligation to USco in consideration for (i) the issue of an interest-bearing note of USco having similar terms to the debt obligation of Canco, or (ii) additional common shares of USco. For the purposes of this case study, it is assumed that the relevant facts and circumstances would justify the competent authority of the United States in determining that the creation or existence of USco did not have as its principal purpose obtaining benefits under the Canada-U.S. tax treaty.



EXPECTED TAX RESULTS

Subject to the potential application of the beneficial-ownership requirement in Article XI and the general anti-avoidance reservation in paragraph (7) of Article XXIX-A (the limitation-on-benefits (LOB) provision) of the Canada-U.S. tax treaty, the expected tax treatment of the arrangement is that Canco would be permitted to deduct interest on the debt and no Canadian withholding tax would be imposed by virtue of the relief provided for such interest in Article XI of the tax treaty.

If the back-to-back nature of the arrangements is carefully structured to ensure that USco has sufficient control and discretion with respect to the interest payments it receives, based on the Canadian jurisprudence in *Prévost Car*[47] and *Velcro*[48] dealing with the meaning of the term "beneficial owner" used in Canada's bilateral tax treaties, it seems likely that under either alternative Canada would be required to regard USco as the beneficial owner of the interest it receives from Canco for purposes of Article XI of the Canada-U.S. tax treaty. The potential application of paragraph (7) of the LOB article to deny the treaty benefits of Article XI is less clear, particularly in the case of the back-to-back loan alternative in circumstances where USco is entitled to treaty benefits only as a result of a determination by the competent authority under paragraph (6) of the LOB article.

In general, the LOB article provides that a resident of either contracting state is entitled to all the benefits of the treaty if the resident is a qualifying person (as defined).[49] For purposes of the case study, it is assumed that USco is a qualifying person and therefore is considered to be a U.S. resident for purposes of the treaty. However, paragraph (7) of the LOB article provides that it "… shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under this Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of this Convention." The technical explanation (TE) explains that paragraph (7) of the LOB article reflects Canada's intention to preserve its right to apply the GAAR to override the LOB article in order to counter arrangements involving treaty shopping through the United States.[50]

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[47] *Prévost Car v. The Queen*, [2009] FCA 57.

[48] *Velcro v. The Queen*, [2012] TCC 57.

[49] A resident that is a corporation, such as USco, is a qualifying resident of the United States if (i) it is a company that satisfies a publicly traded test or that is a subsidiary of such a company, or (ii) it satisfies an ownership test and a base-erosion test. Where a resident of the United States is not a qualifying person, it is denied any treaty benefits except as provided in paragraphs (3), (4) and (6) of the limitation-on-benefits article. A resident of a contracting state that is not a qualifying person may be entitled to claim benefits with respect to certain items of income under paragraph 3 that are connected with the active conduct of a trade or business in the contracting state or under a derivative-benefits test contained in paragraph (4) if the owner of the entity would have been entitled to the same benefit had the item of income been earned directly by that owner. Further, paragraph (6) of the limitation-on-benefits article provides that the competent authority of Canada shall, upon the request of the person, determine on the basis of all factors including the history, structure, ownership and operation of the person, whether its creation and existence had as a principal purpose the obtaining of treaty benefits that would not otherwise be available. Further, where the determination is made that there was no such principal purpose in respect of such treaty benefits, paragraph (6) provides that the U.S. resident shall be granted the treaty benefits. Consistent with the language of paragraph (6), the CRA has confirmed that where the absence of a principal purpose is determined, its application is mandatory and not discretionary.

[50] The statement in the technical explanation to the treaty that the treaty does not prevent the application of domestic anti-abuse rules and that this is inherent in all Canadian (and U.S.) tax treaties rings a bit hollow. However, it seems clear that the statement is at least accurate with respect to the Canada-U.S. tax treaty by virtue of paragraph (7). In paragraph (7), Canada and the U.S. have done exactly what the OECD commentary on Article 1 before 2003 stated should be done to ensure that the provisions of a treaty do not prevent the application of domestic anti-abuse rules — that is, include an express provision in the treaty to that effect.

At first blush, the circumstances described in the case study, particularly the back-to-back debt alternative, seems to be the type of treaty shopping that might have been contemplated by Canada's treaty negotiators. The problem, however, is that the juxtaposition of the detailed LOB article on the one hand, and paragraph (7) on the other hand, is difficult to reconcile. A strong case can be made that the GAAR should have no application to deny Article XI treaty benefits to USco in either alternative in the case study. The LOB article is a specific and comprehensive anti-avoidance rule aimed at treaty shopping[51] and therefore it would be inappropriate for the GAAR to supplement this express rule. On the other hand, it can certainly be argued, particularly with respect to the back-to-back debt alternative, that paragraph (7) should permit Canada to apply the GAAR to deny treaty benefits under Article XI for the interest paid by USco because otherwise paragraph (7) would be meaningless.[52] Nevertheless, in our view, based on the GAAR cases to date, it would be difficult for the Crown to successfully assert that the GAAR should apply (on its own, or in conjunction with paragraph (7) of the LOB article) to either financing alternative in the case study.

The case study presents the issue of the proper interpretation of paragraph (7) where Canada is the source state and raises the principle of reciprocity in treaty construction. A principle of treaty construction is that contracting states should be presumed to have intended the treaties to operate on a reciprocal and symmetrical, although not identical, basis. The principle of reciprocity in treaty construction is well established — it is consistent with the fact that bilateral tax conventions are essentially contracts between the two contracting states with

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[51] Treaty shopping is defined in the technical explanation to include circumstances where a resident of a third state interposes a resident of a contracting state to obtain treaty benefits. No other Canadian bilateral tax treaty has a reciprocal limitation-on-benefits article. The Department of Finance has confirmed that Canada agreed to the limitation-on-benefits article because of the zero rate of withholding tax under the treaty for related-party cross-border interest under Article XI. Canada was concerned that a third-country resident could use a back-to-back financing or similar arrangement through a U.S. stepping stone. Given this background, the argument is that, where the limitation-on-benefits article applies to permit treaty benefits in respect of an item of income (especially the specific rules set out in paragraphs (3) through (6)) there is no basis for the application of the GAAR to deny that result. In particular, paragraph (6) makes express provision for a specific exception to the application of the limitation-on-benefits article where the competent authority determines that the creation and existence of a person that is resident of a contracting state was not principally for the purpose of obtaining treaty benefits that would not otherwise be available. This exception is compelling evidence that the contracting states intended that a person, such as USco, that is a resident of a contracting state and whose creation and existence was not principally for the purpose of obtaining treaty benefits, should be entitled to treaty benefits. In short, the argument is that the contracting states specifically addressed those residents of a contracting state who should be denied treaty benefits and created a specific exception for residents such as USco.

[52] The technical explanation confirms that the other provisions of the limitation-on-benefits article and paragraph (7) are aimed at treaty shopping. The technical explanation states that paragraph (7) is not a "residence-based" provision. While sufficient nexus with a country is the normal focus of treaty shopping, the technical explanation provides that the proper focus of paragraph (7) is the nature of the particular transaction or arrangement effected by residents of the contracting states to generate the entitlement to treaty benefits — including the residence nexus. Thus, the other provisions of the limitation-on-benefits article and paragraph (7) tests are separate and fundamentally different in nature. The focus of the test contemplated in paragraphs (1) through (6) of the limitation-on-benefits article is the taxpayer's nexus to the contracting state of residence — thus, the focus is "residence" treaty shopping. On the other hand, paragraph (7) operates as an anti-abuse rule to limit treaty shopping where a resident of Canada or the United States effects a particular transaction or arrangement to which, where Canada is the source state, the GAAR applies, or where the United States is the source state, its substance-over-form or anti-conduit rules apply. Thus, it can be argued that the focus of paragraph (7) is "transaction-based" treaty shopping. Viewed in this way, paragraph (7) preserves the right of Canada and the United States to deny treaty benefits to treaty shopping and other abusive transactions on the basis of domestic general anti-avoidance rules in circumstances where it has been determined that the treaty benefits are otherwise available to a resident of the other contracting state that has a sufficient nexus with that state. This description of the role of paragraph (7) is consistent with the general approach adopted by the United States in Article 22 of the U.S. Model Income Tax Convention of Nov. 15, 2006 and the accompanying technical explanation.

respect to the sharing of tax jurisdiction over their residents. Thus, the principle of reciprocity would be relevant if Canadian courts were required to consider the proper interpretation of paragraph (7) of the LOB article in relation to the arrangements described in the case study, although it is difficult to predict how they would apply the principle.

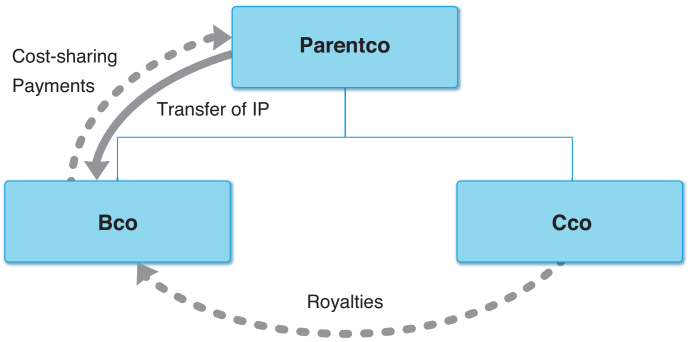
Case Study 2 — Outbound Transfer of Intellectual Property[53]

FACTS

Parentco is a multinational corporation engaged in the worldwide manufacture, distribution and sale of certain products. Parentco is resident in, and carries on business in Canada; it has significant investments in intellectual property (IP) and is actively engaged in the development and exploitation of that IP. The IP used in Canada was developed through research and development (R&D) activities carried out by Parentco and is owned by Parentco.

Parentco incorporates Bco and Cco, two direct, wholly owned subsidiary corporations. Bco carries on business in country B, a low-tax country and Cco carries on business in country C, a high-tax country. Parentco makes an outright sale to Bco of the rights to exploit the IP in the manufacture, distribution and sale of products outside Canada (i.e., the non-Canadian rights to the IP). Parentco retains the right to use the IP in its manufacture, distribution and sale of products in Canada. Parentco continues to conduct all R&D activities in connection with the development and enhancement of the IP. Cco carries on the business of the manufacture and sale of products using the IP in country C and other countries outside Canada.

There is a cost agreement between Parentco and Bco pursuant to which Bco makes payments to Parentco based on the anticipated future benefit that Bco expects to enjoy from the development and enhancement of the IP as a result of Parentco's future R&D activities in relation to the IP. Under the cost agreement, Bco is the owner of all of the newly developed IP, with the result that Cco is required to pay royalties to Bco for the use of the IP rights by Cco in the manufacture and sale of its products.



[53] For further examples of international tax planning structures involving intellectual property, see Annex C of the OECD Report, *Addressing Base Erosion*, 74-79.

EXPECTED TAX RESULTS

There are often two important issues to be considered in international tax planning involving IP. First, the IP owned by a corporation in a multinational group likely has significant value; thus, its transfer or licence to related entities in the multinational group is subject to the transfer pricing and other tax provisions of the relevant countries dealing with non-arm's-length transactions. Second, to maintain the commercial value of the IP, it may be necessary for the original owner of the IP to continue to engage in R&D activities to develop and enhance the IP.

In the case study, the outright sale of the IP rights by Parentco is a taxable transaction for Canadian tax purposes. The transaction will likely be characterized as a capital transaction so that only 50 per cent of any gain will be included in Parentco's income. The valuation of the IP is obviously critical. The royalties paid by Cco to Bco for the IP rights used by Cco in the manufacture and sale of products are deductible in computing the income of Cco and may not be subject to withholding tax by country C, depending on the tax treaty between countries B and C. The royalties received by Bco will not be subject to substantial tax in country B. Under the Canadian FAPI rules, the royalty payments received by Bco are not included in computing Bco's FAPI, either because they are income from an active business[54] or are deemed active business income under subparagraph 95(2)(a)(ii) and therefore are not included in Parentco's income. Thus, the royalties reduce the income of Cco taxable in country C tax but do not result in any income for Parentco pursuant to the FAPI rules. The royalties would be included in Bco's exempt surplus as long as Bco is resident in a treaty country.

If dividends are paid by Bco to Parentco, they would not be subject to country B withholding tax and would be exempt from tax in Canada as dividends out of Bco's exempt surplus. Thus, Bco operates as a tax-effective holding corporation — first, to hold the non-Canadian IP rights and, second, to receive royalty payments from Cco and convert them into tax-exempt dividends, thereby permitting the indirect tax-free receipt by Parentco of royalties from the IP rights developed by Parentco in Canada.

The tax treatment of the cost arrangement for Parentco depends, in particular, on whether the agreement is a cost-sharing or cost-reimbursement arrangement, the application of the transfer-pricing rules under Section 247, and the rules governing tax deductions for R&D. In general, however, a key tax objective of these structures is to ensure that Parentco is permitted to claim the available deductions and tax credits for its R&D expenditures in relation to the IP.[55]

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[54] The royalties would be excluded from the definition of an investment business if Bco employs more than five full-time employees in the active conduct of the business. For a large multinational corporation, this five-employee test is easy to satisfy.

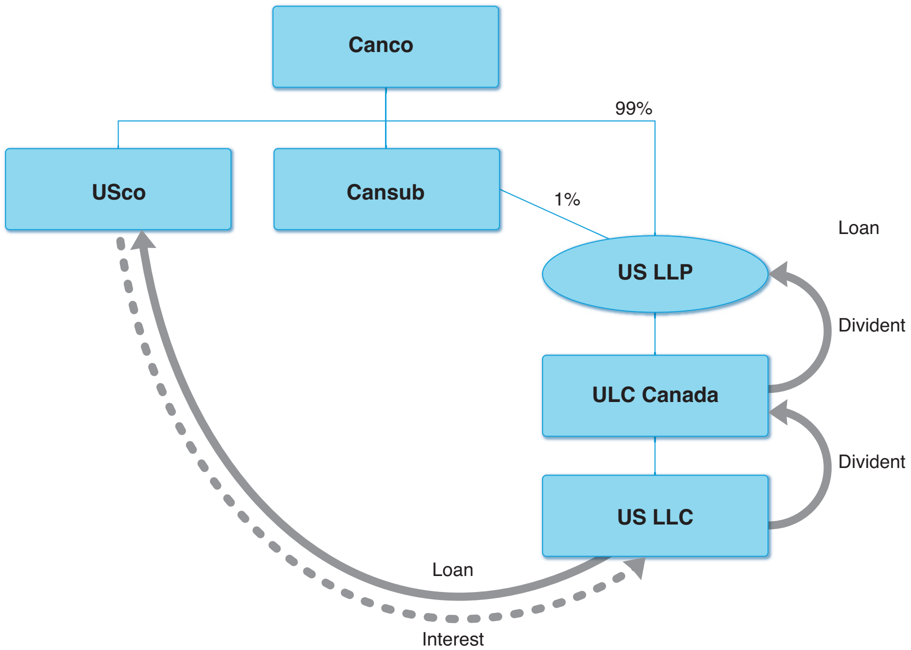
[55] In the Canadian context, for a discussion of the relevant tax considerations, see Tony Ancimer, "Cross-Border Intellectual Property Strategies," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 36:1-39. The OECD *Action Plan on BEPS*, 20, identifies the need to "[D]evelop rules to prevent BEPS by moving intangibles among group members." The key focus of these rules will be to settle on a broad and clear definition of intangibles, ensure that profits associated with the transfer and use of intangibles correspond to value creation, develop special measures for hard-to-value intangibles, and update guidance on cost contribution arrangements. It is expected that the work on this particular action in the Action Plan will reflect the OECD's *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (2013). In that connection, the discussion draft notes that it is a work in process because it deals with issues to be dealt with by the OECD as part of the implementation of the OECD *Action Plan on BEPS*. In general, the discussion draft is intended to provide specific guidance with respect to transfer pricing for use in determining appropriate arm's-length pricing for transfers of intangibles; this guidance is intended to supplement the proper application of Article 9 of the OECD model.

Case Study 3 — Outbound U.S. Tower Financing Structures

FACTS

Canco, a Canadian-resident corporation, uses a "tower" financing structure to finance its U.S. subsidiaries and to generate a double interest deduction — one in Canada for Canco, and one in the U.S. for USco, a wholly owned U.S.-resident operating subsidiary of Canco. This double deduction is achieved by having a partnership — of which Canco is the principal partner along with Cansub, a wholly owned Canadian-resident subsidiary of Canco — borrow funds from an external lender. The borrowed funds are indirectly loaned by the partnership to USco. The structure relies on subparagraph 95(2)(a)(ii) to effectively convert the interest payments made by USco to tax-deductible exempt surplus dividends.

In a typical "long-stack" tower structure,[56] Canco (as the sole limited partner) and Cansub (as the sole general partner) form a limited partnership under the laws of Delaware. Cansub's general partnership interest is typically not greater than one per cent. A check-the-box election is made under U.S. tax law to treat the partnership as a corporation for U.S. federal income tax purposes. The partnership borrows funds from an external lender and uses the borrowed funds to acquire shares of ULC, a wholly owned Canadian-resident subsidiary that is an unlimited-liability corporation. A check-the-box election is made under U.S. tax law so that ULC is treated as a disregarded entity for U.S. tax purposes. ULC uses the funds to subscribe for shares of U.S. LLC, a U.S. limited-liability company. A check-the-box election is made under U.S. tax law to treat U.S. LLC as a disregarded entity. U.S. LLC uses the subscription proceeds it receives to make an interest-bearing loan to USco, a wholly owned U.S.-resident subsidiary of Canco. The interest rate on this loan is higher than the interest rate on the external loan made by the partnership.



[56] In a typical "short-stack" tower structure, the shares of U.S. LLC are held directly by the partnership instead of indirectly through an unlimited-liability corporation. The main advantage of using a short-stack as opposed to a long-stack tower structure is that the short-stack structure mitigates potential foreign-exchange exposure, if any, when the structure is unwound. Otherwise, the expected tax results of the short-stack tower should be the same as those for the long-stack tower.

EXPECTED TAX RESULTS

For Canadian tax purposes, ULC is a taxable Canadian corporation and U.S. LLC is a corporation and a controlled foreign affiliate of ULC. Since the interest income received by U.S. LLC in respect of its loan to USco is deductible by USco in computing its active business income for U.S. tax purposes, such interest income is recharacterized under subparagraph 95(2)(a)(ii) as active business income. The interest is not included in U.S. LLC's FAPI and is added to U.S. LLC's exempt surplus. The result is that U.S. LLC may pay tax-deductible exempt surplus dividends to ULC; in turn, ULC may pay dividends to the partnership. The interest payable by the partnership on its external loan is deductible in computing the partnership's income. The partnership allocates its income (the dividends received from ULC less the interest expense on the partnership's external loan) to its partners, Canco and Cansub; the allocations reflect their proportionate shares of the partnership's income. Canco and Cansub are entitled to a deduction under subsection 112(1) for their respective shares of the dividends received from ULC, and for their shares of the partnership interest expense on the external loan. In effect, the dividends are exempt from Canadian tax but the interest is deductible against the Canadian tax base.

For U.S. tax purposes, the interest expense of USco on its loan is deductible by USco in computing its income. Because both U.S. LLC and ULC are disregarded entities and the partnership is taxed as a corporation for U.S. tax purposes, the interest payable by USco on the loan is included in the partnership's income for U.S. tax purposes. However, because the interest payable on the partnership's external loan is deductible, the interest income of the partnership is substantially offset for U.S. tax purposes, and only the net interest income earned by the partnership is subject to U.S. tax. However, no foreign tax credit or deduction is available for Canadian tax purposes with respect to the U.S. tax payable on the partnership's net income because such taxes can reasonably be regarded as paid in respect of income from a share of a foreign affiliate. Accordingly, the U.S. income tax payable represents an actual cost of the tower structure. By virtue of the amendments made in the Fifth Protocol of the Canada-U.S. tax treaty to deal with hybrid entities, no treaty relief is available for distributions made by the partnership to its partners, Canco and Cansub. The result is that a U.S. 30 per cent withholding tax would apply to any distributions from the partnership.

KEY ASPECTS OF DOMESTIC LAW AND TAX TREATIES THAT MAKE AGGRESSIVE INTERNATIONAL TAX PLANNING POSSIBLE

In broad conceptual terms, international tax planning involves the reduction or elimination of source country tax, or residence-country tax, or both. Ignoring the technical details, in this section we attempt to identify the most basic elements of common international tax planning.

The reduction of source-country tax often involves deductible payments of interest, royalties or other amounts by an entity resident in the source country and/or taking advantage of a tax treaty to reduce the source-country withholding tax otherwise payable on the payments. It is obviously important for the deduction of the payments that any source-country rules limiting the amount of the deductions, such as thin-capitalization rules, be avoided.

Typically, international tax planning also involves the use of an intermediary entity in a tax haven or a country with a preferential tax regime that usually has a large treaty network. The intermediary's role is to receive payments from the source country without much, if any, tax and to avoid the receipt of payments directly by the parent corporation in its high-tax country of residence.

Alternatively, the use of a third-country intermediary can sometimes be avoided through the use of hybrid entities or hybrid instruments.[57] In the case of hybrid instruments or entities, payments are typically treated as deductible by the source country but are exempt from tax by the residence country. It is also critical that payments received by the intermediaries are not subject to the residence country's CFC rules, since that would make them subject to immediate residence-country tax. The funds received by the intermediary can be either retained by it and used to fund offshore activities of group companies or repatriated to the parent company in the form of dividends that qualify for the residence country's participation exemption.

The reduction of residence-country tax often involves the deduction of interest on borrowed funds used to earn exempt dividends from foreign affiliates or the diversion of domestic source income to foreign affiliates. In simple cases, the reduction in residence-country tax may be attempted through the manipulation of transfer prices. In more complex cases it may involve the transfer of intangible assets to a controlled foreign affiliate, as in Case Study 2.

From Canada's perspective as the country of source, several aspects of the tax system facilitate or enable the reduction of Canadian tax by non-resident individuals:

1. The thin-capitalization rules in subsection 18(4) with respect to interest paid by a Canadian corporation to a substantial non-resident shareholder may not be sufficiently robust, as discussed below.
2. There are no restrictions, other than a reasonableness limitation, on the deduction of payments other than interest to related non-residents even if they are subject to no or low taxation.
3. A wide variety of exemptions from Part XIII withholding tax on payments to non-residents is available. For example, interest paid by a resident of Canada to an arm's-length non-resident are exempt from withholding tax.
4. Reductions in the rates of Canadian withholding tax are available under the provisions of several tax treaties.
5. Canada has concluded tax treaties with tax havens and countries with preferential tax regimes, under which Canada gives up its right to tax certain amounts even if the other country does not tax those amounts or taxes them at a relatively low rate. Many of these treaties do not contain any effective anti-abuse provisions.
6. The case law under the GAAR with respect to inbound tax-avoidance transactions has been ineffective in combating such avoidance. In the major case on the issue — *MIL Investments* — the Federal Court of Appeal found that a clear case of treaty shopping did not result in a misuse or abuse of the provisions of the Income Tax Act. Similarly, the case law with respect to the concept of beneficial ownership under Canada's tax treaties — the *Prévost* and *Velcro* cases — is totally ineffective as a means of controlling inbound avoidance of Canadian tax by non-residents.

[57] See, for example, Case Study 1 in Appendix 1.

From Canada's perspective as the country of residence, the following aspects of the Canadian tax system facilitate or enable the avoidance of tax by Canadian multinationals:

1. The absence of any limitations on the deductibility of interest and other financing expenses by a Canadian corporation to earn exempt dividends from foreign affiliates.
2. Relatively weak FAPI rules — in particular, paragraph 95(2)(a), which deems certain inter-affiliate payments to be active business income, with the result that such payments are not subject to immediate Canadian tax under the FAPI rules and are included in exempt surplus so that they can be distributed to the Canadian parent as exempt dividends.
3. A generous participation exemption for dividends from foreign affiliates, which allows exempt surplus to be distributed first before any hybrid, taxable or pre-acquisition surplus. Although the participation exemption is limited to dividends out of the active business income earned in a country with which Canada has a tax treaty by a foreign affiliate resident in a country with which Canada has a tax treaty, Canada has an extensive network of tax treaties, including treaties with several countries that have preferential tax regimes and are used extensively for treaty shopping.
4. Weak foreign investment fund rules.
5. Few specific anti-avoidance rules with respect to outbound investment by Canadian multinationals.[58]
6. There are few cases under GAAR with respect to outbound tax-avoidance transactions. In our view, those cases suggest that GAAR may not be effective in controlling outbound tax-avoidance transactions.

It is also notable that certain aspects of the Canadian tax system with respect to outbound investment by Canadian multinationals facilitate the avoidance of foreign taxes by Canadian multinationals. Understandably, these aspects of the Canadian system are not overtly described in this fashion; however, the effect of the rules is clear. For example, paragraph 95(2)(a) allows Canadian multinationals to divert income from a related entity in a high-tax country to another related entity in a low-tax country by means of deductible payments. The election under Section 93 is an even more obvious example. If a foreign affiliate of a Canadian company realizes a capital gain from the sale of the shares of another foreign affiliate, Section 93 allows the Canadian company to elect to convert the gain into a deemed dividend. This deemed dividend reduces or eliminates the gain without the need for the foreign affiliate whose shares are sold to actually pay a dividend before the sale of its shares in order to reduce the gain (an actual dividend would likely be subject to foreign withholding tax).

[58] Subsection 95(6) is an exception in this regard. Although the provision was originally intended as a relatively narrow rule dealing with artificial arrangements to avoid controlled-foreign-affiliate status, it has been applied more broadly by the CRA. The CRA's broad interpretation of the rule was recently rejected by the Federal Court of Appeal in *The Queen v. Lehigh Cement Limited*, 2014 FCA 103. See Elizabeth J. Johnson, Genevieve C. Lille and James R. Wilson, "A Reasoned Response to the CRA's Views on the Scope and Interpretation of Paragraph 95(6)(b)," *Canadian Tax Journal* 54, 3 (2006): 571-632.

RESPONSES TO AGGRESSIVE INTERNATIONAL TAX AVOIDANCE

Introduction

Aggressive international tax avoidance must be curbed primarily by domestic anti-avoidance legislation and anti-abuse rules in tax treaties. Although judicial and administrative responses are important, they are not sufficient by themselves, especially since, in the absence of clear legislative rules, Canadian courts have not demonstrated any indication that they intend to play a significant role in this regard.[59] Domestic anti-avoidance rules with respect to international tax avoidance take two forms: specific rules and general rules. Neither specific anti-avoidance rules nor a general anti-avoidance rule are "silver bullets" to deter and counter purely domestic abusive tax-avoidance.[60] With respect to international tax avoidance, even a combination of specific anti-avoidance rules and a GAAR may be insufficient; an effective response to international tax avoidance requires co-ordinated international action by governments, as discussed in connection with the OECD's BEPS project.

Specific anti-avoidance rules have been used extensively by Parliament to counter tax avoidance. They are effective in that they can address unacceptable tax avoidance on a targeted and timely basis and are accurately described as "… the first lines of defence against tax avoidance."[61] However, these rules, have their limitations. In particular, they deal only with specific issues and, in most cases, only on a prospective basis in response to tax avoidance activity that has been identified, normally through the administration of the tax system. According to the U.K Tax Law Review Committee "[b]ecause it may be some years before the courts finally pronounce on a scheme's success or not, Parliament continues to change the law preemptively, to prevent the loss of large amounts of revenue."[62]

Specific anti-avoidance rules are often complex. This complexity often arises because the drafters attempt to "bulletproof" the rules in anticipation of expected tax-planning strategies to circumvent them.[63] As well, their specificity establishes clear boundaries (a so-called "road map") that may permit tax-avoidance strategies to be revised to circumvent them.

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[59] The courts play an important role in dealing with tax avoidance because they interpret the relevant domestic tax law and bilateral tax treaties. For some countries, the judicial response to tax avoidance may be an appropriate and adequate response to limit aggressive tax avoidance. Historically, that has been the situation of the U.S. and U.K. tax systems. To counter aggressive tax avoidance, U.S. courts have developed judicial anti-avoidance doctrines such as substance over form, step-transaction and business purpose; for their part, U.K. courts have developed the doctrines of step-transaction and pre-ordination. The Canadian experience has been different. The judicial response to tax avoidance in Canada before the introduction of the GAAR is summarized in Brian J. Arnold and James R. Wilson, "The General Anti-Avoidance Rule — Part 1," *Canadian Tax Journal* 36, 4 (1988): 829-887. A significant problem with the development of judicial anti-avoidance doctrines is that, if they develop at all, they only do so on a case-by-case basis over a long period of time. On this point, see TLRC, 1997 Report, 30. Further, these judicial anti-avoidance doctrines evolve in fits and starts — the development of the *Ramsay* principle by the U.K. courts illustrates the uneven and uncertain trajectory of such doctrines.

[60] TLRC, 2009 Report, describes the situation: "[A] GAAR may have a role to play as a line in the sand and as an aid to construction by the courts, but overseas experience and the review in this paper of the Finance Acts introduced over the past 11 years suggest that a GAAR is no more the solution than any of the other approaches."

[61] Ibid. at xiii.

[62] Ibid. at 5.

[63] Ibid. at para. 1.21: "There are incentives to draft anti-avoidance measures even more widely, even at the risk of catching innocent transactions, and to deal with any cases caught unintentionally by administrative concession." In this connection, the long and tortured experience involving the recently abandoned foreign-investment-entity rules is a case in point.

In light of the inherent limitations of specific anti-avoidance rules, it is not surprising that Canada, like many other countries, chose to supplement its legislative response to abusive tax avoidance by introducing a general anti-avoidance rule. Canada's reasons for doing so seem to mirror the experience of other countries. In particular, the Canadian GAAR was intended to provide a statutory framework to permit Canadian tax authorities to challenge "unacceptable" tax avoidance on a basis that would be sustained by Canadian courts.

In this section of the paper, we describe briefly the major specific anti-avoidance rules that Canada has adopted to deal with both outbound and inbound tax-avoidance transactions, as well as general rules such as the GAAR and transfer-pricing rules. The purpose of this discussion is to allow an assessment both of how the existing rules might be amended to make them more effective and what additional anti-avoidance rules might be adopted to deal with international tax avoidance. Following the discussion of domestic anti-avoidance rules, there is a discussion of the possible tax-treaty provisions that might be used to combat aggressive international tax avoidance.

Inbound Anti-avoidance Measures

THIN-CAPITALIZATION RULES

A common feature of modern tax systems is to permit a tax deduction for interest expense on funds borrowed to earn income from business or property. In Canada, interest expense is deductible in computing profits from a business or property provided that the borrowed funds are used to earn income.[64] Thus, subject to certain statutory limits, Canadian taxpayers can deduct interest on borrowed money used or purchase debt incurred for income-earning purposes. Another common feature of modern tax systems are companion rules — so-called thin-capitalization rules — that deny a deduction for the interest expense incurred by certain resident taxpayers on excessive debt owed to related non-residents. The Canadian thin-capitalization rules are contained in subsections 18(4) through (8) of the Income Tax Act; a general summary of the rules is set out below.[65]

The general purpose of thin-capitalization rules is plain enough: to ensure that the domestic tax base is not unduly eroded by tax-deductible interest payments to related non-residents. In general, the internal financing of corporations resident in a source country by a related non-resident can be effected by debt or equity investment. In addition to the legal and economic differences between debt and equity investment, there is usually a fundamental tax difference. In the case of interest paid on a debt investment, the tax rules of the source country normally permit resident corporations to claim a tax deduction in computing income for tax purposes.

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[64] Paragraph 20(1)(c) of the Income Tax Act provides for a deduction for interest on borrowed money and the unpaid purchase price of property where the borrowed money or property is used for an income-earning purpose. The interest must be paid or payable in respect of the subject taxation year pursuant to a legal obligation to pay interest on the borrowed money or purchase debt, and the amount deducted for tax purposes cannot exceed a reasonable amount.

[65] For an excellent discussion of the current state of the Canadian thin capitalization rules, see Mitchell Sherman and Carrie Smit, "Thin Cap Gains Weight," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 25:1-17.

In contrast, dividends paid on an equity investment are not normally tax deductible; thus, from a resident corporation's tax perspective, dividends are paid on an after-tax basis. Absent tax limits on interest deductibility in the source country, and subject to legal and economic considerations, there is a tendency for resident corporations owned by non-residents to be financed primarily with debt rather than equity. The tax advantages of debt financing are enhanced where non-residents can arrange to receive the interest on a low- or no-tax basis. The interest and dividends paid on a debt or equity investment are normally subject to withholding tax imposed by the source country, subject to reduction under an applicable tax treaty.[66] Further, any source-country withholding tax may give rise to a foreign tax credit for non-resident recipients if the residence-country taxes the interest.

Subsection 18(4) limits the deductibility of interest paid or payable by Canadian-resident corporations on "outstanding debts to specified non-residents" to the extent that the debt exceeds a debt-to-equity ratio. This provision was first enacted as part of the 1972 tax reform and has been regularly strengthened and expanded since its enactment, most recently pursuant to the 2012 federal budget. These changes have reduced the fixed debt-to-equity ratio from 3:1 in 1972 to the present 1.5:1.

In general, subsection 18(4) denies an interest deduction to the extent that the aggregate of debt held by certain "specified non-residents" exceeds a debt-equity ratio of 1.5:1. Subsection 18(4) applies to Canadian-resident corporations and trusts and partnerships in which Canadian-resident corporations and trusts are partners as well as to branches of certain non-resident corporations and trusts operating in Canada. In general, the equity amount of a corporation includes its retained earnings and contributed surplus and paid-up capital that was contributed to or is owned by specified non-resident shareholders of the corporation. In the case of a trust, in general its equity amount comprises its tax-paid earnings and contributions to the trust from specified non-resident beneficiaries, less any capital distributions made by the trust to those beneficiaries.

Subsection 18(4) applies to interest on "outstanding debts to specified non-residents." In the case of corporations, the outstanding debt is any debt or other obligation of the corporation to pay an amount to a "specified non-resident shareholder" of the corporation (or any non-resident person who does not deal at arm's-length with a "specified shareholder"). A "specified non-resident shareholder" of the corporation means a "specified shareholder" of the corporation who is a non-resident person. A "specified shareholder" of the corporation is a person who owns 25 per cent or more of the shares of the corporation by votes or value (whether alone or together with non-arm's-length persons). In the case of a trust, the outstanding debt is any debt or other obligation of the trust to pay an amount to a "specified non-resident beneficiary" of the trust (generally, a specified beneficiary of a trust means a non-resident person who, alone or together with non-arm's-length persons, owns 25 per cent or more of the fair market value of all interests of beneficiaries in the trust). For this purpose, the fair market value of the interest of a discretionary beneficiary means the beneficiary's maximum possible interest in the trust.

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[66] Generally, the Canadian withholding tax rate for dividends, related-party interest, rents, royalties and certain management and technical fees is 25 per cent of the gross amount of such items. The 25 per cent rate may be reduced under an applicable bilateral tax treaty. Most of Canada's tax treaties reduce the withholding tax rate on dividends to 15 per cent generally, and five per cent where the recipient owns 10 per cent or more of the shares of the Canadian-resident corporation; 10 per cent or 15 per cent on interest (however, the Canada-U.S. tax treaty provides for source-country withholding tax on interest to be reduced to zero per cent); and 10 per cent or 15 per cent on royalties.

A recent amendment extended the application of subsection 18(4) to debt of a partnership in which a Canadian-resident corporation is a partner. Under Canadian partnership law, for most purposes a partnership is not regarded as a legal person; rather, a partnership is a relationship that subsists between persons who carry on business in common with a view to profit. With one important exception, the notion that a partnership is not a legal person is respected in the provisions of the Income Tax Act. Many taxpayers considered that subsection 18(4) had no application to the debt of a partnership because the application of the provision was relevant only in computing income of corporations; because a partnership was treated as a separate person under subsection 96(1) for purposes of the computation of its income, the debt of the partnership could not be considered to be debt of its partners, including its corporate partners. The thin-capitalization rules have been amended to ensure that subsection 18(4) applies where a partnership has debt and one or more corporate partners are residents of Canada. In such circumstances, in applying subsection 18(4) to a corporate partner, the corporate partner must treat its specified proportionate share of the partnership debt as its debt; this amount is based on the corporate partner's share of the total income or loss of the partnership.

Where the thin-capitalization rules apply to debts of a partnership in which a Canadian-resident corporation is a partner, the partnership is not denied an interest deduction where the corporate partner's debt exceeds the 1.5:1 debt-to-equity ratio. Instead, the corporation has a deemed income inclusion under subsection 12(1.1) equal to the "excess" portion of the deductible interest of the partnership.

Pursuant to another recent amendment, where the deduction of an amount of interest that is paid or payable on the debt of a Canadian-resident corporation owed to a specified non-resident shareholder is denied under subsection 18(4), the denied amount is deemed to be a dividend paid by the corporation to the specified non-resident shareholder for the purposes of Part XIII of the Income Tax Act. The result is that the deemed dividend is subject to Canadian withholding tax, as reduced under an applicable tax treaty. Consequently, the portion of the interest that is treated as a deemed dividend is subject to Canadian withholding tax as a dividend, not as interest. Depending on the particular case, this treatment may result in an increase or a reduction in Canadian withholding tax.

With the exception of a longstanding rule in subsection 18(6) with respect to back-to-back loans made on condition, the application of subsection 18(4) is limited to circumstances where debt of Canadian-resident corporations or trusts, or certain non-resident corporations or trusts, is held by specified non-residents of these corporations or trusts. Thus, subsection 18(4) does not apply to arrangements that achieve the same or similar economic results but do not include such debt. For example, the provision does not apply to debt issued by a corporation or trust that is held by an unrelated non-resident person and is guaranteed by a specified non-resident shareholder or beneficiary of the corporation or trust. An extension of the subsection 18(4) thin-capitalization rules to include guaranteed debt in such circumstances was proposed in the 2000 federal budget; however, after considerable criticism, the government did not proceed with the proposal.

The Canadian thin-capitalization rules are generally in accordance with international standards. In certain respects, however, they are more rigorous than most other countries' thin-capitalization rules. For example, in most countries the rules apply only to resident entities controlled by non-residents. Further, most countries' rules are overridden by their tax treaties to the extent that the rules are not in accordance with the arm's-length standard; in contrast, Canada has protected the application of its thin-capitalization rules in its tax treaties.[67] In other respects, however, Canada's rules are not as rigorous as those of some other countries. For example, as noted above, the Canadian rules do not deal with guaranteed debt, nor do they take into account arm's-length debt owed by resident entities for purposes of determining whether the entities have excessive debt owed to non-residents. Thus, there are still some limited opportunities to tighten the thin-capitalization rules to make them more effective.

FOREIGN-AFFILIATE-DUMPING RULES

Canada recently enacted specific anti-avoidance rules aimed at curbing arrangements in which foreign multinationals caused shares[68] of related foreign corporations to be transferred to their Canadian-resident subsidiary corporations (so-called "foreign-affiliate dumping" or "debt pushdowns"). Such arrangements, among others, were considered by the government to inappropriately erode the Canadian tax base. The foreign-affiliate-dumping (FAD) rules were introduced in the 2012 federal budget:

> … in response to concerns that foreign-based multinational corporations were causing their Canadian-resident subsidiaries to make investments in non-resident corporations as a means of either leveraging the Canadian subsidiaries ("debt dumping") or repatriating their funds on a tax-free or deferred tax-basis ("surplus stripping").[69]

The government's move to introduce the FAD rules was not unexpected. The use of arrangements by foreign multinationals involving foreign-controlled Canadian corporations — which were designed to generate substantial tax-deductible Canadian (and sometimes foreign) interest or surplus stripping by repatriating Canadian tax-paid retained earnings without any matching income or gains subject to any meaningful Canadian tax, either current or future — was well-known and pervasive.[70]

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[67] The non-discrimination provision in most of Canada's tax treaties gives non-residents only most-favoured-nation treatment, rather than national treatment as provided in the OECD model. In the only treaty that provides national treatment for payments of interest to residents of the other contracting state — the treaty with the United States — the treaty contains a specific provision (Article XXV(7)) allowing the application of the Canadian thin-capitalization rules.

[68] The foreign-affiliate-dumping (FAD) rules are not restricted to acquisitions of shares of a foreign affiliate of a Canadian subsidiary; they apply to any "investment" made by the Canadian subsidiary. For this purpose, the term "investment" is broadly defined to include (i) shares or debt of a foreign affiliate, or an option to acquire such shares or debt, acquired by the Canadian subsidiary, (ii) a capital contribution to, or benefit conferred on, a foreign affiliate by the Canadian subsidiary, (iii) an amount owing by a foreign affiliate that is acquired by the Canadian subsidiary (other than for certain limited exceptions where the amount becomes owing in the ordinary course of business of the Canadian subsidiary), (iv) a debt owing by a foreign affiliate to the Canadian subsidiary or preferred shares of the foreign affiliate held by the Canadian subsidiary if the maturity date of the debt or shares is extended, (v) an indirect acquisition that results from the continuation of a corporation to or from Canada, and (vi) an indirect acquisition where the Canadian subsidiary acquires shares of a Canadian corporation that derives over 75 per cent of its fair market value from shares of foreign affiliates.

[69] Angelo Nikolakakis and Penelope Woolford, "Foreign Affiliate Dumping," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Tax Conference Report (Toronto: Canadian Tax Foundation, 2013), 26:1-69.

[70] Canada, Auditor General of Canada, *2002 Report of the Auditor General to the House of Commons* (Ottawa: Public Works and Government Services Canada, 2002), at paragraphs 11:64 and 11:65. See also Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008), recommendation 5.3, at 69, where the panel recommended that the government "[c]urtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected."

The FAD rules are contained primarily in Section 212.3 and have two basic thrusts — one dealing with leveraged FAD and the other with FAD involving internal funds.

Where a foreign-controlled Canadian subsidiary acquires (directly or indirectly) shares of a non-resident corporation for debt, the FAD rules provide for an immediate deemed dividend to have been paid by the Canadian subsidiary. The amount of the deemed dividend is the principal amount of the debt in excess of the paid-up capital of the shares of the Canadian subsidiary owned by the foreign parent (or a non-arm's-length foreign corporation). The deemed dividend is subject to the normal Canadian withholding tax rules. The result of the deemed dividend is that, in the case of a leveraged FAD, in effect Canada extracts a toll charge in the form of Canadian withholding tax.

Where internal funds of a foreign-controlled Canadian subsidiary are used to acquire (directly or indirectly) the shares of a non-resident corporation, the FAD rules also provide for a deemed dividend to be paid by the Canadian subsidiary. The amount of the deemed dividend is the amount by which the acquisition price for the shares exceeds the paid-up capital of the shares of the Canadian subsidiary owned by the foreign parent (or a non-arm's-length foreign corporation).[71] The effect of the rule is to treat this excess as the repatriation by dividend of the surplus of the Canadian subsidiary. The deemed dividend is subject to the normal Canadian withholding tax rules. Thus, the consequences of the application of the FAD rules for an internal funds FAD arrangement are the same as for a leveraged FAD arrangement — to extract a toll charge for such arrangements in the form of immediate Canadian withholding tax.

For both leveraged- and internal-funds FAD arrangements, at the time or as a consequence of the acquisition of its shares, the foreign corporation must be or become a foreign affiliate of the Canadian subsidiary. Further, the FAD rules contain several important exceptions. First, an exception is provided where the shares of a foreign corporation may be regarded as part of a "strategic" or "more closely connected" expansion of the business of a Canadian subsidiary, as determined in accordance with detailed requirements.[72] Second, a further exception is made where shares of a foreign corporation are acquired by a Canadian subsidiary in certain

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[71] Because an internal-funds FAD arrangement does not create the same Canadian tax-base erosion as a leveraged FAD, the paid-up capital reduction in respect of the deemed dividend under the FAD rules is not limited to that in respect of the Canadian subsidiary, but includes the paid-up capital of any related Canadian corporations. This enhancement is achieved through a dividend substitution mechanism.

[72] In general, for this so-called "more-closely-connected" exception to apply to the acquisition of shares of a non-resident corporation by a Canadian subsidiary, the acquisition must meet certain conditions. In particular, the business activities of the subject non-resident corporation (and corporations in which it has an interest) must be more closely connected to the business activities carried on in Canada by the Canadian subsidiary (or other non-arm's length Canadian corporations) than to the business activities of any other group non-resident corporation that is not the subject non-resident corporation, a corporation in which it has an interest, or an existing controlled foreign affiliate of the Canadian subsidiary. Further, officers of the Canadian subsidiary must be the principal decision-makers with respect to the making of the acquisition in the subject non-resident corporation and have the ongoing decision-making authority with respect to the shares; and, a majority of those officers must be resident and working principally in Canada or in a country in which the subject non-resident corporation or the relevant "connected foreign affiliate" of the Canadian subsidiary is resident. It is expected that it will be difficult for these and other similar requirements of the more-closely-connected exception to be met.

corporate reorganizations that meet detailed requirements.[73] Third, the FAD rules do not apply where a Canadian subsidiary acquires shares of a foreign corporation as part of a series of transactions and the Canadian subsidiary is controlled only by a non-resident corporation prior to the acquisition.[74]

From a tax-policy perspective, the FAD rules constitute an effective but arguably flawed approach to their targeted "mischief." They are effective because the toll charge they impose should deter leveraged- or internal-funds FAD arrangements; however, the FAD rules are complex and difficult for taxpayers, the CRA and, ultimately, the courts to interpret and apply. They are also based on a questionable assumption in that they effectively treat a Canadian subsidiary as having distributed funds out of the Canadian tax system in consideration for property while that property remains subject to Canadian taxation.

Where the FAD rules apply to the acquisition of the shares of a non-resident corporation by a foreign-controlled Canadian-resident subsidiary, the result is a deemed dividend to its controlling foreign parent. Where the foreign parent does not actually own shares directly in the Canadian subsidiary, the reduced rate of withholding tax under Canada's bilateral tax treaties may not be available because the relevant treaty provisions permit a reduced rate for dividends paid only on directly held shares of the paying Canadian-resident corporation. To address this and other tax treaty problems, the FAD rules provide for a dividend-substitution rule.

Under the dividend-substitution rule, the relevant corporations in a foreign parent-controlled group that includes the Canadian subsidiary can elect to have all, but not less than all, of any deemed dividend to be paid by a related Canadian-resident corporation to the foreign parent or another related non-resident corporation. Further, to the extent that a dividend is deemed to have been paid by a related Canadian-resident corporation pursuant to the election, the paid-up capital-reduction rule applies automatically in respect of the corporation. The result is that where the dividend-substitution election is made, it results in the greatest possible reduction of cross-border paid-up capital (up to the amount of the deemed dividend).

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[73] In general, the FAD rules do not apply where, at the time the shares of a foreign subsidiary are acquired by a Canadian corporation, it was not controlled by a particular non-resident corporation and only thereafter becomes controlled by that non-resident corporation as part of a series of transactions, and if one of three conditions are met: (i) at the time of acquisition, the non-resident corporation (alone or together with non-arm's-length persons), owns 25 per cent by votes or value of the shares of the Canadian subsidiary, (ii) the shares of the foreign subsidiary are in substance preferred shares, and the foreign subsidiary is not a "subsidiary wholly owned corporation" of the Canadian subsidiary throughout the series of transactions or events that include the acquisition, or (iii) under an arrangement in connection with such acquisition, a person or partnership other than the Canadian subsidiary or a related person has in any material respect the risk of loss or opportunity for gain or profit with respect to a property that can reasonably be considered to relate to the shares of the foreign subsidiary.

[74] In general, the FAD rules do not apply to the acquisition of the shares of a foreign subsidiary by a Canadian corporation where a non-resident corporation controls a Canadian subsidiary before its acquisition of the shares and, as part of a series of transactions or events that includes the acquisition, the Canadian subsidiary is not controlled by the non-resident corporation at the time of the acquisition and does not become controlled by the non-resident corporation after that time as part of the series. Another important exception from the application of the FAD rules is a "pertinent loan or indebtedness" (PLOI). As discussed in this paper, in general a PLOI is an amount owing by a foreign affiliate to a Canadian subsidiary in respect of which an election is made to treat it as a PLOI. As a result, the amount is subject to special interest imputation rules rather than the FAD rules.

The FAD rules provide for an automatic paid-up capital reduction where the amount of a deemed dividend is not less than the aggregate amount of paid-up capital of all cross-border classes of shares. In this case, the aggregate amount of paid-up capital is reduced to nil, and the amount of the deemed dividend is reduced by the same aggregate amount. Where the deemed dividend amount is less than the aggregate amount of paid-up capital, the deemed dividend is reduced to nil and the aggregate amount is reduced by the amount of the deemed dividend.[75]

The FAD rules permit a paid-up capital reduction that results from the operation of the rules to be reinstated at a subsequent time. Thus, in specified circumstances, the paid-up capital reduction of a Canadian-resident corporation may be reinstated immediately before the corporation makes a distribution of property as a dividend or a reduction of capital. Effectively, the rule permits a reinstatement of paid-up capital that allows the distribution of the shares of a foreign affiliate (or other "investment") that triggered the original application of the FAD rules without the imposition of withholding tax.

SHAREHOLDER-LOAN RULES

Where a loan is made by a Canadian-resident corporation to a non-resident shareholder or a person "connected" with that shareholder (other than a foreign affiliate of the Canadian corporation), the loan is deemed to be a dividend paid to the non-resident shareholder if it is not repaid within one year after the end of the taxation year of the lender or creditor in which the loan arose.[76] The deemed dividend is subject to Canadian withholding tax at a 25 per cent rate subject to reduction pursuant to an applicable tax treaty. The withholding tax is recoverable if, and when, the loan is repaid, except where the repayment is part of a series of loans and repayments.

In connection with the new foreign-affiliate-dumping rules, a new exception to the shareholder-loan rules was introduced for a loan or indebtedness that qualifies as a "pertinent loan or indebtedness" (PLOI).[77] In general, a PLOI is defined as an amount owing (whether a loan received or indebtedness incurred) by a non-resident corporation to a Canadian-resident corporation to which the shareholder-loan rules would apply if: (i) it became owing after March 28, 2012 (ii) the Canadian-resident corporation is controlled by the non-resident corporation (or another non-resident corporation that does not deal at arm's length with the non-resident corporation), and (iii) a joint election by the Canadian corporation and the non-resident corporation is made for the PLOI exception to apply.[78] The PLOI exception applies on a loan-by-loan basis.

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75 To the extent that the automatic paid-up capital reduction in the FAD rules applies to reduce (or eliminate) a deemed dividend, an adverse result may be the creation of a thin-capitalization problem under subsection 18(4) (discussed above).

76 Subsection 15(2).

77 Subsection 15(2.11).

78 A PLOI election may also be made in respect of certain amounts owing by a partnership of which a non-resident corporate debtor is a partner, and for amounts owing to a "qualifying Canadian partnership." The election in respect of each PLOI must be filed before the Canadian corporation's filing due date for the taxation year in which the indebtedness arises, or, in the case of a qualifying Canadian partnership, before the Canadian corporation's filing due date for its taxation year in which the partnership's fiscal period ends (the fiscal period includes the time the amount owing arises), although late filing within three years of the normal filing due date is available in certain circumstances.

If a PLOI election is made for an amount owing to a Canadian-resident corporation, the corporation must include deemed interest income in respect of the PLOI in its income, computed at a prescribed rate.[79] Any actual interest that is paid or payable on the amount owing is credited against the deemed-interest-income inclusion. Where an amount owing would otherwise be a PLOI, it is deemed not to be a PLOI where, by virtue of the application of a bilateral tax treaty, the amount of the deemed interest inclusion of the Canadian-resident corporation is less than it would be absent the tax treaty.[80] This provision seems intended to address circumstances where, under the competent authority procedure in a tax treaty, the amount of deemed interest included in income is less than the prescribed rate.

SECTION 17 — LOW-INTEREST OR INTEREST-FREE DEBT OWED BY NON-RESIDENTS TO CANADIAN CORPORATIONS

In general, Section 17 prevents the erosion of the Canadian tax base through low-interest or interest-free loans (or other indebtedness) to non-residents. If the indebtedness remains outstanding for more than one year without interest at a reasonable rate, interest is included in the Canadian corporation's income at the prescribed rate. Section 17 was amended in 1999 to broaden the provision and make it more effective. For example, Section 17 applies to indebtedness owed to or from non-residents indirectly through partnerships and trusts.[81] However, it does not apply to low-interest or interest-free debts owed to a controlled foreign affiliate of a Canadian corporation if the funds are used to earn income from an active business, including deemed active business income under subparagraph 95(2)(a)(ii).[82]

Under subsection 17(2), Section 17 is extended to certain indirect loans or indebtedness to non-residents that are not controlled foreign affiliates of a Canadian corporation. Subsection 17(2) is an anti-avoidance rule that prevents non-residents that control Canadian corporations from avoiding subsection 17(1). Subsection 17(2) applies where a non-resident owes an amount to a person or partnership other than a Canadian-resident corporation and the amount became owing because a Canadian corporation loaned or transferred property directly or indirectly to anyone. In this situation, the debt is deemed to be owed by the non-resident to the Canadian corporation directly so that interest at the prescribed rate is included in the corporation's income under subsection 17(1). The rules in subsection 17(2) do not apply to certain arm's-length loans and transfers or to commercial loans or loans between controlled foreign affiliates.

Subsection 17(2) was very controversial when it was introduced because it had a major impact on standard tax planning by non-resident corporations with Canadian subsidiaries. It marked the beginning of the increasing focus by the Department of Finance on tax avoidance by non-residents, which in time led to the foreign-affiliate-dumping rules and the recent proposed anti-treaty-shopping rule.

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[79] Section 17.1. Generally, the prescribed rate is the relevant three-month Government of Canada treasury bill rate (rounded to two decimal places), plus four per cent.

[80] Subsection 17.1(3).

[81] Subsection 17(4)-(6).

[82] Subsection 17(8).

SECTION 212.1

Section 212.1 is an anti-surplus-stripping provision that prevents a non-resident that owns shares in a Canadian corporation from converting the corporation's surplus into proceeds from the disposition of the shares of the corporation. In the absence of Section 212.1, where a non-resident sells shares of a Canadian corporation to another Canadian corporation with which the non-resident does not deal at arm's length, the non-resident would realize a capital gain on the disposition. If the non-resident is a resident of a country with which Canada has a tax treaty, the capital gain might be exempt from Canadian tax unless the value of the shares of the corporation is derived principally from real property located in Canada. In contrast, if the Canadian corporation distributes its surplus in the form of dividends to its non-resident shareholders, the dividends would be subject to Part XIII withholding tax. Even if the dividends qualified for a reduced rate of withholding under an applicable tax treaty, the Canadian tax would be at least five per cent.

Section 212.1 operates by deeming a dividend to be paid by the Canadian corporation to the non-resident to the extent that the fair market value of the non-share consideration exceeds the paid-up capital of the shares sold. This deemed dividend is subject to Part XIII withholding tax. To the extent that the non-resident receives shares of the purchaser corporation, the paid-up capital of those shares is reduced by an amount equal to the paid-up capital of the shares that are sold in excess of the fair market value of the non-share consideration. In this way, if the shares are subsequently redeemed, acquired or cancelled or their capital is reduced, the deemed dividend under Section 84 will be greater than it otherwise would be.

Outbound Anti-avoidance Measures

CONTROLLED-FOREIGN-CORPORATION RULES — THE FOREIGN-ACCRUAL-PROPERTY-INCOME (FAPI) RULES

The FAPI rules are intended to prevent Canadian residents from earning certain passive and business income through foreign corporations that they control. At the same time, the FAPI rules are not intended to adversely affect the ability of Canadian corporations to carry on active businesses outside Canada.

The FAPI rules are inextricably linked to the foreign-affiliate rules for dividends received from foreign affiliates of Canadian corporations. As discussed above, under the foreign-affiliate rules, dividends out of the exempt surplus of a foreign affiliate are exempt from Canadian tax; dividends out of hybrid surplus are taxable, with a credit for any foreign tax on the gains out of which the dividends are paid; dividends out of taxable surplus are taxable, with a credit for any underlying foreign tax paid by the foreign affiliate on the income out of which the dividend is paid and any foreign withholding tax on the dividend; and other dividends, referred to as dividends out of pre-acquisition surplus, are tax free but reduce the adjusted cost base of the shares of the foreign affiliate. Since Canada currently has tax treaties with over 90 countries and since dividends are deemed to be paid first out of exempt surplus, virtually all dividends paid by foreign affiliates to Canadian corporations are exempt from Canadian tax.

Passive income, including certain taxable capital gains, is not included in exempt surplus, and dividends out of such income and gains (dividends out of hybrid and taxable surplus) are taxable when distributed to Canadian shareholders. As a result, controlled foreign corporations can be used by Canadian residents to defer or postpone Canadian tax on passive income and certain capital gains. The role of the FAPI rules is predominantly to prevent abuse of this deferral of Canadian tax.

The FAPI rules are crucial to protect the integrity of the domestic tax base. In the absence of these rules, it would be relatively easy for Canadian taxpayers to divert Canadian source income to controlled foreign corporations. In the absence of the FAPI rules, any income diverted to or earned by such corporations could be retained and invested offshore.

The FAPI rules apply to Canadian residents who own shares of "controlled foreign affiliates" and to Canadian residents who are beneficially interested in certain non-resident trusts.[83] A "controlled foreign affiliate" is defined generally to be a foreign affiliate that is controlled, directly or indirectly, by five or fewer Canadian residents or by a Canadian resident and persons with whom the resident does not deal at arm's length.[84] For this purpose, control means legal control (i.e., the control that is exercised through the ownership of a majority of the shares voting in the election of the board of directors of the corporation). A foreign corporation may be controlled indirectly through the ownership of shares in one or more other corporations. A "foreign affiliate" is defined to be a non-resident corporation in which a Canadian resident owns 10 per cent or more of the number of shares of any class.[85] In addition, the Canadian resident must have an interest in the foreign corporation of not less than one per cent. For the purpose of the definition of a foreign affiliate, a taxpayer is considered to own any shares of a foreign corporation that are owned by related persons.

The status of a non-resident corporation as a foreign affiliate or controlled foreign affiliate is determined with respect to each Canadian-resident shareholder of the corporation. In effect, the FAPI rules apply only to non-resident corporations that are controlled by a small group of Canadian residents and only to those Canadian-resident shareholders that, together with related persons, own more than 10 per cent of any class of shares of the foreign corporation.

Any Canadian-resident shareholder of a non-resident corporation that is a controlled foreign affiliate of the shareholder must include in income its pro rata share of any FAPI of the affiliate for the year. This income inclusion is not required if the FAPI of the controlled foreign affiliate does not exceed a (meaninglessly small) de minimis threshold of $5,000 for each year.[86]

FAPI is defined to include income from property, income from investment-type businesses, certain taxable capital gains and certain business income derived from Canadian sources. The definition of FAPI was revised substantially in 1995; new definitions of income from property and income from an active business were added and several deeming rules were adopted to stop obvious abuses of the rules.

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[83] The treatment of non-resident trusts is beyond the scope of this paper; however, such trusts are often used in aggressive tax-avoidance schemes by wealthy individuals.

[84] Subsection 95(1), the definition of "controlled foreign affiliate."

[85] Subsection 95(1), the definition of "foreign affiliate."

[86] Subsection 95(1), the definition of "participating percentage." This amount has not been increased since the FAPI rules were introduced in 1976.

FAPI does not include so-called foreign-base company sales and services income. Thus, Canadian corporations can establish foreign subsidiaries to sell goods or render services to related parties outside Canada, or to sell goods acquired from their Canadian parent corporations to unrelated parties. Further, FAPI does not include certain payments such as interest, rent, and royalties received by a controlled foreign affiliate from another foreign affiliate of a Canadian taxpayer.[87] These payments are deemed to be active business income to the extent that they are deductible in computing the payer's earnings from an active business in the country in which it is resident. This provision enables Canadian multinationals to use double-dip financing structures and to establish international finance, holding and licensing companies in tax havens.

If the FAPI of a controlled foreign affiliate is included in a Canadian shareholder's income, the shareholder is entitled to relief for any income taxes paid by the controlled foreign affiliate on the FAPI and any foreign withholding taxes levied on dividends paid by it within five years.[88] Dividends from a controlled foreign affiliate are tax free to a Canadian shareholder to the extent of any previously included FAPI in respect of the affiliate.[89] Similarly, any subsequent capital gain realized on the disposition of shares of the controlled foreign affiliate is reduced by any previously included and undistributed FAPI. This relief is provided by way of various adjustments to the cost base of the shares of the controlled foreign affiliate.[90] Any FAPI included in a taxpayer's income is added to the adjusted cost base of the shares, while any subsequent dividends received on the shares and any deductions in respect of foreign taxes reduce the adjusted cost base of the shares. If a controlled foreign affiliate has a loss in respect of FAPI for a particular year, the loss is not attributable to the Canadian shareholders of the affiliate. Instead, the loss may be carried forward for 20 years and back for three years to reduce any FAPI of the affiliate in those years.[91]

Several aspects of the FAPI rules could be revised to make them more rigorous.[92] The following list of possible changes is not intended to be comprehensive, but illustrative only. Moreover, the issues in the list are not intended as firm recommendations but as suggestions of changes that might be considered:

- The definition of a "controlled foreign affiliate" could be broadened and disconnected from the definition of a "foreign affiliate."
- The scope of the definition of "foreign accrual property income" could be expanded to include foreign-base company income from sales and services with related parties outside the country in which the foreign affiliate is resident.
- Subparagraph 95(2)(a)(i) could be clarified.

[87] Subparagraph 95(2)(a)(ii). Before 2009, this provision also applied to payments received from related non-resident corporations.

[88] Subsection 91(4).

[89] Subsection 91(5).

[90] Subsections 92(1) and (2).

[91] Subsection 95(1), the definition of FAPI, amount F and Regulation 5903.

[92] See generally Brian J. Arnold, "Reforming Canada's International Tax System: Toward Coherence and Simplicity" (Toronto: Canadian Tax Foundation, 2009), 169-70.

- Subparagraph 95(2)(a)(ii) could be restricted to inter-affiliate payments between foreign affiliates resident in the same country or in listed high-tax countries. This change would adversely affect the ability of Canadian multinationals to reduce foreign tax and as a result, it might be conditional on other countries taking similar action.
- The definition of "investment business" could be revised to make it more effective; in particular, the exemption for businesses with more than five full-time employees should be deleted.
- The FAPI rules could be applied to all foreign affiliates of Canadian shareholders (i.e., Canadian residents owning 10 per cent or more of the shares of the foreign corporation) rather than only to controlled foreign affiliates. This change would effectively moderate the need for the foreign investment fund rules discussed below.

FOREIGN-INVESTMENT-FUND RULES

As discussed above, the FAPI rules apply only to controlled foreign affiliates of Canadian corporations; however, the exemption system for dividends applies to all foreign affiliates. Therefore, the FAPI rules could easily be avoided by ensuring that the shares of non-resident corporations are owned by unrelated residents of Canada, none of whom own more than 10 per cent of the shares of any class. Rules are necessary to prevent the avoidance of the FAPI rules in this way and, more generally, the deferral and avoidance of Canadian tax. These rules, called foreign-investment-fund rules or offshore-property rules, were originally introduced in 1984. In the 1999 federal budget, the government proposed to fundamentally overhaul the rules and replace them with more complex, detailed and rigorous rules. These proposals went through various iterations over a period of 10 years until 2010, when the government abandoned them.

Section 94.1 is a crude, simplistic and ineffective anti-avoidance rule.[93] In general, Section 94.1 applies to an interest in a non-resident entity that derives its value primarily from portfolio investments in passive assets unless none of the taxpayer's main reasons for acquiring the interest was to avoid Canadian tax. If the section applies, the taxpayer is required to include in income a notional rate of return on the interest, computed by applying the prescribed rate of interest to the cost of the interest.

The government should consider replacing the ineffective rules in Section 94.1 with measures that effectively prevent Canadian residents from using investments in non-controlled foreign affiliates to avoid Canadian tax. There are two basic options for achieving this objective. First, as noted above in connection with the discussion of the FAPI rules, those rules could be extended to apply to interests in non-controlled foreign affiliates. As a result, any FAPI earned by a foreign affiliate would be included in the income of any Canadian shareholder that owns 10 per cent or more of its shares. In effect, the same rules would apply to prevent the use of both controlled and non-controlled foreign affiliates to defer Canadian tax. Alternatively, detailed foreign-investment-fund rules along the same lines as the abandoned foreign-investment-entity proposals, but simplified and more certain, could be enacted.

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[93] The 1998 *Report of the Technical Committee on Business Taxation* (Department of Finance, April 1998) at 6.23 suggested that the CRA should apply Section 94.1 more aggressively.

UPSTREAM-LOAN RULES

Before the enactment of the "upstream loan" rules in subsections 90(6) through (15) in 2011, it was common tax planning for a Canadian-resident corporation to repatriate surplus funds from a foreign affiliate by way of loans rather than dividends. In any particular case, there might be legal and business advantages to using loans rather than dividends, but there might be important tax advantages as well. In particular, loans normally do not result in the imposition of foreign withholding tax, whereas dividends often do. Such loans permit the repatriation of the taxable or hybrid surplus of a foreign affiliate of a Canadian-resident corporation in respect of which little or no foreign tax has been paid.

In general, the upstream-loan rules are targeted at upstream loans made by a foreign affiliate to its Canadian-resident parent corporation.[94] They are designed to preclude a foreign affiliate making a loan out of its taxable or hybrid surplus where a dividend of the same amount would have resulted in a Canadian income inclusion that would not have been fully offset by deductions available under Section 113 in respect of the dividend. The rules, however, apply to any loan made by a foreign affiliate to a "specified debtor," defined to include the Canadian parent, any person who does not deal at arm's length with the Canadian parent, and certain partnerships. This extends the application of the rules to a loan made by a foreign affiliate to a related non-resident corporation (other than a controlled foreign affiliate of the Canadian parent).[95]

The main charging provision of the upstream-loan rules is subsection 90(6). It provides that where a specified debtor receives a loan from or becomes indebted to a foreign affiliate (a "creditor affiliate") of a Canadian taxpayer, a specified amount in respect of the loan must be included in the income of the Canadian taxpayer. The upstream-loan rules are modeled on the shareholder-loan rules of subsection 15(2) and, similar to those rules, an exception to the upstream-loan rules is made for a loan or indebtedness that is repaid within two years of the date it was made or incurred (except where the repayment is part of a series of loans and repayments). Another exception is made for loans and indebtedness with bona fide terms of repayment that arise in the ordinary course of the creditor affiliate's business.

In general, the specified amount that is included in a Canadian taxpayer's income is the amount of the loan. Where subsection 90(6) applies to require a specified amount to be included in the Canadian taxpayer's income, subsection 90(9) provides an offsetting deduction in each year during which the subject loan or indebtedness is outstanding if certain conditions are met. Generally, the Canadian taxpayer may deduct the amount that it could have deducted in computing its taxable income under subsections 113(1) and 91(5) if the specified loan had been distributed by the creditor affiliate to the Canadian taxpayer (directly or indirectly) as a dividend. The deductions include those available in respect of dividends out of exempt surplus under paragraph 113(1)(a), in respect of underlying foreign tax relating to dividends out of hybrid surplus under paragraph 113(1)(a.1), in respect of underlying foreign tax relating to

[94] The upstream-loan rules generally apply to loans made or indebtedness incurred after Aug. 19, 2011. The rules also apply to amounts owing on that date that remain outstanding on Aug. 19, 2014; these amounts owing are treated as if they were separate loans made or indebtedness incurred on Aug. 20, 2014. Thus, amounts owing on Aug. 19, 2011 that are repaid within three years after that date are not subject to the upstream-loan rules.

[95] This exclusion means that the upstream-loan rules have no application to loans made from one controlled foreign affiliate of a Canadian taxpayer to another.

dividends out of taxable surplus under paragraph 113(1)(b), and in respect of dividends out of pre-acquisition surplus under paragraph 113(1)(d) (to the extent of the relevant adjusted cost base of the shares of a foreign affiliate held by the Canadian taxpayer).[96]

The deductible amount permitted under subsection 90(9) is "locked in" at the time the loan is made and is generally computed by reference to the relevant tax attributes that would be available at that time.[97] The amount deducted under subsection 90(9) in a taxation year must be included in the taxpayer's income in the following year under subsection 90(12). However, the taxpayer may claim another deduction under subsection 90(9) in that year, provided the conditions of that provision continue to be met.

The upstream-loan rules contain a "back-to-back" anti-avoidance rule in subsection 90(7); this rule targets the use of an intermediary to avoid the rules. Generally, the back-to-back rule applies where an "intermediate lender" makes a loan to an "intended borrower" because the intermediate lender received a loan from an "initial lender." In such cases, subsection 90(7) provides that the loan made by the intermediate lender to the intended borrower is deemed to have been made by the initial lender to the intended borrower. The deemed loan is for an amount equal to the lesser of the loan between the initial lender and the intermediate lender and the loan from the intermediate lender to the intended borrower. The actual loans between parties are deemed not to have been made to the extent of the deemed loan from the initial lender to the intended borrower.

The explanatory notes of the Department of Finance to the upstream-loan rules contain a pointed caution that the GAAR would be used to prevent attempts to circumvent the rules:

> It should be noted that any attempts at circumventing subsection 90(6) or fitting into one of the exceptions in 90(8) or the deduction in subsection 90(9) that are not within the scope of the intended application of these rules, as set out in these notes, will be subject to review under the general anti-avoidance rule in section 245 of the Act. Among other things, it is intended that back-to-back loans, and similar financial arrangements — such as the factoring of receivables or the sale of securities at a discount — in order to avoid the application of subsection 90(6) would be considered misuse of these new provisions and an abuse of the Act (including its Regulations) read as a whole for purposes of section 245.

[96] A deduction in respect of pre-acquisition surplus, however, is not available if the specified debtor is a non-resident person with which the taxpayer does not deal at arm's length or a partnership with a non-resident member that does not deal at arm's length with the taxpayer.

[97] This computation assumes that an actual dividend had been paid by the creditor affiliate, followed by dividends from any other affiliates between the taxpayer and the creditor affiliate. In such cases, the surplus (and deficit) balances of those intervening affiliates would also be relevant. In addition, the surplus amounts of the creditor affiliate are based on a notional aggregation of surplus amounts from any foreign affiliates that are "downstream" from the creditor affiliate.

FOREIGN-TAX-CREDIT-GENERATOR RULES

The foreign-tax-credit-generator rules (FTC-generator rules) in subsections 91(4.1) - (4.7) were enacted on June 26, 2013 and target hybrid investments that are treated as equity under the tax laws of one country and debt under those of another country.[98] In particular, the rules target arrangements in which hybrid investments in foreign entities are used to create credits and deductions for foreign taxes for a taxpayer in circumstances where the taxpayer does not bear the economic cost of such taxes. In general, under these arrangements, foreign tax credits for taxes paid on foreign source income, and deductions for foreign accrual tax on FAPI of controlled foreign affiliates and underlying foreign tax on dividends received from foreign affiliates, are created through the use of hybrid instruments; the foreign tax credits and deductions apply to reduce the taxpayer's Canadian tax on related investment income. Where the FTC-generator rules apply to an investment of a taxpayer, the consequences are that the foreign tax relating to the investment is excluded in computing the taxpayer's foreign tax credits and deductions.

The explanatory notes to the 2010 budget proposal for the FTC-generator rules described the type of targeted arrangement as a repo transaction in which a Canadian-resident corporation acquires preferred shares in a related non-resident subsidiary from a vendor that is another related non-resident corporation. Under Canadian tax law, the Canadian-resident corporation is considered to be the owner of the shares in a foreign affiliate (and perhaps a controlled foreign affiliate, depending on the share arrangements). Under the relevant foreign law, the repo transaction is treated as a secured loan and the related vendor is the owner of the shares. The result of these asymmetrical characterizations of the repo transaction is that, for Canadian tax purposes, any FAPI of the subsidiary that must be included in computing the income of the Canadian-resident corporation is reduced by the foreign-accrual tax attributable to the FAPI.[99]

Provisions Affecting both Inbound and Outbound Transactions

TRANSFER PRICING

Historically, the OECD has been at the forefront of the development of the arm's-length transfer-pricing principle and guidance as to its application.[100] The Canadian transfer-pricing rules contained in Section 247 of the Income Tax Act embody the OECD arm's-length principle with an important addition, which in certain circumstances permits the re-characterization of a transaction effected by a taxpayer.

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[98] The rules were first proposed in the 2010 federal budget.

[99] Another type of arrangement that is targeted involves a U.S. partnership formed by two wholly owned U.S. subsidiary corporations of a U.S.-resident corporation. The partnership holds interest-bearing debt of its U.S. parent. One U.S. subsidiary corporation sells part of its partnership interest in a repo transaction to a Canadian corporation. For U.S. tax purposes, the repo transaction is treated as a secured loan; however, for Canadian tax purposes the Canadian corporation is regarded as a partner in the U.S. partnership. Thus, the Canadian corporation is entitled to claim any U.S. tax paid by the U.S. partnership in respect of the Canadian corporation's share of the partnership income. For a discussion of foreign tax credit generator arrangements and similar examples, see OECD *Report on Hybrid Mismatch Arrangements* (2012), 9-10, available at www.oecd.org.

[100] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2010). The 2010 revisions to the guidelines adopt the "most appropriate method to the circumstances" approach rather than the previous hierarchy of methods. For a review of the historical OECD initiatives dealing with transfer pricing and the impact on the development of transfer pricing rules and guidance in Canada, see Alfred Zorzi and Al Rizzuto, "The Rise and Dominance of Transfer Pricing in Canada," *Canadian Tax Journal* 61, Special Supplement (2013): 415-435. See OECD, *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (Paris: OECD, June 6, 2012).

In general, paragraph 247(2)(a) applies where a taxpayer and a non-arm's-length non-resident are participants in a transaction (or series of transactions) that has terms and conditions that differ from those that would be made between arm's-length persons. In such cases, the amounts otherwise determined in respect of the transaction or series for purposes of the Income Tax Act may be adjusted to reflect the quantum or nature of amounts that would have been determined if the participants dealt with one another at arm's length.

Paragraph 247(2)(b), the re-characterization rule, applies where a taxpayer and non-arm's-length person are participants in a transaction or series that (i) would not have been entered into if the participants dealt at arm's length, and (ii) may reasonably be considered to have been carried out primarily to obtain a tax benefit. In such cases, the amounts otherwise determined in respect of the transaction or series for purposes of the Income Tax Act may be adjusted to reflect the quantum or nature of amounts that would have been determined if the participants had carried out a transaction or series with terms and conditions that would have been agreed to by participants dealing at arm's length. This provision has not yet been considered by the courts and, except in a simple case, it is far from clear how the courts would interpret and apply the provision. For example, the CRA has suggested in audits that it may apply paragraph 247(2)(b) to re-characterize a taxpayer's debt as equity where the debt has certain equity characteristics; however, the taxpayer may have a counter argument that if the debt is re-characterized at all, it should be considered to be a debt with different terms.[101]

To date, there have been four significant Canadian transfer-pricing cases: *Canada v. GlaxoSmithKline Inc.*,[102] *McKesson Canada Corporation v. The Queen,*[103] *General Electric Capital Canada Inc.*,[104] and *Alberta Printed Circuits Ltd. v. The Queen*;[105] they are discussed in Appendix 2. In these cases — characterized by procedural delays, long, protracted and document- and expert-intensive trials, and lengthy decisions — it is apparent that the courts, the Crown and taxpayers have struggled with the transfer-pricing rules and their application. This is not surprising, for several reasons.

First, the transfer-pricing rules in Section 247 embody the arm's-length principle but provide no statutory guidance for the application of the principle. Instead, it has been left to the CRA, taxpayers and ultimately the courts to interpret and apply the rules in particular cases. As the Supreme Court made clear in *GlaxoSmithKline*, while the relevant OECD transfer-pricing guidelines (together with the CRA administrative positions set out *Information Circular* IC87-2R

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[101] The proper interpretation and application of paragraph 247(2)(a) is at issue in a pending case in the Tax Court of Canada. In the *General Electric* case, 2011 DTC 5011 (FCA) (discussed in Appendix 2), the Federal Court of Appeal rejected the CRA's application of paragraph 247(2)(a) to reduce guarantee fees paid by a taxpayer for its 1996 to 2000 taxation years. Based on documents contained in an annex to a Tax Court of Canada decision (reported as *General Electric Canada Company v. The Queen*, 2011 TCC 564), dealing with a procedural matter, the CRA apparently reassessed the successor corporation to the taxpayer for its 2002 and 2004 taxation years on the same issue but purported to apply the re-characterization rule in paragraph 247(2)(b) as well as paragraph 247(2)(a). The Crown's basic argument is that no arm's-length persons would have entered into the transaction or series that were effected by the successor corporation.

[102] 2012 SCC 52.

[103] 2013 TCC 404 (FCA).

[104] 2011 DTC 5011(FCA).

[105] 2011 DTC 1177 (TCC).

which is based on those guidelines)[106] offer guidance, Section 247 sets out a statutory test whose interpretation and application must be determined based on a textual, contextual and purposive reading of that provision.

Second, corporate globalization and the digital economy have outpaced the OECD transfer-pricing guidelines — in particular, the arm's-length principle may not be an effective standard for dealing with transfer-pricing transactions that involve the shifting of financial risks, intangibles, and the digital economy.[107] A frequently cited example of the last-mentioned is the transfer of intellectual property at an early stage of development.

The third reason relates to the efficacy of the arm's-length principle as an appropriate basis for establishing transfer prices. Its application in particular cases can be extremely difficult, even where the subject transactions are not overly complicated.[108] As a result, the application of Section 247 is proving costly and time-consuming for taxpayers (particularly given the attendant documentation requirements) from a compliance perspective and for the CRA from an audit and administrative perspective. Presumably, these costs explode in the context of tax disputes relating to transfer pricing — especially those that end up in tax litigation.[109]

There is a general recognition that transfer pricing has become an increasingly important issue for multinational enterprises and their advisers, national tax authorities, and the courts. The stakes are high, as is evident in the handful of Canadian transfer-pricing cases. In the last few decades there has been a convergence of assertive transfer-pricing planning by multinational enterprises, a spate of increasingly complex domestic tax legislation and OECD guidance to curb such planning, and more aggressive audit and reassessing activity on the part of domestic tax authorities targeting such planning. In the case of Canada, the result is a glut of high-profile transfer-pricing litigation — as noted, some cases have been decided, but a far greater number are at various stages in the tax appeal process. The image of a python that has swallowed a wildebeest seems apt.

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[106] In *Information Circular* IC87-2R, "International Transfer Pricing," Sept. 27, 1999, the CRA confirms its acceptance of the transfer-pricing approaches recommended in the OECD guidelines — the transactional methods (comparable uncontrolled-price method, resale-price method and cost-plus method), and the profit methods (profit-split method and transactional-net-margin method), with the transactional methods preferred in relation to the profit methods. The CRA administrative guidance is supplemented by transfer-pricing memoranda issued at irregular intervals by the International Tax Directorate.

[107] Whatever one's view of the effectiveness of transfer-pricing systems based on the arm's-length principle, a canvass of the transfer-pricing cases supports Robert Couzin's comment that "[T]ransfer pricing is an expensive hobby." Couzin challenges the conventional thesis that a transfer-pricing system based on the arm's-length principle is an effective model for determining the appropriate allocation of income for a multinational enterprise. He makes the case that the arm's-length principle has proved difficult to apply to multinational groups and forces multinational enterprises to adopt a disaggregating separate entity, transaction-by-transaction, approach to a multinational enterprise, which ignores the essence of its reality — "it ignores the inescapable fact that many activities, relationships, and transactions occur within an MNE but never outside of one." See Robert Couzin, "The End of Transfer Pricing?" *Canadian Tax Journal* 61, 1 (2013): 159-78.

[108] In more complicated cases, such as transactions involving intangibles, the practical difficulties of applying the arm's-length principle are exacerbated. This is evident if one reads OECD, *Discussion Draft: Revision* on special consideration for intangibles.

[109] In *General Electric Capital Canada Inc. v. The Queen*, which dealt with the award of costs of the taxpayer's counsel, the Tax Court disclosed that the taxpayer had incurred $7.5 million of solicitor-client fees in the trial.

DISCLOSURE REQUIREMENTS FOR AGGRESSIVE TAX PLANNING

In its *Action Plan on BEPS*, the OECD states that taxpayers should be required to disclose their aggressive tax-planning arrangements. To that end, the OECD has identified as a specific action the need to "[D]evelop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules."[110]

In recent years, a key focus of OECD efforts to curb aggressive tax avoidance has been adequate disclosure by taxpayers. In its 2011 report, *Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure*,[111] the OECD stated with respect to the strategies that it had developed to deal with aggressive tax planning:

> [T]he underpinning of any such strategy, and one of the most important response strategies in itself, is ensuring the availability of timely, targeted and comprehensive information, which traditional audits alone can no longer deliver. The availability of such information on a timely basis is essential to enable governments to quickly identify risk areas and decide whether and how to respond to it. To improve information flows, several countries have developed, or are in the process of developing measures that either require or provide incentives for taxpayers to disclose instances of aggressive tax planning or tax risk more generally (disclosure initiatives). Taxpayers are best placed to know which issues will be of relevance to tax authorities. A system which starts with upfront disclosure of such information not only allows for quicker tax dispute resolution and improved legal certainty, but also holds the potential for significant reduction in cost through better allocation of resources for both governments and taxpayers.

Aggressive tax planning is difficult to identify during a traditional audit process, especially with respect to transactions that are complex and involve related corporations in different countries. Further, even where aggressive tax planning is identified in an audit, the audit often takes place several years after the fact and the scope of such planning may be difficult to determine from an administrative and policy perspective. In its 2011 report on disclosure, the OECD canvassed the disclosure initiatives that had been adopted by certain OECD countries. These included (i) early mandatory disclosure rules, (ii) the use of questionnaires, (iii) co-operative compliance programs,[112] (iv) specific aggressive tax planning rules, often penalty-linked, and (v) advance tax ruling procedures. A common feature of these initiatives is to provide an incentive for disclosure.[113]

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[110] OECD, *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure*, Report (2011), 22. The report was prepared by the Aggressive Tax Planning Steering Committee of Working Party No. 10 on Exchange of Information and Tax Compliance of the Committee on Fiscal Affairs.

[111] Ibid, 6.

[112] For background, see OECD, *Study into the Role of Tax Intermediaries* (2008). See also OECD, *Engaging High Net Worth Individuals on Tax Compliance*, Report (2009).

[113] For an overview of the mandatory early-disclosure rules in several countries, see OECD, *Tackling Aggressive*, 20.

Canada has well-established mandatory disclosure requirements of general application in the domestic tax context.[114] More recently, Canada and Quebec implemented mandatory (and in the case of Quebec, voluntary in certain circumstances) disclosure rules that specifically focus on transactions that may involve the application of the GAAR. These rules are penalty-linked in that they impose significant financial and procedural penalties for failure to disclose.

THE GENERAL ANTI-AVOIDANCE RULE

As discussed above, in 1987 Canada adopted a general anti-avoidance rule in an attempt to deal on a proactive basis with aggressive tax avoidance. Although the GAAR is over 25 years old, the case law with respect to the GAAR is still in its infancy; this is especially true with respect to its application to international avoidance transactions. A discussion of the GAAR cases involving international transactions is included in Appendix 4. Several important general points can be made about the GAAR and aggressive international tax planning.

First, the GAAR was amended pursuant to the 2004 budget to expressly provide that it potentially applies to benefits claimed under a Canadian tax treaty,[115] and that it overrides tax treaties.[116] According to the Department of Finance, the amendments were retroactive to the time that GAAR was first enacted in 1988 on the basis that they simply clarified rather than changed the law. The relationship between the GAAR and Canada's tax treaties was very controversial, even after the commentary on Article 1 of the OECD model was amended in 2003 to indicate that tax treaties based on the OECD model did not prevent the application of domestic anti-avoidance rules.

Second, the GAAR does not provide for the imposition of any penalty where it applies.[117] Thus, the "cost" of a GAAR reassessment is the unpaid tax, non-deductible interest on that tax, and transaction costs. It seems reasonable to conclude that the absence of a penalty makes some taxpayers more willing to effect tax-driven transactions.[118] It is presumably to discourage

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[114] For example, the tax shelter investment rules in section 237.1 (as supplemented by the limited-recourse rules in section 143.2).

[115] The 2004 amendments made two significant changes to the GAAR with respect to tax treaties. First, the *tax benefit* requirement in subsection 245(1) was expanded to provide that the term includes a reduction, avoidance or deferral of tax or other amount as a result of the provisions of a tax treaty. Further, the *abusive tax avoidance* requirement in subsection 245(4) was expanded to provide that the GAAR applies where it is reasonable to consider that a transaction results directly or indirectly in a misuse or abuse of a treaty or the Income Tax Application Rules (ITARs), as well as a misuse or abuse of the Income Tax Act or regulations. This reference to the ITARs is important because treaty benefits are based in substantial part on subsection 10(6) of the ITARs.

[116] Section 4.1 of the Income Tax Conventions Interpretation Act.

[117] As important context, the initial proposal for a "GAAR" contained in the 1987 white paper did not provide for a penalty where GAAR applied. In the related commentary, however, the Department of Finance stated its view that a GAAR penalty was desirable, and suggested that the penalty might be based on a specific percentage of tax reassessed under GAAR. The prospect of a GAAR penalty provoked a hostile reaction from the tax community and, in the end, GAAR was enacted without a penalty.

[118] Brian Arnold has expressed the view that "… a general anti-avoidance rule that applies only to clearly abusive tax avoidance should be subject to a penalty." He argues that since the tax imposed where GAAR applies is limited to the amount that would have been imposed if the abusive tax avoidance transaction had not been carried out: "[S]mall wonder, then, that tax avoidance schemes have continued to flourish since the adoption of the GAAR." Abusive tax avoidance presents the possibility of significant tax savings and little downside risk. Thus, to make GAAR more effective in deterring abusive tax avoidance, it may be time for taxpayers to have a bit more skin in the game. See *The Arnold Report 019*, September 21, 2011, available at www.ctf.ca.

this attitude that other jurisdictions, such as Australia, New Zealand and Ireland, impose penalties where their GAARs apply. For example, in Australia the penalty varies — it starts at 50 per cent of the tax reassessed under the GAAR, and decreases to 25 per cent where the taxpayer can establish that it is arguable that GAAR should not apply, having regard to the wording of the legislation, judicial decisions and public tax rulings. Quebec recently enacted disclosure rules modeled on the American and U.K. disclosure rules. They are similar to the Canadian federal disclosure rules, but with some important differences; in particular, a 25 per cent penalty is imposed on the reassessed tax under the Quebec GAAR.[119] In 2010, the U.S. government codified the judicial economic substance doctrine to remove ambiguities and make its application more effective. The legislation imposes a new "strict liability" base penalty of 20 per cent of the reassessed tax, increasing to 40 per cent if there is not adequate disclosure of the relevant facts in the original return (and certain qualified amended returns).

Third, to date, with few exceptions, the Crown has fared poorly in GAAR cases where it has asserted that treaty benefits should be denied in tax-avoidance cases. These cases include *Canada v. MIL (Investments) SA*[120] and *St. Michael Trust Corp. v. Canada*,[121] where the Crown's arguments included the GAAR, and other cases such as *Prévost Car, Velcro* and *Sommerer*,[122] which were non-GAAR treaty cases. From a taxpayer perspective, the high-water mark in the GAAR cases is the decision of the Federal Court of Appeal in *MIL (Investments)*. A notable exception is the Tax Court of Canada decision in *Antle v. The Queen*,[123] where that Court concluded that GAAR applied to deny treaty benefits when viewed from the perspective of a taxpayer who is a Canadian resident. These cases are discussed in Appendix 4.

With the limited exceptions of *Antle* and *RMM Canadian Enterprises Inc. v. The Queen*,[124] these cases reflect a clear reluctance on the part of Canadian courts, even in cases where the GAAR is argued, to deny a taxpayer's entitlement to treaty benefits based on the language of the relevant treaty provisions. On the one hand, the courts seem to recognize that tax treaties should be interpreted differently from domestic tax law given their dual status as treaties as well as domestic tax statutes, and that they should be interpreted using the modern rule (which involves a consideration of the text, context and purposes of the relevant treaty provisions) and on a basis that is consistent with the international principles that apply to the interpretation of treaties (most notably, Article 31(1) of the *Vienna Convention on the Law of Treaties*). Article 31(1) of the Vienna Convention is essentially similar to the modern-rule approach in requiring a tax treaty to be interpreted in accordance with the ordinary meaning given to its terms in their context and in light of the object and purpose of the treaty.

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[119] The penalty may be avoided where an avoidance transaction is either disclosed (a) as part of the mandatory early-disclosure rules, or (b) in accordance with a separate preventative-disclosure procedure — in both cases, before the statutory filing period for the relevant taxation year in which the avoidance transaction occurred. The taxpayer can avoid the 25 per cent penalty by showing due diligence.

[120] 2007 FCA 236.

[121] 2010 FCA 309.

[122] 2012 FCA 207.

[123] 2009 TCC 465.

[124] [1998] 1 CTC 2300 (TCC).

On the other hand, the courts seem reluctant to determine that the purpose of treaty provisions can be anything other than to provide a treaty benefit or relief in the very circumstances they describe. Under this approach, which is based largely on emphasis on the text of the treaty, the interpretation of treaties is consistent with the Canadian approach to the interpretation of statutes. Absent the potential application of the GAAR, the interpretation of taxing statutes has remained primarily a textual exercise. As the Supreme Court of Canada stated in *Canada Trustco Mortgage Co. v. The Queen*,[125] the Income Tax Act is "dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation." Canadian courts seem to have adopted the same approach to the interpretation of tax treaties in avoidance cases.

Notwithstanding the Crown's lack of success to date in tax-avoidance cases involving tax treaties, until the Supreme Court of Canada considers the application of tax-treaty provisions in an avoidance case (and in particular, one involving the application of the GAAR) it is difficult to predict in what circumstances, if any, treaty benefits can be denied in avoidance cases. The Supreme Court has provided considerable guidance respecting the interpretation and application of the GAAR in a domestic context; similar guidance is needed from the court with respect to its application in a treaty context.

For the most part, the basic approach of Canadian courts in recent avoidance cases involving tax treaties is that where the textual requirements for entitlement to treaty benefits are met — specifically, the residence requirement — the GAAR cannot be applied to override that entitlement. In these cases, the courts have been reluctant to give much weight to a "purposive" reading of the relevant treaty provisions; they seem to be persuaded that the "spare" drafting style in tax treaties does not lend itself to a purposive interpretation. As noted, the high-water mark of these cases is *MIL (Investments)*. However, much about that decision is less than compelling — in particular, the Federal Court of Appeal's decision, given orally, was short and perfunctory. With respect, it reflects a surprising absence of any detailed analysis as to what constitutes abusive tax avoidance in the context of a treaty provision.

The existing Canadian jurisprudence dealing with the GAAR and tax treaties, as well as the existence (or not) of an inherent treaty-abuse rule, is at an early stage, as it is in other countries.[126] As a result, its reliability and predictive value are uncertain. The few cases in the lower courts that have dealt with these issues do not provide sufficient guidance to permit the distillation of consistent and general principles with meaningful predictive value.

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[125] 2005 DTC 5523.

[126] It seems that the CRA will continue to use the GAAR to challenge what it regards as aggressive tax planning in the international tax context. In that connection, in Canada, "Tax Evasion," 32, the Standing Committee on Finance recommended "[T]hat the Canada Revenue Agency commit to applying the General Anti-avoidance Rule in the *Income Tax Act* to aggressive international tax planning." In response, the CRA stated: "The Government supports this recommendation. The General Anti-avoidance Rule (GAAR) was introduced to prevent abusive or artificial tax avoidance schemes, and the CRA applies the GAAR when dealing with aggressive international tax planning whenever it is appropriate to do so."

Measures Targeted at the Use of Tax Treaties for Tax Avoidance

INTRODUCTION

As the case studies indicate, tax treaties are often used to avoid a country's tax laws in ways that are considered to be abusive. Countries use a variety of measures to prevent aggressive tax avoidance through the use of tax treaties, and Canada is no exception in this regard. The anti-avoidance measures used to prevent treaty abuse include specific and general anti-abuse rules in tax treaties, anti-treaty-shopping provisions and domestic anti-avoidance rules, including the GAAR. As discussed in the preceding section, the GAAR explicitly overrides the provisions of Canada's tax treaties and is potentially applicable to aggressive tax avoidance involving the use of tax treaties. However, the case law to date indicates that the GAAR may not be effective as a means of combating treaty abuse.

According to the 2003 commentary on Article 1 of the OECD Model Convention, one of the purposes of a tax treaty is to prevent tax evasion and avoidance. This statement of purpose has two implications. First, tax treaties should not be interpreted to prevent the application of domestic anti-avoidance rules, assuming that they conform to a treaty anti-abuse test (which is remarkably similar to the GAAR).[127] Second, tax treaties contain an inherent anti-abuse rule as a matter of the proper interpretation of the treaty.[128] These aspects of the commentary on Article 1 of the OECD Model Convention are very controversial. As discussed above, Canadian courts seem to have been reluctant to embrace the approach set out in the commentary. The application of the 2003 commentary on Article 1 to tax treaties entered into before 2003 is especially contentious and is unlikely to be applied by Canadian courts, despite the statement by the OECD that subsequent revisions of the commentary should be applied to pre-existing treaties.[129]

The various types of specific anti-avoidance rules contained in Canada's tax treaties — the one-of-the-main-purposes test in Articles 10, 11 and 12, the conduit rule, the LOB provision in the U.S. treaty and the general rule in the treaty with Hong Kong — are discussed briefly above.[130] In this section we discuss the government's recent proposals to curtail treaty shopping.

[127] See paragraph 9.5 of the commentary on Article 1, which provides as follows:

> 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.

The OECD Public Discussion Draft on treaty abuse (OECD, BEPS Action 6) proposes several actions to reinforce this point. The title and the preamble to the OECD model will be amended to include references to the prevention of tax avoidance, the guiding principle in paragraph 9.5 of the commentary will be included in the OECD Model Convention itself and the commentary on Article 1 dealing with the improper use of tax treaties will be clarified.

[128] Paragraph 9.3 of the commentary on Article 1.

[129] *Introduction to the OECD Model Tax Convention on Income and on Capital*, paragraphs 33-35.

[130] See above in this paper "An Overview of the International Aspects of the Canadian Tax System: Canada's Tax Treaties." The limitation-on-benefits provision in the treaty with the United States is discussed in connection with Case Study 1.

PROPOSED ANTI-TREATY-SHOPPING RULE

In August 2013 the Department of Finance released a consultation paper, *Treaty Shopping — The Problem and Possible Solutions*, dealing with treaty shopping. The consultation paper described treaty shopping as circumstances where "a person who is not entitled to the benefits of a tax treaty with Canada uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits." The consultation paper left no doubt that the Finance Department considers treaty shopping to be a problem that requires a response,[131] especially since Canadian courts have not played an effective role in applying either the GAAR or the beneficial-ownership requirement to prevent treaty shopping.

The consultation paper suggested that a domestic legislative solution to address treaty shopping is preferable to the re-negotiation of tax treaties to include anti-treaty-shopping measures, since re-negotiating existing treaties, (even on a selective basis) and negotiating new ones is a time-consuming process.

Surprisingly, the government received only eight submissions on the consultation paper. Most of the submissions contained fairly consistent themes and can be summarized as follows.[132] First, the case law dealing with treaty shopping is not sufficiently negative to warrant a legislative solution. Second, no action should be taken until the results of the OECD's BEPS Action Plan are known.[133] Third, no action should be taken until the Finance Department does a more rigorous cost/benefit analysis of the problem and defines treaty shopping more precisely. Fourth, the re-negotiation of treaties to include a limitation-on-benefits provision along the lines of the OECD model provision is preferable to domestic legislation overriding treaties.[134] Fifth, if, notwithstanding its disadvantages, a domestic legislative approach is used, it should consist of a specific and focused rule based on objective tests that ensure a reasonable level of predictable results for taxpayers and ease of administration for the CRA (i.e., a U.S.-style limitation-on-benefits provision). Sixth, if a domestic legislative approach is used, existing investments should be grandfathered and the implementation date of the legislation should be delayed.

The government apparently did not take these submissions seriously, and in the Feb. 11, 2014 budget it announced the broad outlines of a domestic anti-treaty-shopping rule to be included in the Income Tax Conventions Interpretation Act.[135] The proposed rule will override Canada's

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[131] The consultation paper disingenuously suggests that Canada has consistently considered treaty shopping to be a problem. However, in the Third Protocol to the Canada-United States treaty, Canada rejected the application by Canada of the limitation-on-benefits provision in the treaty.

[132] See for example "Submission of Tax Executives Institute" (December 16, 2013); and "Submission of the Joint Committee on Taxation" (December 11, 2013), available at www.fin.gc.ca.

[133] "Submission of the Joint Committee," 5, states that "[I]n brief, we believe that any decision that Canada makes to enact a new rule should not be based on a general aversion to treaty shopping in theory, but rather on a rigorous analysis of costs and benefits. It is possible that a multilateral approach arising under the BEPS Initiative may produce a very different balance of costs and benefits. It is therefore prudent for the Government to await the outcome of that process before enacting a new measure."

[134] Ibid., 5. The submission states that if Canada renegotiated a selective group of its bilateral tax treaties to add new protocols, in addition to dampening taxpayer activity in the interim, "[it] would tend to reduce treaty shopping, but in a way that best preserves certainty, predictability and fairness."

[135] The 2014 federal budget plan, available at http://www.budget.gc.ca/2014/home-accueil-eng.html; specifically, Annex 2, "Tax Measures: Supplementary Information Notice of Ways and Means Motion and Draft Amendments to Various GST/HST Regulations," 311-419 (and the proposed anti-treaty-shopping rule and related discussion, 357-397).

tax treaties in the case of a conflict, although the government indicates its belief that the proposed rule conforms to the international norms set out in the commentary on Article 1 of the OECD Model Convention. The proposed rule will apply to taxation years beginning after the date of enactment, although the government has indicated its willingness to consult on transitional relief. The proposed rule consists of a one-of-the-main-purposes test supplemented by several presumptions and a discretionary-relief provision. Under the proposed rule, treaty benefits will be denied if one of the main purposes of a transaction or series of transactions is to obtain those benefits. The purpose test is a question of fact, which will presumably be based on both subjective and objective evidence of the purpose of the transaction or series. The purpose test is presumed to be met if the income qualifying for treaty benefits is primarily used to pay, distribute or otherwise transfer income to another person or persons who would not be entitled to the treaty benefits if the income were received directly. This presumption (the conduit presumption) contains what is known as a derivative-benefits rule so that if the income is paid, distributed or transferred to a person who would be entitled to the same or more favourable treaty benefits had such income been earned directly, the purpose test is presumed not to be met. The presumption is rebuttable, although it would appear to be difficult for a taxpayer to present sufficient evidence to do so.

The proposed rule will also contain presumptions, subject to the conduit presumption, that the purpose test will not be met in the following three circumstances:

1. the person carries on an active business (other than managing investments) in the other contracting state and that business is substantial compared to the activity in Canada that produced the income qualifying for treaty benefits;
2. the person is not controlled by another person or persons who would not be entitled to equivalent or more favourable treaty benefits; or
3. the person is a corporation or trust whose shares or units are regularly traded on a recognized stock exchange.

These presumptions operate independently, so that the purpose is presumed not to be met if any one of the presumptions applies. Once again, the presumptions are rebuttable if the CRA can present sufficient evidence to show that one of the main purposes of the transaction is to obtain treaty benefits.

The "one of the main purposes" test is a low threshold and makes the potential scope very broad. The result is that the proposed rule will have a more expansive ambit than the GAAR (which is premised on a "primary purpose" test) and that result is clearly intended. A "one of the main purposes" test is contained in several provisions of the act and has been given a broad application by Canadian courts. In cases such as *Groupe Honco Inc. v. The Queen*,[136] the courts

[136] 2013 FCA 128 (aff'g 2012 TCC 305). Subsection 83(2.1) applies if one of the main purposes of a transaction or series of transactions is to receive the capital dividend. This contrasts with other provisions of the act that refer to circumstances where it is reasonable to conclude or presume that one of the main purposes of transactions was to obtain a certain result. Nonetheless, the wording of subsection 83(2.1) does not result in an entirely subjective test. The Supreme Court of Canada said in *Symes v. Canada*, [1993] 4 S.C.R. 695, at page 736: "As in other areas of law where purpose or intention behind actions is to be ascertained, it must not be supposed that in responding to this question, courts will be guided only by a taxpayer's statements, *ex post facto* or otherwise, as to the subjective purpose of a particular expenditure. Courts will, instead, look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances."

have confirmed that a taxpayer may have more than one main purpose in effecting a transaction or arrangement — in particular, a business purpose and a tax purpose may both be main purposes.[137] Since obtaining a particular tax-treaty benefit or benefits is often a relevant consideration in establishing a corporation or other entity in a particular country, or effecting a transaction involving that entity, and not another, the potential scope of the proposed rule is quite broad.

Even if the one of the main purposes test is met, the proposed rule contains a "relieving provision" described in this way: "[I]f the main provision applies in respect of a benefit under a tax treaty, the benefit is to be provided, in whole or in part, to the extent that it is reasonable having regard to all the circumstances."[138] Although it is not clear from the 2014 budget materials, it is understood that the relieving provision is intended to be discretionary. In effect, this provision would allow the CRA to narrow the broad ambit of the "one of the main purposes" test to provide discretionary relief from the application of the proposed rule. This discretionary relief permits the CRA to grant the treaty benefits for ordinary commercial transactions with respect to which it is expected that a taxpayer would take the benefits available under a treaty into account as one of the main purposes for the transaction. Presumably, it will be necessary for the proposed rule to contain an express provision for the exercise of this discretionary relief by the CRA, taking into account all the relevant facts and circumstances. As such, the CRA's exercise of discretionary relief will be subject to an objective standard and the subjective views of the CRA should not be relevant. How this objective standard will be interpreted and applied by the CRA and, ultimately by Canadian courts is uncertain. Without more statutory guidance, it is difficult to predict what the courts would consider to be relevant or important in determining whether the CRA has exercised its discretion properly and in accordance with this objective standard in a particular case.

In sum, the essence of the proposed rule is that, if obtaining a particular tax treaty benefit is a material consideration in establishing a corporation or other entity in a particular country to engage in a business or hold property, or carry out a transaction or arrangement involving that entity, the treaty benefit will be denied unless the CRA exercises its discretion to grant the benefit, having regard to the relevant facts and circumstances. The proposed rule is

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[137] The Federal Court of Appeal stated, at para. 24, as follows:

> "The phrase 'one of the main purposes' is unambiguous and implies that a taxpayer may have more than one main motive in acquiring shares. With respect, it seems to me that counsel for the appellants is ignoring the purpose and spirit of subsection 83(2.1) of the Act in attempting to persuade us that the word "main" does not leave open the possibility of having two or three motivations that explain a transaction or series of transactions. According to this interpretation, a taxpayer would merely have to present two or three plausible and credible main purposes for a transaction or series of transactions to shield himself or herself from the anti-avoidance rule. The intention to receive a capital dividend would be the "one purpose too many" that could not give rise to the application of subsection 83(2.1) simply because it would take a back seat to the other purposes advanced by the taxpayer. I am unable to agree with this interpretation. The fact that the taxpayer has provided reasons for getting involved in a transaction or series of transactions in no way excludes a finding that one of the main purposes—one not generally disclosed by the taxpayer—is to obtain a tax advantage."

[138] "Tax Measures: Supplementary," 352.

substantively similar to the former Section 246, which gave the Treasury Board a broad discretionary power to curb what was described as improper avoidance or reduction of tax. Former subsection 246(1) provided:

> [W]here the Treasury Board has decided that one of the main purposes for a transaction or transactions effected before or after the coming into force of this Act was improper avoidance or reduction of taxes that might otherwise have been payable under this Act, the *Income War Tax Act*, or *The Excess Profits Tax Act*, *1940*, the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction.

Former subsection 246(6) confirmed that an avoidance or reduction of taxes could be regarded as improper for the purposes of Section 246, although it was not illegal. The provision was rarely used, if at all, and its application does not seem to have been considered by a court. It was repealed in 1984, because, according to the explanatory notes, "…the authority so provided to the Treasury Board conflicts with the underlying purpose of the *Canadian Charter of Rights and Freedoms*…".

The description of the proposed anti-treaty-shopping rule in the budget does not deal with the relationship between the proposed rule and the GAAR. In the absence of a specific rule, both provisions would be potentially applicable to treaty-shopping arrangements. However, the definition of an avoidance transaction for purposes of the GAAR is a primary-purpose test whereas the proposed anti-treaty-shopping rules will use a one-of-the-main-purposes test. Thus, if a transaction does not have as one of its main purposes obtaining a treaty benefit, logically it would appear to be impossible for it to have the primary purpose of obtaining a tax benefit. Moreover, it is difficult to imagine a court applying the GAAR to find an arrangement to be abusive when the arrangement is found to be acceptable under the proposed more specific anti-treaty-shopping rule.[139]

As a final point, it should be noted that, like the GAAR, the proposal for an anti-treaty-shopping rule does not include any penalty if the rule applies.

In our view, whether the proposed anti-treaty-shopping rule represents a reasonable and balanced attempt to protect the Canadian tax base without discouraging investment in Canada by non-residents is unclear.[140] Our major concern with the rule is the uncertainty associated with the purpose test, the presumptions and the discretionary relief provision. In the end, the effectiveness of the rule, if it is enacted in its current form, will depend on how it is administered by the CRA and, ultimately, interpreted by the courts.

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[139] However, it is theoretically possible for the GAAR to apply in these circumstances and, arguably, this is the way in which the LOB article in the U.S. treaty and the GAAR could apply, as discussed above in connection with Case Study 1.

[140] For a useful review of the some of the concerns with the proposed rule, see Steve Suarez, "Canada to Unilaterally Override Tax Treaties with Proposed New Anti-Treaty-Shopping Rule," *Tax Notes International* 73, 9 (March 3, 2014): 797-806.

In the 2014 federal budget, the government invited comments on the proposed rule. It is understood that many of the submissions reiterate the same basic concerns made to the government in response to the consultation paper. These concerns include the basic arguments that no response to address treaty shopping is necessary and, even if some response is necessary, it should take the form of a bilateral re-negotiation of tax treaties rather unilateral domestic legislation. As noted above, one of the specific actions identified in the OECD Action Plan was the need to address the problem of treaty abuse and, specifically, treaty shopping. On March 14, 2014 the OECD released a discussion draft, "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances."[141] In general, in its discussion draft the OECD recommends a three-pronged approach to address treaty shopping through the inclusion of:

- a clear statement in the title and preamble of tax treaties that the contracting states intend tax treaties to prevent tax avoidance and, in particular, treaty shopping,
- a specific anti-abuse rule based on the LOB provisions included in U.S. and other countries' tax treaties to address residence-based treaty shopping, and
- of a general anti-abuse rule to address transaction-based treaty shopping such as conduit-financing arrangements.

The general anti-abuse rule to be included in tax treaties will incorporate the principles reflected in paragraph 9.5 of the OECD commentary to Article 1 "according to which the benefits of a tax treaty should not be available where one of the main purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty…"[142] The OECD confirms that, even where it is reasonable to conclude in the relevant facts and circumstances that obtaining a treaty benefit was one of the main purposes of any arrangement or transactions, the benefit should be granted where "it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions" of the treaty.[143]

In contrast, Canada's proposed anti-treaty-shopping rule is not only a unilateral domestic-based rule rather than a bilateral treaty provision, it does not contain any express statutory exception to ensure that treaty benefits are denied only where obtaining them is contrary to the object and purpose of the relevant treaty provisions. The Department of Finance might consider addressing its treaty-shopping concerns with more targeted provisions. Such provisions might include specific anti-conduit rules, specific changes to the GAAR to enhance its application to deny tax-treaty benefits (perhaps by amending the definition of "avoidance transaction" or the misuse or abuse requirement or changes to the definition of "real property" that would be applicable to all of Canada's tax treaties.

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[141] OECD, *Discussion Draft: BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Paris: OECD, March 14, 2014–April 9, 2014).

[142] Ibid., at 5.

[143] Ibid., at 10.

CONCLUSION

This paper has attempted to show that aggressive international tax planning is a multi-faceted problem that requires a multi-faceted solution consisting of, at best, specific anti-avoidance rules, a general anti-avoidance rule, and anti-abuse rules in tax treaties. Aggressive international tax avoidance involves both the erosion of the domestic tax base by non-residents through inbound transactions and by residents through outbound transactions.

The paper shows that, historically, Canada has been vigilant about protecting the Canadian tax base from aggressive tax planning by non-residents. This vigilance continues today, as shown by the recent enactment of the foreign-affiliate-dumping rules, the tightening of the thin-capitalization rules and the recent proposed anti-treaty-shopping measures. However, historically, Canada has not been particularly concerned about the erosion of the domestic tax base by Canadian multinationals. It appears that the government is reluctant to adopt tax policies that might adversely affect the international competitiveness of Canadian multinationals. This aspect of government policy can be seen in the absence of rules restricting the deductibility of interest expenses incurred to earn exempt dividends from foreign affiliates, relatively weak FAPI and foreign investment fund rules, and a generous participation exemption for dividends from foreign affiliates. The recent enactment of upstream-loan rules reinforces this point — the problem of the use of upstream loans to avoid the Canadian taxation of dividends out of taxable surplus was well known for decades, but nothing was done to deal with it.

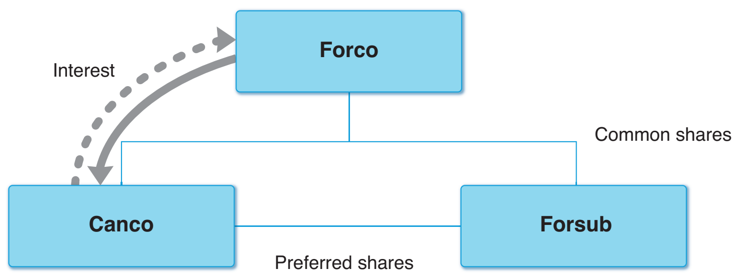
It seems likely that the basic thrust of Canadian tax policy with respect to aggressive international tax planning will continue along the same lines. We suspect that any Canadian action pursuant to the OECD's BEPS initiative is likely to focus on base erosion by non-residents rather than by Canadian multinationals. In this regard, Canada has done almost everything that might reasonably be expected to protect its domestic tax base. However, the key issue presented by the OECD's BEPS project is whether OECD member countries and other countries with large economies will be willing to take co-ordinated action against aggressive international tax avoidance. Given the current political paralysis prevailing in the United States, it seems unlikely that the United States will be able to take any effective action in this regard even if the U.S. government concludes that such action is desirable. Without action by the U.S., it seems unlikely that Canada and other smaller countries would be willing to take any significant action to curtail aggressive tax planning by their multinationals that might risk placing them at a competitive disadvantage vis-à-vis American multinationals.

APPENDIX 1 — CASE STUDIES

Case Study 1 — Inbound Leveraged Foreign-Affiliate Dumping

FACTS

Forco, a non-resident corporation, has two wholly owned subsidiaries — Canco, a Canadian-resident corporation, and Forsub, a corporation resident in the same country as Forco. Forsub carries on an active operating business. Forsub issues preferred shares to Forco, and these shares are transferred by Forco to Canco in consideration for a debt obligation that bears interest.



EXPECTED TAX RESULTS

For Canadian tax purposes, Canco is permitted to deduct interest on the purchase debt; however, when paid, the interest is subject to Canadian withholding tax, which may be reduced under an applicable tax treaty. Further, dividends paid to Canco on the Forsub preferred shares are tax-deductible dividends out of Forsub's exempt surplus.

Under the relevant foreign tax law, Forco is subject to no or low tax on the interest received from Canco on the purchase debt.

In the OECD Report, *Addressing Base Erosion and Profit Shifting*,[144] the use of leveraged acquisitions (or so-called "debt pushdowns") through the use of intermediate holding corporations in high-tax jurisdictions was identified as a common type of aggressive international tax planning. There are two basic variations of such planning, both of which seek to generate debt financing and a corresponding tax-deductible interest expense for an intermediate holding corporation resident in a high-tax country. Thus, both rely on asymmetrical treatment in the relevant tax jurisdictions.

In the first variation, the debt financing is used to acquire a target business and in the second, the debt financing is used to acquire an equity interest in a related foreign corporation. The expected tax results of such arrangements are simple enough. Typically, the intermediate holding corporation is entitled to an interest deduction in respect of the debt financing (or a tax

[144] OECD, *Addressing Base Erosion and Profit Shifting*, Report (2012).

saving in respect of the foregone income and the absence of withholding tax in respect of its repatriated funds) and there is no tax on dividends received on, or profit or gains realized from the disposition of the shares of the related foreign corporation. Further, in some of these arrangements, one or more hybrid entities may be used to achieve a double deduction for the interest payments on the debt financing without any significant tax on the receipt of the interest payments where the debt financing is internal group financing.

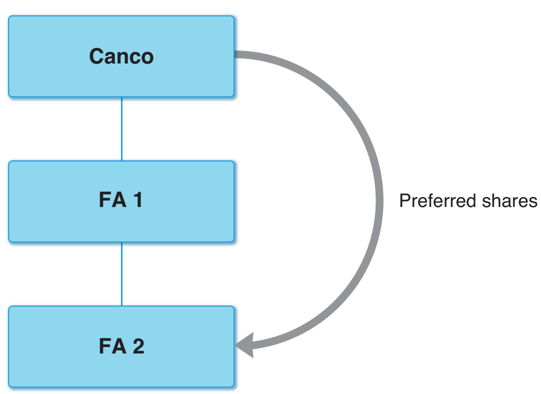
As discussed in the paper, Canada recently introduced rules that target so-called "foreign-affiliate-dumping" (FAD) arrangements in response to concerns with arrangements in which a Canadian-resident subsidiary of a foreign parent corporation uses debt financing (or retained earnings) to acquire a direct or indirect investment in the common or preferred equity of a related non-resident corporation or entity. These FAD rules would apply to Canco in determining its tax results as a consequence of the arrangement.

Case Study 2 — Outbound Investment Using Repo Arrangement

FACTS

This case study deals with a common hybrid arrangement — a repo arrangement — that is treated for Canadian legal and tax purposes as a share investment involving a sale and repurchase agreement and for U.S. or other foreign tax purposes as a secured loan. Canco is a Canadian-resident corporation, FA1 is a wholly owned U.S. subsidiary of Canco and FA2 is a wholly owned U.S. subsidiary of FA1.

FA1 subscribes for preferred shares of FA2. The preferred shares have a redemption price equal to their subscription price and entitle the holder to a fixed, cumulative preferential dividend. FA1 and Canco enter into a sale and repurchase agreement under which FA1 sells the preferred shares of FA2 to Canco and FA1 agrees to repurchase the preferred shares at a future date for a fixed price. The repurchase price is based on the original purchase price paid by Canco for the shares, plus an amount that represents an agreed "yield" that Canco is to receive until the repurchase date. The repurchase price is reduced if and to the extent that dividends are received by Canco on the preferred shares before the repurchase date. The obligations of FA1 are guaranteed by FA2.



EXPECTED TAX RESULTS

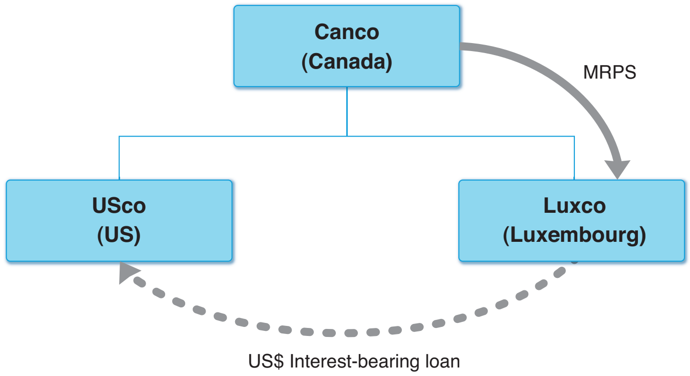
For Canadian tax purposes, Canco holds preferred shares of a controlled foreign affiliate, with the result that Canco would be entitled to Section 113 deductions in computing its taxable income in respect of any dividends received on the preferred shares of FA2.

For U.S. tax purposes, the dividends paid on the preferred shares would be treated as deductible interest.

Case Study 3 — Outbound Luxembourg-Financing Intermediary

FACTS

In this case study, Canco, a Canadian-resident company, provides financing to USco, a wholly owned U.S.-resident operating subsidiary of Canco. The financing is provided through Luxco, a wholly owned Luxembourg-resident financing subsidiary. Luxco is established with nominal common equity, which minimizes the capital duty payable in Luxembourg. Canco provides funding to Luxco through a subscription for mandatory redeemable preferred shares, or MRPS.[145]



EXPECTED TAX RESULTS

USco deducts the interest expense on the loan from Luxco for U.S. tax purposes, subject to the applicable U.S. thin-capitalization rules. For its part, Luxco is entitled to a “notional” deduction in respect of the MRPS in the amount of the stated dividend rate on the MRPS under Luxembourg tax law; this deduction effectively offsets the interest income that Luxco receives on its loan to USco. Thus, only the spread earned by Luxco is subject to Luxembourg tax. There should be no withholding tax on the interest payments made by USco on the loan from Luxco under the U.S.-Luxembourg tax treaty, provided that the relevant requirements (including the limitation-on-benefits (LOB) provision) are met. The MRPS are considered to be equity under U.S. tax law and, consequently, the U.S. anti-conduit financing rules should have no application.

[145] Generally, the MRPS are a preferred class of Luxco shares, which provide a preferential dividend and liquidation entitlement. Luxco uses the subscription proceeds for the issue of the MRPS shares to make an interest-bearing loan to USco.

For Canadian tax purposes, the MRPS are treated as equity, not as debt; the result is that under Canadian tax law, Canco has no interest income from the MRPS. Any dividends received by Canco on the MRPS will qualify as exempt dividends out of Luxco's exempt surplus. However, the Canadian foreign-tax-credit-generator rules may be applicable.

APPENDIX 2 — TRANSFER-PRICING CASES

In *GlaxoSmithKline Inc. v. The Queen*,[146] the Supreme Court considered the proper interpretation and application of former subsection 69(2), which was repealed when the current transfer-pricing rules in Section 247 were enacted in 1997. In general, subsection 69(2) (and its companion rule, former subsection 69(3)) targeted the overstatement of deductions, or the understatement of revenue, that resulted where the transfer prices in non-arm's-length transactions involving a taxpayer and a non-resident were different from the prices that would have been reasonable in the circumstances had the parties been dealing at arm's length. If the rules applied, the taxpayer's income was computed using the reasonable amount.

In the *Glaxo* case, the Crown's position was that subsection 69(2) applied to reduce the amount of payments made by the taxpayer (a Canadian drug manufacturer and marketer) to a non-arm's-length non-resident supplier of ranitidine, which was used as an active ingredient in the production of the drug Zantac. The taxpayer manufactured Zantac under patent and trademark rights granted under licence by another non-arm's length non-resident corporation.

The Tax Court held that subsection 69(2) applied to reduce the amount of the payments made by the taxpayer. The court refused to consider, however, whether the rights and benefits under the licence were relevant in determining the reasonable cost for ranitidine using the arm's-length principle.[147] On appeal, the Federal Court of Appeal referred the case back to the Tax Court for re-hearing by the same judge. The Court of Appeal held that the Tax Court judge had made an error in failing to consider the licence as part of the determination of reasonable cost.[148]

On appeal, the Supreme Court referred the case back to the Tax Court for reconsideration, with instructions that the reasonable amount should be determined taking into account the licence. The court stated that, in determining an amount using the arm's-length principle, all the relevant circumstances should be considered. On the facts of the case, the determination of a reasonable price under the purchase agreement should have taken the licence into account because of its linkage to the purchase agreement.

The Supreme Court provided some important guidance on the application of the transfer-pricing rules in general, and on the arm's-length principle in particular. The most important general guidance was the court's view that the 1995 OECD guidelines on transfer pricing are informative and should be considered, but that the real issue was the proper interpretation of a Canadian statute (specifically, subsection 69(2)) and not "any particular methodology or

[146] 2012 SCC 52.

[147] *GlaxcoSmithKline Inc. v. The Queen*, 2008 TCC 324.

[148] *GlaxcoSmithKline Inc. v. The Queen*, 2010 FCA 201.

commentary set out in the Guidelines."[149] With respect to the specific application of the arm's-length principle, the court emphasized the breadth of the inquiry this way:

> Because s. 69(2) requires an inquiry into the price that would be reasonable in the circumstances had the non-resident supplier and the Canadian taxpayer been dealing at arm's-length, it necessarily involves consideration of all circumstances of the Canadian taxpayer relevant to the price paid to the non-resident supplier. Such circumstances will include agreements that may confer rights and benefits in addition to the purchase of property where those agreements are linked to the purchasing agreement.[150]

Further, the court noted that the requirement under the arm's-length principle to determine the "reasonable amount" means that "transfer pricing is not an exact science" and "some leeway must be allowed in the determination of the reasonable amount."[151] Finally, the court stated that in applying the arm's-length principle to determine a particular transfer price, the independent interests of both non-arm's-length participants must be considered.[152]

In *McKesson Canada Corporation v. The Queen*,[153] the Tax Court accepted the Crown's application of the transfer-pricing rules to increase the sale price of receivables sold by a taxpayer to a non-arm's-length non-resident. Specifically, the court reduced the discount rate that the parties had used to determine the sale price.[154] At the heart of the decision was the failure of the taxpayer to discharge its onus to show that the amount of the reassessment was not the correct amount. In particular, the court found that the written and oral evidence of the taxpayer challenging the discount rate used by the Crown was deficient and unpersuasive.

In *General Electric Capital Canada*,[155] the Federal Court of Appeal rejected the Crown's appeal of a decision of the Tax Court, which held that a guarantee fee paid by a Canadian subsidiary to a related non-arm's-length non-resident corporation was equal to or less than the arm's-length transfer price. Notably, both courts accepted the argument that, in applying the transfer-pricing rules, the hypothetical non-arm's-length participants should be considered to have attributes similar to those of the actual participants. Thus, in determining the amount of the guarantee fee that the hypothetical arm's-length borrower would have paid, that hypothetical borrower should be one that was a subsidiary in a multinational group that had the implicit financial support of the ultimate parent of the group.

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[149] OECD, Action Plan on *Base Erosion*, paragraph 20. The 1995 OECD guidelines were the basis for the CRA views set out in *Information Circular* IC 87-2R "International Transfer Pricing," September 27, 1999.

[150] Ibid., paragraph 44.

[151] Ibid., paragraph 61. According to the Supreme Court, where the taxpayer establishes that an amount is within a reasonable range, the transfer pricing requirements are met. In the end, the court notes, at paragraph 61, "… it is highly unlikely that any comparisons will yield identical circumstances, and the Tax Court judge will be required to exercise his best informed judgment in establishing a satisfactory arm's-length price."

[152] Ibid., paragraph 63.

[153] 2013 TCC 404.

[154] The parties used a 2.206 per cent discount rate; the Tax Court agreed with the Crown that an arm's-length discount rate was 1.103 per cent. In a secondary matter, the court upheld the Crown's reassessment of a penalty imposed on the taxpayer for failure to withhold, on the basis that there was no limitation on the reassessment of Part XIII tax or related penalties and that this was not changed by Article 9 of the applicable tax treaty. The decision has been appealed by the taxpayer to the Federal Court of Appeal.

[155] 2011 DTC 5011 (FCA).

APPENDIX 3 — BENEFICIAL OWNERSHIP AND TREATY ABUSE

In general, in its administration of the Canadian federal tax system, the CRA can make five basic challenges to what it considers to be unacceptable treaty shopping. It can argue that:

- a specific domestic anti-avoidance applies,
- the intermediary entity is not a resident of the treaty country,
- the intermediary entity is not the beneficial owner of the particular income,
- the GAAR applies, or
- the result is an abuse of the particular treaty.[156]

The residence challenge was considered in *Crown Forest Industries Inc. v. The Queen*,[157] in which the Supreme Court endorsed the general principle that a person is resident in a country if the person is subject to full tax liability in that country on its worldwide income.[158] The Supreme Court held that Norsk, a Bahamian corporation with a place of management in the United States that carried on a U.S. trade or business, was not a resident of the United States for purposes of the Canada-U.S. tax treaty. Norsk received barge-rental fees from a Canadian resident, and the specific issue was whether these payments were entitled to the reduced rate of withholding tax provided by the treaty. Under the relevant U.S. domestic tax law, the payments were not subject to U.S. income tax. Although Norsk was engaged in trade or business in the United States, its income was exempt from U.S. tax pursuant to a reciprocal shipping exemption. The Supreme Court held that in order for an entity to be a resident of a contracting state under the treaty, it must be liable to the most comprehensive form of taxation imposed by that state — in other words, a resident of a contracting state must be subject to full tax liability on its worldwide income. The court also commented on the proper approach to interpreting tax treaties with respect to treaty shopping.

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[156] As a matter of tax administration, the 2005 federal budget proposed to invest an additional $30 million annually to enhance CRA audits and tax collection in respect of international tax evasion and aggressive international tax planning. The International Tax Directorate and the Tax Avoidance and Special Audit Division formed a strategic partnership to audit and to challenge, where appropriate, aggressive international tax planning. A key objective of this strategic partnership was to create 11 centres of expertise across Canada to co-ordinate activities involving the identification, audit and reassessment of aggressive international tax planning. Most of the $30 million annual budget for the project is spent on staff. In addition, the CRA has initiated several multilateral exchange arrangements aimed at international tax planning. In 2004, Canada joined Australia, the United Kingdom and the United States (Japan joined later) in establishing the Joint International Tax Shelter Information Centre (JITSIC) with offices in Washington and London. A key objective of this multilateral task force is to identify and develop a co-ordinated administrative and legislative approach to dealing with abusive international tax planning. The five JITSIC members, together with Germany and France, have also formed the Seven Country Tax Haven Working Group to develop a co-ordinated approach to curbing the use of tax havens. A third group, composed of the Seven Country working group and China, India and South Korea, formed the Leeds Castle Group; it has a similar mandate. Finally, in 2006, the member countries of the International Forum for Tax Administration, a panel of tax administrators associated with the OECD, issued the Seoul Declaration aimed at promoting co-operation among tax administrators in dealing with aggressive international tax planning.

[157] [1995] 2 SCR 802.

[158] With respect to residence, the basic premise of bilateral tax treaties based on the OECD model is that the entitlement of a foreign entity to treaty benefits is based on residence. Thus, a Canadian tax treaty with another contracting state extends treaty benefits to residents of that contracting state. While the concept of residence is the basis for Canadian taxation under the Income Tax Act, the treaty concept of residence, based on Article 4 of the OECD model, is different. Article 4 of the OECD model provides:

> For the purposes of the Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

The beneficial-owner requirement has also recently been considered by Canadian courts. In most of Canada's bilateral tax treaties, the dividend, interest and royalty articles (normally articles 10, 11 and 12) provide for a reduction in the Canadian statutory withholding tax rate of 25 per cent imposed on amounts paid or credited by a resident of Canada as dividends, interest or royalties where the "beneficial owner" of the dividend or interest is a resident of the other contracting state.[159]

The term "beneficial owner" is not defined in Canada's tax treaties or in the OECD Model Convention. The OECD commentaries represent important guidance in determining the proper interpretation of bilateral tax treaties based on the OECD model. In *Prévost Car Inc. v. The Queen*,[160] the Federal Court of Appeal confirmed that in interpreting a treaty provision, the OECD commentary on the provision at the time that the treaty came into force should be taken into account. The court stated that subsequent commentaries (i.e., those updated by the OECD after the treaty was concluded) should also be taken into account where they represent "a fair interpretation of the words of the Model Convention and do not conflict with the commentaries in existence at the time a specific treaty was entered."[161] Stated simply, the Federal Court of Appeal rejected the notion that the OECD commentary should be regarded as ambulatory. This is important in connection with the concept of beneficial owner because the related OECD commentary has undergone significant revision over the years.

The concept of beneficial owner was added to the OECD Model Convention in 1977. Where and to the extent that a source country cedes its right to tax dividends, interest and royalties by virtue of articles 10, 11 and 12, it does so on the premise that the owner of the relevant items of income is a bona fide resident of the other contracting state — described in articles 10, 11 and 12 as the "beneficial owner" of such income. The 1977 OECD commentary on these articles confirmed that a beneficial owner of income does not include an agent or nominee. The commentary was revised in 2003 to clarify that the term "beneficial owner" is not used in a narrow technical sense, but should be read in light of one of the basic purposes of tax treaties — namely, to prevent fiscal evasion and avoidance. The 2003 commentary confirmed that it would be inconsistent with that object and purpose to grant treaty relief to a resident of a contracting state acting in the capacity of an agent, nominee or mere fiduciary.

The OECD commentary went on to state that it would be equally inconsistent to grant treaty relief in respect of particular income to a resident who "… simply acts as a conduit for another person who in fact receives the benefit of the income concerned." By way of clarification, the OECD commentary (quoting from the OECD Council's report on conduit companies) stated that "a conduit company cannot normally be regarded as beneficial owner if, though the formal owner, it has as a practical matter, very narrow powers which render it, in relation to the income concerned a mere fiduciary or administrator acting on account of the interested parties." At the same time, however, the 2003 commentary cautioned that the concept of beneficial owner was not intended to apply to holding corporations that were entitled to treaty relief as residents of contracting states, but only to holding corporations whose activities and circumstances with respect to the income were so minimal that they acted only as nominees or agents.

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[159] For example, Article 10(2) of the Canada-U.S. tax treaty provides that dividends paid by a resident of a contracting state to a resident of the other contracting state may be taxed by the contracting state of which the company paying the dividend is resident, but if the resident of the other contracting state is the beneficial owner of such dividends the tax so charged cannot exceed 15 per cent (or 5 per cent in certain cases).

[160] 2009 FCA 57 (affirming 2008 TCC 231).

[161] Ibid., at paragraph 11.

In 2011, the OECD released a public discussion draft setting out proposals for further revisions to the OECD commentary designed to clarify the beneficial-owner test. The proposals proved to be controversial and revised draft proposals were released in October 2012. These proposals have recently been incorporated into the commentary pursuant to the 2014 update of the OECD model. Generally, the revised proposals provide that "beneficial owner" would not include an agent, nominee or conduit and a person is considered to be a conduit where the person is constrained by contractual or legal obligations to pass the income to another person. Thus, the revised proposals would treat as a beneficial owner a person who receives such income (for example, a dividend) and has "the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person."[162]

On the strength of the OECD commentary on the meaning of the term "beneficial owner," the CRA has attempted to deny treaty benefits on the basis that the recipient of dividend, interest or royalty income that would otherwise benefit from a reduced rate of withholding under a treaty is not the beneficial owner of the income. Canadian courts have strongly resisted this approach and have instead adopted a technical and legal approach to the interpretation of the term "beneficial owner." The leading Canadian case in that respect is the decision of the Federal Court of Appeal in *Prévost Car*.[163]

The taxpayer in *Prévost Car* was a Canadian-resident corporation incorporated under the laws of Quebec. In 1995, a Swedish-resident company (Volvo) acquired all the shares of the taxpayer and shortly thereafter transferred the shares of the taxpayer to a wholly owned Dutch BV (private limited liability company) that was a resident of the Netherlands for purposes of the Canada-Netherlands tax treaty. Subsequently, Volvo sold 49 per cent of the shares of the Dutch BV to an unrelated corporation incorporated and resident in the United Kingdom (Henlys).

Both Volvo and Henlys were in the business of manufacturing bus parts, and their purchase of an interest in the taxpayer constituted a means of expanding into the North American market. A shareholders' agreement between Volvo and Henlys provided that not less than 80 per cent of the profits of the taxpayer and Dutch BV were to be distributed to shareholders, subject to the taxpayer and Dutch BV having sufficient financial resources to meet their normal and foreseeable working capital requirements at the time of payment, unless the shareholders agreed otherwise. Dividends paid by the taxpayer to the Dutch BV were entitled to a reduced rate of withholding of five or six per cent under the Dutch treaty. Absent the interposition of the Dutch BV in the structure, the rate of withholding on dividends paid by the taxpayer to Volvo and Henlys would have been significantly higher.

The minister assessed the taxpayer for failure to withhold at the higher withholding-tax rates on the basis that Volvo and Henlys, rather than the Dutch BV, were the beneficial owners of the dividends paid on the shares of the taxpayer to the Dutch BV. The Crown argued that the concept of beneficial ownership did not have an established meaning for Canadian tax purposes, in part because the civil law tradition of Quebec did not recognize the concept of beneficial ownership. Instead, the Crown submitted that an international fiscal meaning of the term "beneficially owned" should be applied for the purpose of interpreting the Dutch treaty, and that the international fiscal meaning required that the beneficial owner should be regarded

[162] See OECD Model Tax Convention: "Revised Proposals Concerning the Meaning of 'Beneficial Owner' in Articles 10, 11 and 12."

[163] *Prévost Car*.

as the person who could ultimately benefit from the income. The taxpayer argued that the term "beneficially interested" had a well-understood meaning in Canadian law and that because the Dutch BV did not act as a nominee or agent of Volvo and Henlys and had a legal right to receive the dividends, the Dutch BV was the beneficial owner of the dividends and was therefore entitled to the benefits of the Dutch treaty.

The Tax Court held that the Dutch BV had beneficial ownership of the dividends received by it and the shares on which those dividends were paid. The court summarized the test for beneficial ownership as follows:

> In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. When the Supreme Court in *Jodrey* stated that the "beneficial owner" is one who can "ultimately" exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word "ultimately," to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation. The word "ultimately" refers to the recipient of the dividend who is the true owner of the dividend, a person who could do with the dividend what he or she desires. It is the true owner of property who is the beneficial owner of the property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatory is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients.

The Tax Court decision was upheld and the test of beneficial owner endorsed by the Federal Court of Appeal:

> The Judge's formulation captures the essence of the concepts of "beneficial owner," « bénéficiaire effectif » as it emerges from the review of the general, technical and legal meanings of the terms. Most importantly, perhaps, the formulation accords with what is stated in the OECD Commentaries and in the Conduit Companies Report.

Thus, in *Prévost Car*, the Tax Court made it clear that the term "beneficial ownership" has a well-understood meaning in Canadian tax law, and that a person with legal entitlement to a particular amount is the beneficial owner of that amount. More importantly, the court held that a holding corporation was the beneficial owner of the income it received unless it "has absolutely no discretion" as to the use of the funds.

In *Velcro Canada Inc. v. The Queen*,[164] the Tax Court adopted a similarly narrow view of the concept of beneficial ownership in concluding that royalty payments for the use of Velcro-brand technology made by Velcro Canada Inc., a Canadian-resident corporation, to Velcro Holdings BV, a related Netherlands-resident corporation, were entitled to the benefit of Article 12 of the Canada-Netherlands tax treaty. From 1987 to 1995, Velcro Canada had paid royalties under a licence agreement to Velcro Industries, a related Netherlands-resident corporation. In October 1995, Velcro Industries became a resident of the Netherlands Antilles and therefore ceased to be entitled to the benefits of the Canada-Netherlands treaty. At that time, Velcro Industries assigned its rights to the royalties from Velcro Canada to Velcro Holdings and, consequently, Velcro Canada paid royalties to Velcro Holdings for the period 1996 to 2004. As part of the assignment, Velcro Holdings was contractually obliged to make royalty payments to Velcro Industries within 30 days of the receipt of royalty payments by Velcro Holdings from Velcro Canada. Pursuant to that contractual obligation, the court made a finding of fact that an amount equal to approximately 90 per cent of the royalty payments received by Velcro Holdings were paid by it to Velcro Industries.

The CRA reassessed Velcro Canada for tax and penalties based on its failure to withhold the required amount of Canadian withholding tax, without any reduction under the Canada-Netherlands treaty. The basis of the reassessment was that Velcro Industries, not Velcro Holdings, was the beneficial owner of the royalty payments.

The Tax Court rejected the Crown's basic argument that Velcro Holdings was not the beneficial owner of the royalty payments because it was an agent or conduit of Velcro Industries and did not exercise the "incidents of ownership" in respect of the royalties, as required in the *Prévost Car* case. The court applied the same narrow approach to the meaning of "beneficial ownership" endorsed in *Prévost Car* — namely, that a person is the beneficial owner of amounts unless the person is a conduit for another person and has absolutely no discretion as to the use or application of the amounts received. The court was not persuaded that the contractual obligation of Velcro Holdings to make payments to Velcro Industries was tantamount to Velcro Holdings having no discretion with regard to the use and application of the royalty payments it received.

The court identified several factors that supported its conclusion that Velcro Holdings exercised sufficient discretion and control over the royalty payments it received to be properly regarded as the beneficial owner: (i) the royalty payments were commingled with the other funds of Velcro Holdings, were fungible and earned interest for Velcro Holdings; (ii) Velcro Holdings bore the currency risk associated with the royalty payments; (iii) Velcro Industries was an unsecured creditor of Velcro Holdings; and (iv) there was no pre-determined flow of funds from Velcro Holdings to Velcro Industries.

The Crown did not appeal the Tax Court decision in *Velcro*.

[164] 2012 TCC 57 (TCC).

While the decision in *Prévost Car* seems consistent with current OECD commentary, including the 2012 revised proposals, it is less clear that *Velcro* is consistent with the current OECD commentary. The experience of other countries is mixed with respect to applying the beneficial-owner requirement in avoidance cases involving their tax treaties and domestic laws. Many countries have opted to supplement the beneficial-ownership requirement in such cases with a substance-over-form or abuse-of-law principle.[165]

[165] For an extensive canvas of the use of the beneficial-ownership concept in other countries, see Brian J. Arnold, Elinore J. Richardson and Geoffrey Walker, "Judicial Approaches to Treaty Interpretation — A Global Perspective," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013) 29:65. See also Michael N. Kandev and Matthew Peters, "Treaty Interpretation: The Concept of 'Beneficial Owner' in Canadian Tax Treaty Theory and Practice," in *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 26:1-60.

APPENDIX 4 — GAAR CASES INVOLVING INTERNATIONAL TAX AVOIDANCE

To date, with few exceptions, the Crown has fared poorly in Canadian courts where it has asserted that treaty benefits should be denied in tax-avoidance cases. The relevant cases examined here are *RMM Canadian Enterprises v. The Queen*,[166] *St. Michael Trust Corp. v. The Queen* (formerly *Garron Family Trust*),[167] *The Queen v. MIL (Investments) SA*,[168] and *Antle v. The Queen*.[169] The basic approach adopted by the courts in these international tax-avoidance cases is that where a resident of a treaty country meets the conditions for entitlement to treaty benefits set out in the relevant treaty provision, that entitlement does not constitute abusive tax avoidance. In these cases, the courts have been reluctant to give much weight to a "purposive" reading of the relevant treaty provisions; they seem to have been persuaded that the "spare" drafting style in tax treaties does not lend itself to a purposive interpretation. Instead, the courts have emphasized a textual and contextual approach to interpreting treaty provisions.

MIL (Investments) is regarded as the leading case involving treaty shopping. MIL (Investments) S.A. was a corporation resident in the Cayman Islands. Canada has no tax treaty with the Cayman Islands. MIL (Investments) owned shares in a Canadian mining corporation (DFR). In a tax-deferred rollover for Canadian tax purposes, the Canadian taxpayer corporation sold a portion of its DFR shares to Inco, another Canadian mining corporation, for Inco shares. MIL (Investments) was continued to and became a resident of Luxembourg, and was therefore entitled to treaty benefits under the Canada-Luxembourg tax treaty. A year later, MIL (Investments) sold its Inco shares and the remaining portion of its DFR shares pursuant to a public takeover of DFR. MIL (Investments) claimed an exemption from Canadian tax on the capital gain resulting from the sale of the DFR shares under Article 13 of the treaty. The CRA reassessed on the basis that GAAR applied to deny the treaty exemption.

The Tax Court held that the GAAR did not apply because the sale was not an *avoidance* transaction; further, and in any event, there was no misuse or abuse of the act or of the treaty.[170]

[166] 97 DTC 302 (TCC). In the case, Bowman CJ considered the application of GAAR to a surplus-stripping arrangement. Although he concluded that the application of GAAR was not needed for the minister to successfully reassess the arrangement (subsection 84(2) and the surplus-stripping jurisprudence, including cases such as *Smythe v. MNR*, 72 DTC 6470 (SCC) were sufficient), he would have applied GAAR to obtain the same result if it had been needed. In connection with GAAR, Bowman CJ stated:

> "… the *Income Tax Act*, read as a whole, envisages that a distribution of corporate surplus to shareholders is to be taxed as a payment of dividends. A form of transaction that is otherwise devoid of any commercial objective, and that has as its real purpose the extraction of corporate surplus and the avoidance of the ordinary consequences of such a distribution, is an abuse of the Act as a whole."

[167] 2012 SCC 14 (affirming 2010 FCA 309 and 2009 TCC 450).

[168] 2007 FCA 236 (affirming 2006 TCC 460).

[169] 2009 TCC 465 (affirmed 2010 DTC 5172 (FCA)).

[170] The case was heard before the Supreme Court reformulated the misuse-and-abuse test in subsection 245(4) into an *abusive tax-avoidance* requirement.

On the Crown's appeal to the Federal Court of Appeal, the taxpayer conceded that the sale was an avoidance transaction. The taxpayer argued, however, that GAAR did not apply because obtaining the treaty exemption did not constitute abusive tax avoidance. In a surprisingly brief oral decision, the Court of Appeal summarily rejected the Crown's argument:

> … we are of the view that the appeal would fail in any event as we are unable to see in the specific provisions of the Income Tax Act … and the Tax Treaty to which we were referred, interpreted purposively and contextually, any support for the argument that the tax benefit obtained by the respondent was an abuse or misuse of the object and purpose of any of those dispositions (sic).[171]

The Court of Appeal gave the treaty provisions what it described as a "purposive" reading and, based on that reading, was not persuaded by the Crown's arguments that obtaining the treaty benefits was contrary to the object and spirit of the relevant treaty provisions. On this point, the court stated:

> It is clear that the Act intends to exempt non-residents from gains on the disposition of treaty exempt property. It is also clear that under the terms of the Tax Treaty, the respondent's stake in DFR was treaty exempt property. The appellant urged us to look behind this textual compliance with the relevant provisions to find an object or purpose whose abuse would justify our departure from the plain words of the disposition. We are unable to find such an object or purpose.
>
> If the object of the exempting provision was to be limited to portfolio investments, or to non-controlling interests in immoveable property (as defined in the Tax Treaty), as the appellant argues, it would have been easy enough to say so. Beyond that, and more importantly, the appellant was unable to explain how the fact that the respondent or Mr. Boulle had or retained influence of control over DFR, if indeed they did, was in itself a reason to subject the gain from the sale of the shares to Canadian taxation rather than taxation in Luxembourg.
>
> To the extent that the appellant argues that the Tax Treaty should not be interpreted so as to permit double non-taxation, the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities.[172]

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[171] Supra note 171, paragraph 5.

[172] Supra note 171, paragraphs 6-8.

Strictly speaking, the *St. Michael Trust* and *Antle* cases were not decided on the basis of GAAR; however, both provide some insight into GAAR's potential application to treaty benefits. In general, *St. Michael Trust* followed the reasoning of the courts in *MIL (Investments)* and rejected a treaty override using GAAR. In *Antle*, as an alternative basis for its decision confirming the Crown's reassessment, the Tax Court held that GAAR applied to deny any treaty benefit. In contrast to *St. Michael Trust*, in *Antle* the issue of GAAR overriding the treaty was considered in relation to determining the tax liability of a resident of Canada, which was clearly a factor in the court's approach. The Tax Court's reasoning in this regard differed from its approach in *Canada v. Sommerer*,[173] although both cases were decided by the same judge.

In *St. Michael Trust*, Canadian-resident taxpayers who held the common shares of a Canadian corporation converted their shares into "freeze" preference shares with a fixed redemption value. The taxpayers caused the common or "growth" shares to be acquired by two spousal trusts established in Barbados. At issue was whether the substantial capital gains realized by the spousal trusts on the disposition of the common shares two years later were exempt from Canadian tax under Article XIV(4) of the Canada-Barbados tax treaty. The Tax Court concluded that the spousal trusts were resident in Canada (not Barbados) under case-law principles; consequently, the spousal trusts were not residents of Barbados for purposes of the tax treaty. Both the Federal Court of Appeal and the Supreme Court confirmed this conclusion.

In addition, the Tax Court dealt with the Crown's alternative argument that GAAR should apply to deny the expected treaty benefits. The key issue in that regard was whether obtaining the treaty benefits met the *abusive tax-avoidance* requirement. In obiter comments, the Tax Court held that there was no *abusive tax avoidance* of the relevant treaty provisions. The court rejected the Crown's argument that treaty benefits should be denied to the trusts because they had "very little connection with Barbados" and that granting the treating benefits "would facilitate the avoidance of tax by Canadians." The Tax Court concluded that GAAR did not apply to deny treaty benefits to the trusts:

> The problem with this argument is that, if accepted, it would result in a selective application of the treaty to residents of Barbados, depending on criteria other than residence. This seems contrary to the object and spirit of the treaty, which is apparent in Article I and Article IV(1). Residents of Barbados, as defined for purposes of the *Treaty*, are entitled to the benefits of Article XI(4) as long as they are not also residents of Canada.[174]

The Federal Court of Appeal agreed with this reasoning in its decision on the appeal. The Supreme Court did not deal with the treaty issues.

Antle dealt with the application of GAAR in similar circumstances to those considered in *St. Michael Trust*. A key difference, however, is that in *Antle* the Canadian-resident individual who transferred shares to a Barbados trust, rather than the trust itself, was the taxpayer reassessed on the basis of GAAR. The Tax Court held (affirmed by the Federal Court of Appeal) that the trust was not validly constituted as a matter of law. The result was that the Canadian-resident individual was subject to tax on the capital gain realized by the putative trust on its disposition of the "growth" shares.

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[173] 2012 FCA 207. *Sommerer* was a non-treaty case.

[174] Supra note 172, paragraph 381.

The Tax Court also considered the potential application of GAAR. In obiter comments, the court seemed to conclude that obtaining treaty benefits for the Barbados trust resulted in an abuse of the Income Tax Act and the treaty. At first blush, it might appear that the Tax Court found that abuse of the treaty in itself was a basis for concluding that obtaining treaty benefits for the Barbados trust met the *abusive tax-avoidance* requirement. However, it is by no means clear that this was the basis for the court's conclusion:

> The respondent argues that GAAR applies to both the individual Appellant, Mr. Antle and to the Trust. To apply GAAR to the Trust itself would require identifying the spirit, object and purpose of the Treaty provision (Article XIV) or to identify the policy of that Treaty provision together with the relevant Income Tax Act provisions read as a whole. The former analysis is not difficult: for the most part gains on disposition(s) of moveable property are to be taxed in the alienator's country of residence. There is no further object or purpose to be found — it is clear from the provisions itself. The latter analysis is not so straightforward. Indeed, it is, I suggest, unreceptive to analysis. To suggest that one can cobble together some policy underlying the interplay between Article XIV of the Treaty and the Income Tax Act provisions at issue is to provide fodder perhaps for academics, but it is, with all due respect to the drafters of both, an attempt to create object, spirit and purpose — policy if you will — where none was contemplated. Certainly, no such policy has been pointed out to me. Article XIV is what it is.[175]

In the end, the court seems to have concluded that obtaining the treaty benefits by the trust did not meet the *abusive tax-avoidance* requirement, but that the use by a Canadian-resident taxpayer of certain provisions of the act and the treaty was abusive.

Notwithstanding the foregoing GAAR cases, it is not clear that the current law with respect to the application of GAAR to treaties is sufficiently developed to have any reliable predictive value. A case can be made that obtaining treaty benefits in a particular case may meet the *abusive tax-avoidance* requirement. The principal reasons for this are twofold. First, while the Supreme Court has endorsed general principles to govern the application of the GAAR in the domestic context, it has not considered the application of the GAAR in a treaty context. Until it has done so, it is difficult and premature to predict the approach that the court will take in applying the GAAR in a treaty context. That said, it would be surprising if the court adopted a fundamentally different approach from the one it has endorsed in applying the GAAR in the domestic context. Less certain, however, is whether the court will adopt the same textual approach to the determination of what constitutes an abuse of a treaty provision as the one the lower courts adopted in *MIL (Investments), St. Michael Trust* and *Antle*.

[175] Ibid., paragraph 100.

Although GAAR was not an issue in *Crown Forest*,[176] it is relevant in considering the potential application of the GAAR in a treaty context, most notably because the court commented on treaty shopping in that case. It endorsed a common-sense approach to treaty interpretation in order to achieve the three principal purposes of a treaty: to avoid double taxation, to prevent tax avoidance and evasion, and to mitigate administrative complexities. With respect to the purposes of the relevant U.S. treaty, the court referred to a document tabled in the U.S. Senate (foreign relations committee), *Tax Convention and Proposed Protocols with Canada*, which summarized those purposes as follows:

> The principal purposes of the proposed income tax treaty between the U.S. and Canada are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of income taxes of the two countries.[177]

The court seemed to give equal weight to the words and the purpose of a particular provision in determining its proper interpretation. With respect to the entitlement of Norsk, a Bahamian corporation, to treaty benefits, the court stated:

> It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements.[178]

This statement seems to be consistent with the Supreme Court's general view of tax-treaty interpretation: that treaties should be interpreted on a purposive as well as a textual basis. The court went on to state that it would be "highly undesirable" if the taxpayer were treated as a U.S. resident under the treaty by reason of its place of management.

Some factors — the comments by the Supreme Court in *Crown Forest*, its decision in *Copthorne Holdings Ltd. v. The Queen*,[179] aspects of the majority decision of the court in *Lipson v. The Queen*,[180] and the changed composition of the court — may indicate that its approach to the application of the GAAR to tax treaties is more nuanced and assertive than the decisions of the lower courts dealing with GAAR and treaties. At the least, the absence of any consideration of GAAR in a treaty context by the Supreme Court creates considerable uncertainty as to the predictive value of current jurisprudence. The obiter comments of the Supreme Court in *Crown Forest* provide some support for the argument that obtaining treaty benefits in particular cases may be abusive.

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[176] Supra note 158. This case dealt with a residence-based challenge to deny treaty benefits and is discussed further in Appendix 3.

[177] Ibid., paragraph 52.

[178] Ibid., paragraph 55.

[179] [2011] 3 SCR 721 (affirming 2009 FCA 163 and 2007 TCC 481).

[180] 2009 SCC 1 (affirming 2007 FCA 113 and 2006 TCC 148).

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