

FEATURED PERSPECTIVES

Canada to Unilaterally Override Tax Treaties With Proposed New Anti-Treaty-Shopping Rule

by Steve Suarez

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International tax avoidance has been in the news for the past two years, as large multinational entities (MNEs) that reduce their global tax bill through various strategies are criticized publicly and scrutinized by governments seeking a “fair” share of taxes. The perception that MNEs are able to use income shifting and other forms of tax arbitrage to achieve an unfair advantage over domestic taxpayers and deprive governments of badly needed revenues is discussed by both the public and the tax community. The result has been a flurry of activity, most notably the OECD’s base erosion and profit-shifting initiative. Among the issues addressed by the BEPS initiative is treaty abuse.¹

Canada’s Department of Finance issued a consultation paper in August 2013 setting out possible approaches for addressing the government’s dissatisfaction with treaty shopping.² Among the questions posed by Finance in the consultation paper were whether:

- the government’s response should be treaty-based or based on domestic law;
- the approach taken should be general or specific; and
- a “main purpose” test would be appropriate in terms of both effectiveness and providing an acceptable level of certainty for taxpayers.

¹See Action 6, “Prevent Treaty Abuse,” in “Action Plan on Base Erosion and Profit Shifting,” at <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

²See <http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp#a1>.

The submissions received largely advocated a treaty-based approach and specific rather than general provisions, with a notable lack of enthusiasm for a main purpose test.³

I. Budget 2014: Proposed Rule

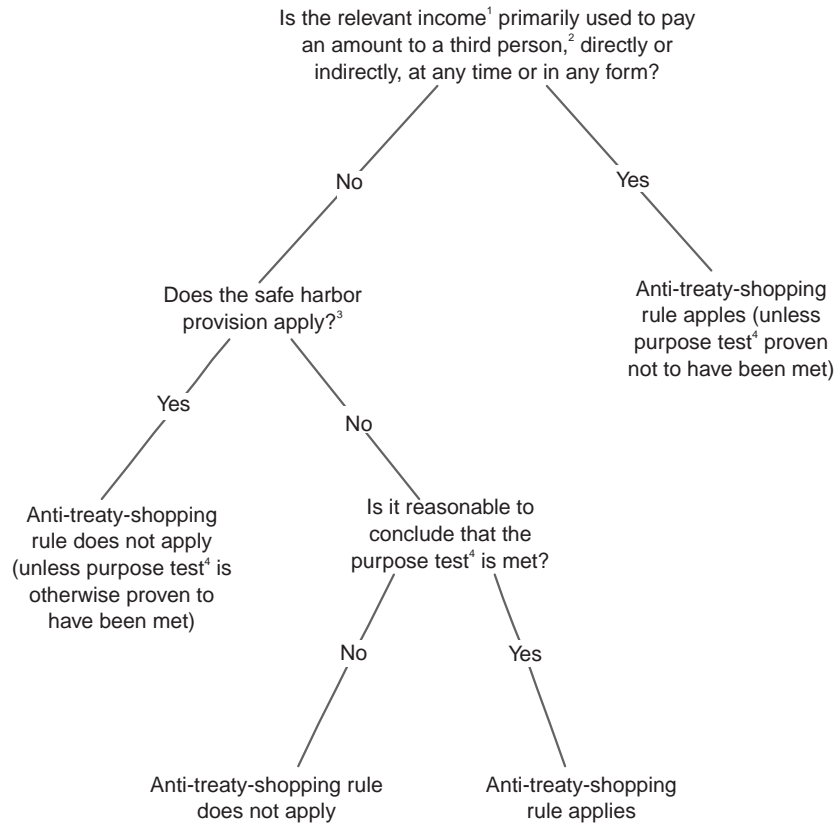
In the 2014 federal budget delivered on February 11, 2014,⁴ Finance unveiled “a proposed rule to prevent treaty shopping.” The proposed rule would be enacted under domestic law, is general in nature, and is based on a “main purpose” test (actually a “one of the main purposes” test). Briefly:

- Canada proposes to take unilateral action and amend its Income Tax Conventions Interpretation Act (ITCIA) to create a domestic anti-treaty-shopping rule. The ITCIA sets out rules for how Canada will interpret and apply its tax treaties, and as such, the proposed rule effectively constitutes a treaty override to the extent that it changes the result that would otherwise occur from Canada interpreting and applying a tax treaty (which is clearly the intent).
- The proposed rule would “use a general approach focused on avoidance transactions” but include “specific provisions setting out the ambit of its application.”
- Ostensibly, the proposed approach “would ensure that treaty benefits are provided with respect to

³The submissions are available at <http://www.fin.gc.ca/consultresp/ts-cf-eng.asp>.

⁴The 2014 budget documentation is available at <http://www.budget.gc.ca/2014/home-accueil-eng.html>; pp. 349-357 deal with the proposed rule.

Proposed Anti-Treaty-Shopping Rule



¹“Relevant income” is the particular item of income, profit, or gain received by the nonresident claiming treaty relief from Canadian taxation (the “actual recipient”).

²“Third person” is a person (or persons) who, if they received the relevant income directly from the Canadian payer, would not be entitled to treaty relief at least as favorable as the actual recipient.

³The safe harbor provision applies where (1) the actual recipient (or a related person) carries on an active business (other than managing investments) in the treaty country (and, if the Canadian payer is related, that business is substantial relative to the Canadian activity that gives rise to the relevant income), (2) the actual recipient is not controlled directly or indirectly in any manner whatever by one or more third persons, or (3) the actual recipient is a corporation or trust whose shares/units are regularly traded on a recognized stock exchange.

⁴The purpose test is met if one of the main purposes for undertaking a transaction that results (or is part of a series of transactions that result) in the tax treaty benefit applying to the relevant income is obtaining that treaty benefit.

ordinary commercial transactions,” and “the proposed rule would not apply in respect of an ordinary commercial transaction solely because obtaining a tax treaty benefit was one of the considerations for making an investment.”

- The proposed rule would apply to tax years commencing after the enactment of the rule, with consideration being given to whether “transitional relief would be appropriate.”

The 2014 budget documentation provides a general outline on how the proposed rule would work and includes five examples illustrating how the government

intends for it to be interpreted and applied. The figure above sets out the analytic framework of the proposed rule. Essentially it is a purpose test: It applies if it is reasonable to conclude that “one of the main purposes” of undertaking a transaction that results in (or that is part of a series of transactions that results in) a tax treaty benefit applying to income received by a treaty country resident in a treaty country is obtaining that tax treaty benefit. The purpose test is deemed to have been met in some “conduit” situations in which the relevant item of Canadian-source income is used “primarily” to fund payments to third persons who would, had they received the amount directly from the

Summary of Proposed Rule

- Targets “treaty shopping” rather than “treaty abuse.”
- To be enacted as domestic law treaty override, with Canada unilaterally setting its own standards.
- Essentially a “purpose” test, with low threshold to trigger application.
- Where rule applies, treaty benefits are allowed only to the extent “reasonable in the circumstances.”
- Lower threshold for application than existing domestic law GAAR, which was specifically amended to encompass treaty abuse.
- Scope is overbroad; “one size fits all” solution is too general; where rule applies, standard for granting treaty benefits (to the extent “reasonable”) is too vague and leaves taxpayers with too much uncertainty.
- “Main purpose” test inherently problematic, and there is little evidence justifying its use as an across-the-board standard for defining treaty abuse.
- Payers of amounts subject to Canadian withholding tax have little ability to determine recipient’s entitlement to treaty benefits under proposed rule, based on recipient’s “purpose” and “reasonableness.”
- Canadians with foreign subsidiaries or who are recipients of foreign-source income should expect reciprocal denial of benefits by Canada’s treaty partners.
- Unilateral action is not the right way to create new standards for granting treaty benefits, especially with the BEPS initiative well advanced.
- Superior approach would be:
 - Short term, wait for BEPS recommendations in September 2014 to develop broad-based solutions on treaty abuse and related issues (for example, hybrids, harmful tax practices).
 - Medium term, seek bilateral solution (treaty renegotiation or technical explanation (extrinsic guidance on object, spirit, and purpose of treaty provisions) and existing domestic law GAAR) with priority being treaties perceived to be problematic. Unilateral action should be a last resort and targeted.

Canadian payer, have been entitled to less favorable Canadian tax treaty relief than the actual recipient of the Canadian-source income.⁵ If the facts do not constitute a conduit situation, then three fairly narrow safe harbors exist where the purpose test is presumed not to have been met so that the proposed rule will not apply.⁶

⁵A conduit situation exists where the relevant item of income is primarily used to pay an amount (directly or indirectly, at any time or in any form) to a person (a third person) who would, if that person had received the relevant income directly, be entitled to a lesser Canadian tax treaty benefit than the actual recipient is entitled to. It is stated that in a conduit situation, it would be possible to escape the application of the proposed rule if it could be proven that the purpose test was nonetheless not met on the facts, although how or under what circumstances this could be achieved is not apparent.

⁶The safe harbor provision applies where:

- the actual recipient of the relevant income (or a related person) carries on an active business (other than managing investments) in the treaty country (and, if the Canadian payer is related, that business is substantial relative to the Canadian activity that gives rise to the relevant income);
- the actual recipient is not controlled directly or indirectly in any manner whatever by one or more third persons (that is, someone who would be entitled to lesser tax treaty benefits than the actual recipient had they received the relevant income directly); or

(Footnote continued in next column.)

Where the rule does apply, then the tax treaty benefit will be provided, if at all, only “to the extent that it is reasonable having regard to all the circumstances.” No further detail is provided on what the government considers to be “reasonable.” Comments on the proposed rule are invited if received within 60 days of February 11. The BEPS recommendations due to be released in September 2014 are stated as being “relevant in developing a Canadian approach to address treaty shopping.”

II. Analysis

Tax treaties are powerful instruments negotiated between sovereign states and given the force of law. It is perfectly reasonable for a government to wish to take steps to ensure that its treaties are not being used inappropriately to reduce taxes in ways that treaty signatories had not intended. The government can choose whether to:

- substantively change the law in terms of when Canada will grant treaty benefits; or
- the actual recipient is a corporation or trust whose shares/units are regularly traded on a recognized stock exchange.

- adopt a more modest approach of accepting the current standards and provide interpretative guidance to the courts on how to apply those rules.

A substantive change in law effectively constitutes a unilateral revision to the agreement negotiated with each of Canada's treaty partners. The government can do it, but it should be clearly identified as such, and Canada should expect its treaty partners to feel free to do likewise if they find aspects of their treaties with Canada not to their liking. A substantive change in law also adversely affects taxpayers who have structured their affairs in reliance on existing standards, necessitating fair transitional relief to allow for restructuring. Conversely, accepting the current standards for entitlement to treaty benefits and providing additional interpretative guidance respects existing treaty agreements and is less likely to be objectionable to our treaty partners and unfair to taxpayers, but also limits the scope of what the government can do to achieve a change of results.

The proposed rule amounts to a sweeping unilateral change regarding when Canada will provide treaty benefits to residents of its treaty partners. While the proposed rule is framed as occurring within the scope of an international initiative, there is little evidence that most of Canada's treaty partners would agree the proposed rule is the right approach, and it is unclear why the government feels the need to announce the change seven months before the release of the BEPS recommendations on preventing treaty abuse in September 2014. Instead, Canada seems to be heading off in its own direction without treaty partner input and before considering the important work the OECD (of which Canada is a member) is doing toward a broad-based multilateral solution that achieves the best possible results and enjoys the widest degree of acceptance.

Fundamentally, the proposed rule dramatically changes Canada's tax treaty landscape by imposing a main purpose test that starts from the dubious premise that seeking treaty benefits is inherently objectionable. The threshold for triggering the proposed rule is very low — the one for the main purposes test will be difficult to avoid, since tax is a significant expense that virtually all ordinary commercial activities seek to minimize. Indeed, any multinational structure that includes an entity resident in a country with a favorable Canadian tax treaty (Luxembourg and the Netherlands come to mind) receiving income from Canada that is subject to withholding tax or holding property subject to Canadian capital gains tax is effectively presumed guilty until proven innocent. Except where the taxpayer can meet the positive obligation of proving itself to be within the scope of three relatively narrow safe harbor provisions, a tax reduction purpose is deemed to be objectionable and the proposed rule applies. Taxpayers caught within the proposed rule's broad net will be allowed only such treaty benefits as Canada decides is "reasonable" in the circumstances from time to time, providing them with very little certainty in structuring

their affairs. The approach seems to be to sweep as much as possible into the net and then separate the good from the bad (however that is to be determined) later.

Clearly, what the government finds most offensive is where significant direct or indirect stakeholders in the entity claiming Canadian treaty benefits are fiscally resident in one or more countries with less advantageous Canadian treaties (or no treaty at all) than the entity's jurisdiction. In these situations, the proposed rule would see Canada unilaterally imposing its own standard for when the presence of third-country stakeholders should result in the denial of treaty benefits, such that the treaty entity's entitlement to Canadian benefits depends on the least advantageous treaty position in the ownership chain above it, a kind of "least favored nation" standard.

Payers of amounts to nonresidents that are subject to 25 percent Canadian withholding tax under domestic law (for example, dividends, royalties, and non-arm's-length, or participating interest) are themselves liable for all amounts that should have been withheld, plus interest and penalties, with no time limit for the Canada Revenue Agency to reassess. Those payers have no realistic way of knowing what the recipient's main purposes are, whether the proposed rule applies, and (if so) what level of treaty benefits will be determined to be "reasonable having regard to all the circumstances." As such, their only recourse to avoid potential liability will be to withhold and remit the full 25 percent in all but the clearest of cases, requiring the recipient to seek a refund from the CRA in a process that will be lengthy and costly for all concerned, and needlessly impede international commerce. Parties to existing contracts with gross-ups or indemnities on amounts potentially subject to Canadian withholding tax⁷ will need to review them to determine who bears the burden of this change in law, while those drafting new agreements must allocate the risk that Canadian withholding rates will be treaty-reduced much less frequently.

While not themselves directly affected by the proposed rule, Canadians with foreign subsidiaries or otherwise earning foreign-source income could ultimately feel its ramifications. Canada is both a capital-importing and a capital-exporting nation, and it would be entirely rational for Canada's treaty partners to respond to the proposed rule by similarly restricting treaty benefits they grant to Canadians or foreign entities in which Canadians own a significant interest. Enactment of the proposed rule risks setting off a race to the bottom as other countries respond with similarly overbroad regimes, causing taxpayers in various countries to view foreign investment as riskier and less desirable.

⁷Canada's domestic law does not impose withholding tax on payments of interest (other than participating interest) to nonresidents who deal at arm's length with the debtor.

These are hard problems to deal with, and one can certainly sympathize with tax authorities who have the unenviable job of confronting them. Ultimately however, the proposed rule does not really address the fundamental issue (treaty abuse, not treaty shopping), signal to Canada's treaty partners that our preference is to work jointly with them, or make a persuasive case for the general, main purpose approach being adopted. The result is an overbroad, one-size-fits-all solution that ignores the existing tools already available to the government, most notably the general antiavoidance rule in section 245 of the Income Tax Act (Canada). The proposed rule is neither an advisable change in law to make nor one that should be made in the unilateral manner being adopted.

A. Treaty Shopping Defined

In the 2014 budget documentation introducing the proposed rule, Finance states as follows:

Budget 2013 set out the Government's concerns with the abuse of Canada's tax treaties through "treaty shopping." This term is commonly used to refer to arrangements under which a person not entitled to the benefits of a particular tax treaty with Canada uses an entity that is a resident of a state with which Canada has concluded a tax treaty to obtain Canadian tax benefits.⁸

The term "treaty shopping" is widely and somewhat loosely used. While the definition ascribed to it by Finance may or may not be one that is "commonly used," certainly in the last year or two, treaty shopping has acquired a pejorative connotation as something that is inherently objectionable, and the use of the term in the 2014 budget documentation is consistent with that.⁹ This has not always been the case, however, and equating treaty abuse with treaty shopping starts the analysis on a faulty premise.

Treaty shopping should properly be described as simply a subset of the basic tax planning objective of seeking to minimize one's tax burden, in this case through the use of a tax treaty versus another. Treaty abuse, on the other hand, involves judging the taxpayer's actions against some normative touchstone of what should be allowed: The question becomes not merely whether a tax treaty is being used but whether it is being used in a way other than what the signatories intended, or contrary to its object, spirit, or purpose.¹⁰ Understanding the difference is crucial to defining the problem and to designing any solution.

⁸P. 349.

⁹P. 347: "[T]he Government is conducting a consultation on a proposed rule to prevent treaty shopping."

¹⁰See, e.g., "Treaty Abuse and Treaty Shopping," United Nations Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, E/C.18/2006/2, Oct. 16, 2006, para. 24, available at <http://www.un.org/esa/ffd/tax/secondsession/Taxation-Treaty%20Abuse.doc>.

In the August 2013 consultation paper, Finance framed the issue as follows:

"Treaty shopping" generally refers to a situation under which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits.¹ Such practice is generally considered to be an "improper" use of tax treaties.²

¹According to the OECD Glossary of Tax Terms, "treaty shopping" refers to "[a]n analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident in either of the treaty countries establishes an entity in one of the treaty countries to obtain treaty benefits." See also Larking, *IBFD International Tax Glossary*, 5th ed. (2005).

²See section 1 of the Annex which sets out the OECD's position on the improper use of tax treaties. Also, paragraph 47 of the Commentary on Article 1 of the United Nations Model Convention clearly provides that treaty shopping is an improper use of tax treaties.

Footnote 2 cited as the authority for the second sentence above refers the reader to section 1 of the annex to the August 2013 consultation paper, which reproduces excerpts from the OECD commentary to article 1 of the model tax convention. However, paragraph 9.5 of the cited OECD commentary does not equate treaty shopping with treaty abuse. Treaty abuse requires more than a mere purpose to access favorable tax treaty benefits:

9.5 It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. 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. [Emphasis added.]

The proposed rule appears to characterize treaty shopping as inherently a form of tax treaty abuse, a position at odds with the OECD's work to date, and out of line with international norms that assess a claim to benefits under a particular tax treaty with reference to the object, spirit, and purpose of the relevant provisions of the treaty in question. The problem that Canada should be addressing is not how to stop treaty shopping, but rather under what circumstances is the claiming of treaty benefits (including through treaty shopping) abusive.

B. The Justification for Taking Action

The August 2013 consultation paper made the case for taking action on treaty shopping by recounting the history of Canadian court cases dealing with disputed

claims for tax treaty benefits, which has been well-reviewed elsewhere.¹¹ Essentially, Finance points to three cases in which the taxpayer was successful in claiming treaty benefits (the facts of which are largely replicated in three of the five examples included in the 2014 budget documentation accompanying the proposed rule),¹² and concludes as follows:

Collectively, these three cases indicate in relatively strong terms that the courts in Canada are not currently inclined to find against taxpayers in treaty shopping cases. In other words, the courts in Canada require clearer legislative direction to the effect that treaty shopping is an improper use of Canada's tax treaties.

The following observations can be made regarding this very small number of cases:

- as noted earlier, since treaty shopping (properly understood) is in fact not inherently abusive or improper, it is not surprising that the CRA has had limited success before the courts on the small number of cases it has chosen to litigate;
- the CRA sought to apply the GAAR in only one of the three cases,¹³ a fact that might reasonably cause a court deciding the other two cases to doubt that any abuse of the relevant treaty was occurring¹⁴;
- the CRA chose not to exercise its right to appeal the Velcro case to the Federal Court of Appeal; and
- if the CRA felt that any or all of these cases was wrongly decided based on their individual circumstances (bad facts, suboptimal presentation, unsympathetic judge, and so forth), it certainly could have taken any number of other cases to court later to establish a different legal precedent.¹⁵

¹¹See Kristen A. Parillo, "Canada's Tough Choices in Combating Treaty Shopping," *Tax Notes Int'l*, Sept. 23, 2013, p. 1159.

¹²MIL (Investments) S.A. v. The Queen (2006 TCC 460; aff'd, 2007 FCA 236); Prévost Car Inc. v. The Queen (2008 TCC 231, aff'd, 2009 FCA 57); and Velcro Canada Inc. v. The Queen (2012 TCC 273).

¹³MIL (Investments), in which a company originally resident in a non-treaty country continued itself into a tax treaty country and claimed the capital gains exemption under that country's treaty with Canada.

¹⁴In Prévost Car and Velcro, the CRA's argument was essentially one of beneficial ownership and agency, not treaty abuse. One case not mentioned in the August 2013 consultation paper is Antle v. Canada (2009 TCC 465, aff'd, 2010 FCA 280), in which the Tax Court of Canada in obiter made very clear its willingness to apply the GAAR to deny treaty benefits where an abuse is found to occur, even in the absence of an explicit antiavoidance rule in that treaty.

¹⁵Indeed, in the August 2013 consultation paper, Finance refers to "numerous other cases of treaty shopping that have been resolved out of court."

As such, we should be careful about reading too much into how the Canadian tax treaty jurisprudence has developed. Given the right interpretive tools and enough good cases, Canadian courts are clearly willing to act to prevent treaty abuse.

A court that is being asked to apply GAAR to strike down tax planning that meets the letter of the relevant provisions of a tax treaty on the basis that the result is abusive or improper would be guided by some evidence of what the signatories to the treaty intended, that is, the object, spirit, and purpose of the provisions. Tax treaties have a number of purposes,¹⁶ and Canada's interests in negotiating a tax treaty with, for example, a first-world country will not be the same as with a developing nation: Different choices are made depending on the circumstances.¹⁷ It is difficult for a court to analyze whether an abuse of the provisions of a tax treaty has occurred, particularly when the situation is one that the signatories must have been aware of but did not specifically address.¹⁸

It is noteworthy that to date, Canada has not prepared extrinsic interpretative aids to help courts determine what the signatories to its tax treaties intended, and hence what might reasonably be considered abusive:

- Canada has not published a commentary to any of its more than 90 treaties, expanding on the intent and interpretation of its provisions, (such as the United States has done with its technical explanation to the Canada-U.S. income tax convention¹⁹); and
- Canada has not prepared a model tax convention and associated commentary, again as the United States does, explaining its rationale for the provisions it seeks to negotiate and the object, spirit, and purpose of those provisions.

¹⁶For example, the avoidance of double taxation, the allocation of taxing jurisdiction between the source state and the residence state, the exchange of information between treaty partners, and so forth.

¹⁷See, e.g., the wide variation amongst Canada's tax treaties in the source country's ability to tax capital gains realized by a taxpayer in the residence country, discussed in Suarez, "Canadian Taxation of Mining," *Tax Notes Int'l*, Dec. 13, 2010, p. 867.

¹⁸The MIL (Investments) case is an example. Tax authorities entering into tax treaties must be taken to have been aware of the fact that taxpayers can change their fiscal residence (indeed, a number of Canada's treaties have rules limiting treaty benefits for former residents). What should a court infer from the absence of any text in the treaty or extrinsic guidance from the signatories on this issue? Canadian tax authorities can reasonably be unhappy with the result in MIL (Investments), but they certainly had some ability to shape how a court would determine whether an abuse had occurred and the GAAR should apply.

¹⁹Although Canada has expressed agreement with the U.S. technical explanation as representing Canada's understanding of that treaty; see New Release 2008-052, July 10, 2008, available at <https://www.fin.gc.ca/n08/08-052-eng.asp>.

This is somewhat surprising given that it has now apparently been decided that the potential for abuse of these treaties is so great as to necessitate unilaterally overriding all of them. It is absolutely clear that Canadian courts will use these kinds of extrinsic aids in interpreting tax treaties.²⁰ One can't have it both ways: If the CRA should have won a case like MIL (Investments) because the result does not reflect the proper interpretation of the object, spirit, and purpose of the treaty's existing provisions and the signatories' intentions, then clearly something less than an actual treaty amendment (viz., a technical explanation or commentary) can change that result.

C. Domestic Law vs. Treaty-Based Solution

Without a doubt, renegotiating all of Canada's tax treaties would be a major long-term exercise. While over time the government should commit to updating its tax treaties to include whatever antiabuse provisions the signatories agree are appropriate (although unlike the proposed rule, this carries with it the inconvenience of actually obtaining the agreement of the other country), it is not surprising that the government does not view broad-based treaty renegotiation as its first choice for an immediate response.

That being said, unilateral action to rewrite all of Canada's tax treaties (as the proposed rule entails) is simply not the best available option open to the government. The evidence the government put forward in the August 2013 consultation paper to make the case that a treaty-shopping problem (as Finance defines it) exists identifies a handful of countries whose inbound and outbound foreign direct investment (FDI) in Canada suggests a conduit situation. As such, limiting the potential for abuse in a very small number of Canada's tax treaties would surely address most of whatever problem does in fact exist. Moreover, the result of other work streams included within the BEPS initiative (for example, hybrid mismatch arrangements, limiting base erosion, and countering harmful tax practices) will indirectly address many situations that the government believes constitute treaty shopping. There is no need to pick a single solution to immediately address 100 percent of whatever problem exists: Multiple, more targeted alternatives are available.

If in fact a few countries are the source of most of the problem, it would seem quite manageable to at least initiate the process of making amendments to

those few treaties. The counterparties may or may not be willing to negotiate, although if the disproportionate FDI numbers used by the government as evidence of the problem are indeed indicative of treaty abuse, one would think that those countries would find it in their interest to renegotiate their Canadian treaty rather than risk seeing it terminated (especially if those countries are of the same mind as Canada as to the object, spirit, and purpose of the treaty's provisions). In any event, assuming the validity of the government's evidence, there doesn't seem to be any reason not to formally serve notice to the counterparties to those treaties Canada perceives as being abused that a problem exists and that action needs to be taken. Simply assuming that those countries will refuse to negotiate is not a valid reason to make no bilateral effort. The government's response can consist of multiple concurrent initiatives (indeed, different forms of abuse require different responses rather than a one-size-fits-all approach), and a bilateral effort will identify fairly quickly which areas the signatories agree constitute abuse (and which don't).

A bilateral effort need not result in an actual treaty amendment. To the extent that the signatories to a particular treaty can agree on what is abusive, they could prepare an extrinsic aid similar to the technical explanation to the Canada-U.S. treaty that gives a court real, meaningful guidance as to the signatories' intentions and the object, spirit, and purposes of the treaty provisions that they think are susceptible to abuse. While not as authoritative as the actual treaty text, Canadian courts have clearly shown their willingness to use those extrinsic aids in interpreting tax treaties, and a bilateral expression of object, spirit, and purpose would no doubt receive great deference from a court hearing a tax treaty case. To the extent that different treaties raise different abuse concerns (either because of the specific provisions of that treaty or the domestic law of the particular counterparty), bilateral extrinsic aids can address them in a targeted way.²¹ The government would be well-advised to wait for the BEPS recommendations to be released, see where they produce bilateral agreement as to what constitutes treaty abuse, and produce an extrinsic aid that reflects that agreement. Abuse standards that enjoy broad-based support arising from the BEPS initiative can be put in place swiftly.

If exceptional cases arise where a treaty partner is unwilling to adopt the BEPS standards of treaty abuse, the government can prepare its own technical explanation for those specific treaties, to serve as an extrinsic aid to a Canadian court interpreting them. Even preparing a single model technical explanation covering Canada's treaties generally and consistent with the

²⁰See, for example, the Tax Court of Canada's decision in *Elliott et al. v. the Queen* (2013 TCC 57), at para. 53:

In [*Crown Forest Industries Limited et al. v. The Queen*, 95 DTC 5389] the Supreme Court of Canada also held that, in ascertaining the purposes of a treaty article, a Court may refer to extrinsic materials which form part of the legal context, including model conventions and official commentaries thereon, without the need to first find an ambiguity before turning to such materials.

²¹For example, in the August 2013 consultation paper, Finance identified treaty country tax regimes that impose low or no tax on the entity claiming treaty benefits as a "hallmark" of treaty shopping.

broad-based standards being established under the BEPS initiative would be a useful step. Admittedly, the preparation of these sorts of materials requires incremental time and personnel potentially beyond what could reasonably be expected from the small number of dedicated but already fully occupied professionals who staff Finance's Tax Policy Branch. However, the government is clearly able to invest in additional resources to address what it identifies as a serious issue with significant potential revenue leakage.

A treaty technical explanation would be effective as an extrinsic aid for a court to use in interpreting and applying the GAAR: the existing mechanism already in the ITA for preventing the abuse or misuse of statutory or treaty provisions. Roughly 10 years ago, the government amended the GAAR (retroactively no less) to ensure that the abuse or misuse of the provisions of a tax treaty would be subject to the GAAR. Why then is a new rule that applies a different (and clearly lower) standard for the denial of treaty benefits required to prevent treaty abuse? The mechanism to prevent treaty abuse already exists: The courts simply require more guidance in terms of defining what constitutes the abuse or misuse of a treaty. Canada does not need any additional domestic law to address treaty abuse; instead, Canada needs to work directly with its treaty partners and the OECD.

D. The 'Main Purpose' Test

The 2014 budget documentation notes that purpose tests of one form or another have been included in a number of Canadian tax treaties, and advances this fact for the proposition that "a main purpose rule is an approach that is relatively familiar to Canadian taxpayers, tax professionals and Canada's tax treaty partners." This is a rather optimistic assertion. To begin with, the scope of these existing main purpose tests is not uniform, and the proposed rule would constitute a major expansion of the concept. Moreover, of the list of 16 countries identified by Finance in the August 2013 consultation paper as having those provisions in their treaties with Canada, only the United Kingdom and Mexico are major trading partners of Canada, meaning that Canadian taxpayers and their advisers do not have much familiarity with these provisions (there is no Canadian jurisprudence on their interpretation). Major Canadian trading partners such as the U.S. and Japan employ a completely different (limitation on benefits) approach. As such, the case is not strong for using a limited main purpose test in a small subset of Canada's tax treaties to justify imposing an across-the-board main purpose test as the standard for granting all benefits in all of Canada's tax treaties, as the proposed rule would do.

Quite apart from the absence of widespread support for using a main purpose test generally, the main purpose test in the proposed rule sets a very low threshold for potentially denying treaty benefits. Apart from the three safe harbor exclusions, the proposed rule applies if it is

merely "reasonable" (not correct on a balance of probabilities, but simply "reasonable") to conclude that "one of the main purposes" (not the primary purpose as under the "tax avoidance" element of the GAAR) of the transaction in question that results in a tax benefit is obtaining that tax benefit. Put simply, this sets the bar too low, particularly in a withholding tax context where a Canadian payer facing strict liability for underwithholding has little practical means of making an informed judgment as to whether the treaty rate applies.

Indeed, there are very significant shortcomings to relying on a main purpose test for determining when treaty benefits should be granted. These shortcomings have been described elsewhere, most notably in a Canadian context by Jim Wilson in July 2013 with reference to the new Canada-Hong Kong tax treaty (one of the ones cited by the government to support using a main purpose test as the basis for the proposed rule).²² As noted by that learned author (who with more than 30 years of CRA experience would certainly understand the tax authority's perspective), overreliance on a purpose test (particularly one with as low a threshold as the proposed rule) without reference to some normative standard for determining abuse leads to all kinds of benign transactions potentially being denied treaty benefits and an unacceptable level of uncertainty for taxpayers. A key purpose of tax treaties is to offer tax benefits to encourage transactions that otherwise would not occur. If the signatories' intent is to modify taxpayers' behavior by offering treaty relief, why should pursuing that relief be treated as evidence of mischief per se? As discussed above with reference to the proper definition of treaty shopping, the relevant question should not be whether one of the taxpayer's main purposes was to obtain a treaty benefit, but rather is the grant of that benefit in the circumstances consistent with what the treaty signatories intended? If an individual resident in a treaty country transfers personally owned shares of a Canadian company to a holding company resident in the same treaty country solely in order to obtain the reduced dividend withholding rate generally applicable to corporations that own 10 percent or more of the shares of the dividend payer, would anyone anticipate that this is a transaction that should be caught? And if not, then doesn't this demonstrate the shortcomings of making a main purpose test the basis for an antiabuse rule?

E. Ordinary Commercial Transactions

The 2014 budget documentation states that the proposed rule would "ensure that treaty benefits are provided with respect to ordinary commercial transactions." There is, however, no protection for "ordinary

²²See Wilson, "New Limitation on Benefits Provisions in Canada's Tax Treaties — A Step Too Far?" (July 2013), available at <http://www.gowlings.com/KnowledgeCentre/article.asp?pubID=2955&lang=0>.

commercial transactions” unless it is unreasonable to conclude that any of the main purposes of the transaction that results in (or is part of a series of transactions that results in) the tax benefit is to obtain that tax benefit. As noted above, to apply the proposed rule the CRA need only be “reasonable,” not judged correct, in concluding that one of the taxpayer’s main purposes was obtaining a treaty benefit. Most “ordinary commercial transactions” are structured with tax considerations in mind, since tax is often one of the biggest costs incurred. It will be very difficult for most taxpayers not to fall within the scope of the proposed rule.

The gap between the description of the proposed rule in the 2014 budget documentation and its actual operation is significant. One is reminded of the foreign affiliate dumping (FAD) rules introduced in 2012,²³ which were described as excluding transactions meeting a business purpose test but which in fact did not exclude transactions on the basis of having a primary (or even exclusive) business purpose.²⁴

F. ‘Conduit’ Situations

The conduit element of the proposed rule is also problematic. The government can reasonably take the position that the beneficial ownership standard currently used in Canada’s tax treaties is not by itself achieving the desired result, and that a change in the rules is warranted (this may or may not be the right tax policy choice, and may or may not require the consent of our treaty partners, but these are other questions). However, the proposed rule effectively treats conduit situations as per se abusive, without explaining why. At a conceptual level, this may or may not be the right answer (and it will be interesting to see what the BEPS recommendations are on this topic), although it is certainly open to debate²⁵ and if the case supporting it is that obvious, it should be easy for the government to make it.²⁶

In any event, if (as the government believes) conduit situations are determined to be offensive from a policy

perspective, what is the appropriate level of third-country ownership to define when treaty benefits should be denied as being abusive? The proposed rule creates a low standard (that is, if the relevant income is “primarily” used, “directly or indirectly, at any time or in any form,” to fund a payment to a third-country resident entitled to lesser treaty benefits), without any discussion as to why this is the appropriate benchmark. This wording requires very little linkage between events to create a conduit situation, and the terms used are very broad and not well-defined.

Taxpayers planning a cross-border commercial transaction need both a meaningful level of certainty as to the tax consequences and a rule that is practical and workable. Canadian payers facing strict liability for underwithholding have no ability to anticipate the recipient’s future use of the payment. Recipients whose source-country tax liability may remain uncertain for many years will encounter problems in claiming foreign tax credits in their home country. In particular, the proposed rule does not seem very practical in dealing with collective investment vehicles and other situations in which the identity of the stakeholders changes frequently and/or their entitlement to treaty benefits with Canada will be very difficult to determine with a meaningful degree of certainty.²⁷ At the very least, in those situations it is certainly harder to make the case that an abuse of a tax treaty is present in such ordinary commercial transactions. While tax authorities may reasonably decide that the traditional beneficial ownership test is no longer sufficient, the definition of conduit situations in the proposed rule is much too overinclusive and impractical.

G. Determining Reasonableness

Finally, where the proposed rule does apply, the extent to which treaty benefits are granted (if at all) is to be limited to what is “reasonable having regard to all the circumstances.” It is not clear on what basis a determination of reasonableness will be made, and in the absence of further guidance such as a tax treaty technical explanation or similar extrinsic aid as is being suggested here, a Canadian court may not be much more informed than it is today. Since what is reasonable constitutes a question of judgment, and given how frequently the purpose test will be triggered, this proposed rule created for attacking treaty benefit claims (incremental to the GAAR but with a lower threshold for application) will add an unreasonable level of uncertainty for taxpayers resident in countries with which Canada has a tax treaty. Canadians hoping to claim

²³See Suarez, “New Foreign Affiliate ‘Dumping’ Rules Constitute Major Canadian Tax Policy Change,” *Tax Notes Int’l*, Dec. 17, 2012, p. 1145.

²⁴The closest business connection test in the FAD rules that was provided as a substitute for a business purpose test considers the degree of connection between different businesses and the location of who the decision-makers are, but not the presence or absence of any tax motivation for entering into a transaction. *Id.* at 1162-1163. It is interesting that the proposed rule is triggered by the presence of a tax reduction purpose, but the absence of one is not enough to preclude the FAD rules from applying.

²⁵See, e.g., Robert Couzin, “A Few Thoughts on Treaty Shopping,” *Canadian Tax Journal* (2013), Vol. 61, No. 3, pp. 671-676.

²⁶This is not a new issue: The signatories to a tax treaty would certainly be aware that an entity in one treaty country earning income from the other treaty country may well have shareholders (or unit holders) resident in one or more third countries, and LOB provisions have been around for quite some time.

²⁷One approach would be to limit the rule to situations in which a particular entity (or group of related entities) has de jure control over the entity claiming the treaty benefit, similar to the manner in which the FAD rules apply only where the relevant Canadian corporation is de jure controlled by a nonresident corporation.

treaty benefits from other countries should expect to encounter corporate restrictions soon enough as Canada's treaty partners reciprocate with new rules of their own.

III. Conclusion

Countries are not obliged to provide tax treaty benefits in situations where they perceive the treaty's provisions are being abused (even where the treaty contains no antiavoidance provision). That being said, the proposed rule is an extremely blunt instrument, a one-size-fits-all solution to a complex, multifaceted (and bilateral) problem, and one that will create significant costs through overreaching and risks irritating Canada's treaty partners who find unilateral amendment to their Canadian tax treaties offensive. One cannot help but be reminded of the FAD rules, which tried to address both cross-border surplus stripping and debt dumping within the same rule. The result was overbroad legislation that:

- clearly encompasses situations beyond those that produced the sort of mischief that prompted the introduction of the FAD rules;
- generates significant risk of double taxation in some cases; and
- potentially discourages legitimate and beneficial business investment that has no particular tax-reduction motive, purpose, or result.

The government made sure that every possible abusive situation was caught, but in doing so also caught more than it needed to (in fairness, some accommodations were made to reduce the extent of the overreach and make the consequences less painful). Overreach has a cost, particularly in the context of tax treaties designed to encourage and facilitate cross-border investment that might not otherwise occur. The proposed rule does not strike the appropriate balance.

An immediate and more targeted solution would be to address the specific tax treaties perceived to be the source of most of the problem. Proper notice should be served to the counterparties to those treaties that problems exist, and that Canada wants their cooperation in developing a solution. That solution can take

the form of a duly negotiated treaty amendment, or a technical explanation directed at what Canada and the other treaty signatory believe to be abusive in the context of any particular treaty, taking into account the specifics of that treaty and the domestic law of the signatories. That targeted approach would be consistent with international norms, reduce the risk of both overreach and underreach, and still be achievable in a realistic time frame while allowing the results of the BEPS initiative to be incorporated into the solution.

No government should be expected to accept the abuse of its tax treaties, and where abuse occurs, remedial action should be taken. However, the scope of what constitutes abuse needs to be very carefully considered, in a way that takes into account the views of Canada's treaty partners (or at least as many of them as can reasonably be accommodated — unanimity is not required). Without some degree of common acceptance of the problem, the optimal solution cannot be reached. Different forms of abuse may require different solutions (especially where the treaty partner's domestic law contributes to the problem), and the government should acknowledge that overly broad responses carry a real cost and ensure that any new measures are targeted to catch that which should be caught, and no more. Those new measures must give taxpayers an acceptable level of certainty sufficient to plan their affairs (and reasonable transitional relief to bring existing arrangements into line), and be sufficiently practical to give those obligated to comply with them (including payers liable to withhold and remit on account of Canadian tax and those claiming home-country FTCs for Canadian taxes paid) the ability to do so without undue cost or risk. Finally, whatever action is taken should be developed with due regard for Canada's tax treaty partners, and include only measures that the government is prepared to see Canadians themselves be subject to when other countries take action to restrict treaty benefits. Unilateral action should be a last resort targeted at specific forms of abuse for which a bilateral solution cannot be found. While defining and combating treaty abuse is a difficult issue and there are no easy answers, whatever steps Canada takes to prevent abuse of its tax treaties should meet these standards. ♦