TREATY SHOPPING AFTER *PRÉVOST CAR*: WHAT DOES THE FUTURE HOLD?

In 2009 IFA (Canada) Seminar Proceedings

By

Michael N. Kandev, LL.M. (International Tax)[1]

Partner, Davies Ward Phillips & Vineberg, LLP, Montreal

I. INTRODUCTION

Canada currently has 87 tax treaties in force. Each one of them reflects an individually-negotiated "deal". In this respect, although Canada's tax treaties are generally based on the OECD's *Model Convention on Income and Capital* (the "**OECD Model**"), they are all different. The absence or presence of a tax treaty between two countries and the inherent differences between tax treaties give rise to the tax planning technique pejoratively known as "treaty shopping". This is the subject of this paper, which is an expanded version of the author's presentation at the 2009 IFA (Canadian Branch) International Tax Seminar (the "**Seminar**").

This article first provides a *tour d'horison* on the treatment of treaty shopping in Canada. Then, it examines in detail the decisions in Canada's second and most recent treaty shopping case, *Prévost Car Inc. v. Canada*.[2] Finally, it attempts to answer the question "What does the future hold?" in respect of Canada's approach to treaty shopping.

II. TREATY SHOPPING: A *TOUR D'HORISON*

A. Overview

[1] The author would like to thank his partner, David A. Ward, for his helpful comments in respect of this article. All errors or omission remain the responsibility of the author.

[2] 2009 DTC 5053 (FCA) aff'g 2008 DTC 3080 (TCC).

Although over the years the subject of treaty shopping has steadily been gaining exposure on the international scene,[3] until now Canada has seen only very few developments in this area of tax law. Canada's first treaty shopping case, *MIL (Investments) S.A. v. Canada*,[4] reached the courts in 2006. The Tax Court's decision in this case, affirmed by the Federal Court of Appeal (FCA) on June 13, 2007, was a clear victory for the taxpayer. In 2008 the Tax Court of Canada (TCC) held in favour of the taxpayer in its second treaty shopping case, *Prévost*, and, most recently on February 26, 2009, the FCA affirmed that decision.

In the meantime, three days after the TCC's judgement in *Prévost* was rendered on April 22, 2008, the Advisory Panel on Canada's International Tax System (Advisory Panel)[5] released a consultation paper (Consultation Paper) aimed at eliciting submissions on how Canada's international tax system can be improved.[6] One of the subjects of consultation was inbound treaty shopping.[7] In December 2008, the Advisory Panel issued its Final Report, which contains the Advisory Panel's recommendations on Canada's approach to treaty shopping.[8]

The analysis in this paper proceeds in light of these Canadian developments.

---

[3] For a recent article discussing various developments in the area of treaty shopping see Sander Bolderman, "*Tour d'Horizon* of the Term 'Beneficial Owner'", 54 *Tax Notes Int'l* 881 (June 8, 2009).

[4] 2006 D.T.C. 3307 (TCC), aff'd 2007 D.T.C. 5437 (FCA).

[5] This government-mandated panel was struck by the Minister of Finance pursuant to the 2008 federal budget.

[6] APCSIT, *Enhancing Canada's International Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: APCSIT, April 2008). For further details, see Boidman, Nathan, "Reforming Canada's International Tax: An Interim Report", *Tax Notes International*, 19 May 2008, at 613.

[7] See David A. Ward, *Access to Tax Treaty Benefits: Research Report Prepared for the Advisory Panel on Canada's System of International Taxation* (Ottawa: APCSIT, September 2008).

[8] APCSIT, *Enhancing Canada's International Tax Advantage: Final Report* (Ottawa: APCSIT, December 2008): http://www.apcsit-gcrcfi.ca/07/cp-dc/pdf/finalReport_eng.pdf ("**Final Report**"). See Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 1", *Tax Notes International*, Vol. 53, No. 3, January 19, 2009, at page 247; Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 2", *Tax Notes International*, Vol. 53, No. 4, January 26, 2009, at page 345

B. What is Treaty Shopping?

The expression "treaty shopping" was first used in Canada in the 1995 seminal tax treaty decision of the Supreme Court in *Crown Forest v. Canada*,[9] which, however, did not deal with treaty shopping. Neither in *Crown Forest* nor in Canada's two treaty shopping cases, *MIL (Investments)* and *Prévost*, did the courts seek to define that concept. It is the Advisory Panel that for the first time provided a formal Canadian definition of the notion:

> The term “treaty shopping” refers to the situation where where a person, who is resident in a given country (the home country) and who derives income or capital gains from another country (the source country), is able to gain access to a tax treaty in place between the source country and a third country that offers a more generous tax treatment than the tax treatment otherwise applicable. This situation could arise if the person is resident in a country that does not have a tax treaty with the source country, or if the tax treaty between the source country and the person's home country offers less generous tax treatment than the tax treaty between the source country and the third country.[10]

This definition appropriately encapsulates the core elements of treaty shopping. It acknowledges that this kind of arrangement may be desirable either if the taxpayer is resident in a country that does not have a tax treaty with the source country, or if the tax treaty between the source country and the person's home country offers less generous tax treatment than the tax treaty between the source country and the third country. It also identifies the essence of treaty shopping as the ability to "gain access to a tax treaty in place between the source country and a third country that offers a more generous tax treatment than the tax treatment otherwise applicable". In this respect, since the benefits of a tax treaty are available only to residents of one or both of the contracting states, the key to treaty shopping is treaty residence.

---

9 [1995] 2 S.C.R. 802, 95 D.T.C. 5389.

10 Consultation Paper, *supra* note 6, Para. 3.18.

The most obvious way to achieve treaty residence status and, hence, to gain access to a tax treaty is through the use of a corporation.[11] This is clear from the statement of the Advisory Panel that "[t]he most common way for a person resident in a given country to access the benefits under a tax treaty between a source country and a third country is to set up a corporation in the third country through which the income or capital gains will be channelled." Such set up may be achieved either through incorporation, corporate continuance or the establishment of the corporation's place of management in the desired jurisdiction.

To be effective, a treaty shopping structure must ensure that no material tax is incurred in the third country. This can be achieved either when income, profits or gains are exempt or where an offsetting deduction is available in respect of payments made by the holding company.[12] In both cases, outbound payments should not be subject to any material withholding taxes in the intermediary state.

C. What is the Problem with Treaty Shopping?

The practice of treaty shopping has been the subject of diverging perceptions by governments and taxpayers. On the one hand, taxpayers and their advisors tend to believe that, if it is not abusive, treaty shopping should be perfectly acceptable since it is "but a form of tax planning that happens to involve a tax treaty as part of the overall arrangement."[13] In this respect, the Advisory Panel reported on the common use of treaty shopping to the effect that:

> businesses use treaties to mitigate the effect of delays in the negotiation or ratification of treaties when lower withholding rates are expected, to reduce the cost of capital on foreign investments,

---

[11] In some cases, the entity used may also be a partnership or a trust.

[12] See OECD, *Double taxation conventions and the use of conduit companies* (Paris: OECD, 27 November 1986) at 3 (the "**Conduit Report**").

[13] Boidman, *supra* note 6 at 622.

> and to ease compliance burdens when treaty benefits are ultimately available […] to reduce tax on capital gains and real estate, to minimize income tax on active business income, and to move such income within a group with no or lower withholding taxes.[14]

On the other hand, tax administrators seem to perceive inbound treaty shopping as inherently offensive.[15] In essence, their objection seems to be founded on the argument that the benefits of a tax treaty are reserved for persons with material economic nexus to one or both contracting states. In this respect, as discussed next, the Canada Revenue Agency (CRA) has, in more recent times, been challenging treaty shopping structures that it perceives objectionable.

D. <u>Challenges to Treaty Shopping</u>

Conceptually, challenges to treaty shopping may be pursued either based on domestic tax law or pursuant to the provisions of the treaty being shopped.

1. Challenges under Domestic Law

Canada does not have specific domestic anti-treaty shopping legislation. Instead, as noted by the Advisory Panel in its Consultative Report, Canada relies principally on the general anti-avoidance rule (GAAR) in section 245 of the *Income Tax Act*[16] to counter treaty shopping situations. In this respect, in 2005, the GAAR was retroactively amended, effective from the initial enactment of section 245 on 12 September 1988, to explicitly apply to tax treaties.[17] The

---

[14] Final Report, *supra* note 8, Para. 5.64.

[15] Notably, though understandably, governments are much less worried about outbound treaty shopping: see report by P. Marley & P. Macdonald, "Canada Revenue Agency Offers Views on Cross-Border Antiavoidance Rules", *Worldwide Tax Daily*, May 15, 2005, 2005 WTD 92-3: "In her commentary at the IFA conference, [Patricia Brown, acting international tax counsel (treaty affairs) at the U.S. Treasury Department] suggested that <u>in the context of U.S. outbound investment, if a treaty can be shopped, it should be shopped</u>."

[16] R.S.C. 1985 c. 1 (5th Supp.) as am. (the "**Act**").

[17] *Budget Implementation Act*, 2004, No. 2, S.C. 2005, Chap. 19, Secs. 52 and 60.

application of the amended GAAR in a tax treaty context was first considered in 2006 in *MIL (Investments)*.

MIL (Investments) dealt with a claim for an exemption from Canadian tax, under Art. 13 of the Canada-Luxembourg tax treaty, on a capital gain of approximately CAD 425 million realized by the taxpayer, MIL (Investments), on the sale of its shares in Diamond Field Resources Ltd. (DFR) on the 1996 takeover by mining giant, Inco, of DFR, which had discovered one of the world's largest nickel mines at Voisey Bay in Newfoundland. MIL (Investments), a corporation owned by a non-resident of Canada, was initially incorporated in the Cayman Islands. Before June 1995, it owned 11.9% of DFR. On 8 June 1995, MIL (Investments) exchanged, on a tax-deferred basis, 703,000 DFR shares for 1,401,218 common shares of Inco, thereby reducing its shareholding in DFR to 9.817%. On 17 July 1995, MIL (Investments) was continued under the laws of Luxembourg. Between 14 and 17 August 1995, MIL (Investments) disposed of the 1,401,218 common shares of Inco for CAN 65,466,895 and claimed an exemption from Canadian tax on the resulting capital gain under Art. 13 of the Canada-Luxembourg treaty. MIL (Investments) was not assessed in Canada on the gain, and it paid no tax in Luxembourg because the cost basis of the shares for Luxembourg tax purposes was their value at the time of the continuance, which exceeded the sale price. On 14 September 1995, MIL (Investments) disposed of 50,000 DFR shares for CAD 4,525,000 and claimed an exemption from Canadian tax on the gain under Art. 13 of the Canada-Luxembourg treaty. Again, it was not assessed in Canada on the gain, and it paid no tax in Luxembourg. On 22 May 1996, the DFR shareholders approved the Inco takeover of DFR to take effect on 21 August 1996. MIL (Investments) received CAD 427,475,645 for the disposition of its DFR shares. It claimed an exemption from Canadian tax on

the resulting capital gain of CAD 425,853,942 under Art. 13 of the Canada-Luxembourg treaty. This claim was the subject of the appeal.

In a lengthy, reasoned decision, the TCC held in favour of MIL (Investments) and rejected the government's claims that the transactions constituted treaty shopping which should be struck down either as being abusive tax avoidance under the GAAR or as violating an alleged inherent anti-treaty shopping rule in the Canada-Luxembourg treaty.

With respect to the GAAR, the TCC found that none of the relevant transactions was an avoidance transaction under Sec. 245(3) of the Act. Bell J. stated that he accepted the taxpayer's contention that the continuation of MIL (Investments) from the Cayman Islands to Luxembourg was primarily for *bona fide* commercial reasons because Luxembourg was a better jurisdiction than the Cayman Islands from which to carry on a mining business in Africa. Hence, the Court found that the GAAR had no application to the case.

Furthermore, the TCC stated that, in any event, it would not be able to find abusive avoidance under subsection 245(4). On this point, the government had argued that treaty shopping is an abuse of bilateral tax treaties and is recognized as such by the Supreme Court of Canada. In this respect, the government quoted from *Crown Forest* (see below) to argue that if the Supreme Court had access to section 245, it would have used that provision to deny a benefit from treaty shopping. Dealing with these arguments, Bell J. stated as follows (Para. 69):

> I do not agree that Justice Iacobucci's *obiter dicta* can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed

> as being abusive. It is the use of the selected treaty that must be examined.

On 13 June 2007, the Federal Court of Appeal unanimously affirmed the Tax Court's decision from the bench.

2. Challenges under Tax Treaties

a) Treaty Residence

So far, in Canada there have been no reported court decisions where treaty shopping has been challenged on the basis that the holding entity is not a resident for the purposes of the treaty being shopped. This may be because the law in Canada on treaty residence has been settled since the Supreme Court's 1995 decision in *Crown Forest*. In that case, Crown Forest, the taxpayer, rented barges from Norsk, a company incorporated in the Bahamas, whose sole office and place of business were located in the United States. Norsk filed income tax returns in the United States only, where it was considered a foreign corporation which was exempt from US income tax on the barge rentals under §883 of the *Internal Revenue Code* and, accordingly, paid no US tax on the barge rental payments. Crown Forest applied the reduced 10% rate to the rental payments under Art. XII of the Canada-United States treaty, rather than the 25% domestic withholding tax rate, on the basis that Norsk was a "resident of a Contracting State" for purposes of the treaty.[18]

The Supreme Court of Canada ruled against the taxpayer and held that Norsk could not benefit from the reduced withholding tax rate as it was not a resident for purposes of the Canada-US treaty. But for reciprocal shipping profits legislation in the US and the Bahamas, Norsk would have had a tax liability in the United States arising from the fact that it conducted a trade or business in the United States and derived income that was effectively connected with that

---

[18] Art. IV of the Canada-US treaty provides that a "resident of a Contracting State" is any person or entity who, under the laws of that state, is liable to tax therein by reason of domicile, residence, place of management, place of incorporation or any other criterion of a similar nature.

business. Although the fact that its "place of management" was located in the United States was one factor contributing to the finding that it conducted a trade or business in the United States, the Supreme Court found that this did not constitute the basis for Norsk's tax liability in the first place. The only way for Norsk to benefit from residence status under the treaty was if source taxation of income that was effectively connected with a US trade or business constituted a criterion similar to the criteria enumerated in Art. IV. Iacobucci J. held that source taxation is not similar since all the criteria in Art. IV constitute grounds for taxation on worldwide income, not just on source income. The Court reasoned that the parties to the treaty intended that only persons who were resident in one of the contracting states and liable to tax in one of them on their "world-wide income" should be considered "residents" for purposes of the treaty.

Hence, based on *Crown Forest*, so far it has been accepted that as long as a corporation is liable to full or worldwide taxation in its home country, it will be eligible for benefits under the treaty between Canada and that country, without regard to the residence of the corporation's shareholders or the degree of its economic nexus to that country. Accordingly, the reasoning in *Crown Forest* provides a firm legal basis for inbound treaty shopping in Canada. Yet, as mentioned above, it is notable that the notion of treaty shopping was considered in *Crown Forest*. Specifically, Iacobucci J. stated the following regarding treaty shopping:

> It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by <u>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</u>. [...]
>
> In fact, under the respondent's interpretation, a foreign corporation whose place of management is in the U.S. would be a resident of the U.S. for purposes of the Convention notwithstanding that such a corporation may not have any effectively connected income to

> the U.S. and hence no U.S. tax liability at all. I find this possibility to be highly undesirable. "Treaty shopping" might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the U.S. as the resident country would tax the income.[19] [emphasis added]

b) General anti-treaty shopping rules

It has been a long-standing US treaty policy to deal with treaty shopping by the inclusion in US tax treaties of a limitation on benefits (LOB) provision. Generally, Canada, like most other countries, has not followed in this path.[20] Currently, only Canada's treaty with the US contains a LOB provision in Art. XXIX-A. Before the coming into force of the 5th protocol, this provision was only for the benefit of the US.[21] Consistent with Canada's position, Art. XXIX A(7), which has been preserved in the updated bilateral LOB introduced in the 5th protocol, confirms Canada's right to apply the GAAR to deal with abusive treaty shopping.

Separately, *MIL (Investments)* raised the issue of whether all tax treaties are implicitly governed by a general anti-treaty shopping principle. In this case, the government presented an alternative argument to the effect that even if the GAAR did not apply to deny treaty benefits in the case, it would still be possible to deny the treaty exemption based on an anti-abuse rule inherent in the Canada-Luxembourg treaty. The government presented the 2003 revisions of the OECD Commentaries and a confusing option of an expert as support for the existence of an inherent anti-abuse rule in tax treaties. The Tax Court rejected the Crown's arguments on this point. Bell J. interpreted Art. 31(1)(c) of the *Vienna Convention on the Law of Treaties* to mean that one can

---

19 *Crown Forest*, *supra* note 9, at 5397.

20 Canada's position is that it is preferable to rely on the GAAR to counter treaty shopping than to include detailed LOBs in its tax treaties.

21 Although of apparent limited necessity, it was added by the 1995 protocol at the insistence of the US to counter treaty shopping.

consult only the OECD Commentaries in existence at the time the treaty was negotiated without reference to subsequent revisions.

c) Specific anti-treaty shopping rules

Canada's tax treaties provide reduced withholding tax rates only to the beneficial owners of payments subject to withholding tax.[22] The *Prévost* decision, discussed in detail next, is the first case to reach Canada's courts where the CRA used the undefined treaty notion of "beneficial owner" as a weapon to combat treaty shopping.[23]

III. THE *PRÉVOST* CASE

A. The Facts

The taxpayer in the case, Prévost Car Inc. (Prévost), was a Canadian manufacturer of motor coaches. In 1995, Volvo Bussar AB (Volvo), a Swedish company, and Henlys Group PLC (Henlys), a UK company, entered into a joint venture arrangement to acquire the shares of Prévost. Volvo acquired all the shares of Prévost and shortly thereafter transferred them to a wholly-owned special purpose Dutch subsidiary, Provost Holding BV (Dutchco), which had no employees or other activities. Volvo then sold 49% of the shares of Dutchco to Henlys.

There were several "bad facts" in the case. From the beginning, Volvo and Henlys had agreed in their Shareholders' and Subscription Agreement that not less than 80% of the profits of Prévost and Dutchco would be distributed to the shareholders. In 1996, Volvo and Henlys, although not direct shareholders of Prévost, agreed to a dividend policy for Prévost "that following the

---

22 All but one of Canada's 87 tax treaties use the term "beneficial owner" in this context. Canada's treaty with Australia uses the term "beneficially entitled" instead.

23 For detailed comment see Kandev, M., "Prévost Car: Canada's First Word on Beneficial Ownership", Tax Notes International, 19 May 2008, at 526; N. Boidman & M. Kandev, "News Analysis: Canadian Taxpayer Wins Prévost Appeal", Tax Notes Int'l, March 9, 2009, p. 862; M. Kandev & B. Wiener, "Some Thoughts on the Use of Later OECD Commentaries After Prévost Car", Tax Notes Int'l, May 25, 2009, p. 667.

completion of accounts for each quarter, and subject to adequate working and investment capital being available to the company, a dividend of 80 percent of the net retained profit after tax should be paid by the end of the following quarter". Moreover, there were errors in the corporate minute book of Prévost that confused Volvo and Henlys with its actual sole shareholder, Dutchco. Finally, in documentation provided to its banker, Dutchco had declared that the shares of Prévost were beneficially owned by Volvo and Henlys.

In 1996, 1997, 1998, 1999 and 2001, Prévost paid dividends to Dutchco according to the predetermined dividend policy and withheld and remitted tax at the rate of 5% (6% for 1996), which was the applicable rate under the Canada-Netherlands tax treaty. Dutchco then distributed the dividends received from Prévost to Volvo and Henlys.[24] The CRA reassessed the Canadian withholding tax for the years at issue without relying on the GAAR, but solely on the basis that Dutchco was not the beneficial owner of the dividends for purposes of Art. 10(2) of the Canada-Netherlands treaty; Prévost therefore should have withheld at the rates of 15% and 10% pursuant to the Canada-Sweden tax treaty and the Canada-United Kingdom tax treaty, respectively. Prévost appealed to the Tax Court of Canada.

B. <u>Decision of the TCC</u>

Rip A.C.J. (as he then was)[25] ruled in favour of Prévost. The Tax Court rejected the CRA's position that Dutchco was a conduit for Volvo and Henlys, and it found that Dutchco was the beneficial owner of the dividends paid by Prévost.

[24] Presumably, the dividends received by Dutchco were eligible for the Dutch participation exemption and, further, were exempt from any Dutch withholding tax, pursuant to the EC *Paren-Subsidiary Directive*, upon further distribution by Dutchco to Volvo and Henlys.

[25] On 15 July 2008, Rip J. was appointed Chief Justice of the Tax Court of Canada.

To answer the interpretational question before the Court, Rip A.C.J. sought a "domestic solution" pursuant to Art. 3(2) of the Canada-Netherlands treaty.[26] Rip A.C.J. found that the expression "beneficial owner" is not alien to Canadian law and held that the beneficial owner 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.[27]

The judge reasoned that when corporate entities are involved, the corporation is the beneficial owner of its assets and the income therefrom 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.[28]

Rip A.C.J. held that this was not the case with Dutchco. The fact that a few resolutions in Prévost's minute books contained references to Volvo and Henlys instead of Dutchco as the shareholders of Prévost and that Dutchco had no office or employees in the Netherlands was not sufficient to show that Dutchco was a conduit for Volvo and Henlys. Despite the provision in the shareholders' agreement to the effect that 80% of Prévost's income must be distributed, there was no predetermined or automatic flow of funds from Dutchco to its shareholders since Dutchco was not party to the shareholders' agreement and it was therefore not legally bound to pay dividends according to the policy set out in the agreement. As Dutchco was free to use the

---

26 Art. 3(2) of the treaty provides that terms not defined in the treaty must, unless the context otherwise requires, be given their domestic tax meaning in the state applying the treaty.

27 *Prévost* (TCC), *supra* note 2, Para. 100.

28 *Ibid*.

dividends as it wished without being accountable to anyone, the dividends were beneficially owned by it. The Crown appealed the TCC's decision to the FCA.

C. **Decision of the FCA**

In a short nineteen-paragraph decision rendered only nine days after the appeal was heard, Décary J.A., on behalf of the FCA, dismissed the Crown’s appeal. The FCA found no error of law with the conclusions of the TCC and accepted the TCC's characterization of the legal relationships, which it summarized as follows:

> [16] The Judge found that:
>
> a) the relationship between Prévost Holding and its shareholders is not one of agency, or mandate nor one where the property is in the name of a nominee (par. 100);
>
> b) the corporate veil should not be pierced because Prévost Holding is not “a conduit for another person”, cannot be said to have “absolutely no discretion as to the use or application of funds put through it as a conduit” and has not “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: (par. 100);
>
> c) there is no evidence that Prévost Holding was a conduit for Volvo and Henlys and there was no predetermined or automatic flow of funds to Volvo and Henlys (par. 102);
>
> d) Prévost Holding was a statutory entity carrying on business operations and corporate activity in accordance with the Dutch law under which it was constituted (par. 103);
>
> e) Prévost Holding was not party to the Shareholders’ Agreement (par. 103);
>
> f) neither Henlys nor Volvo could take action against Prévost Holding for failure to follow the dividend policy described in the Shareholders’ Agreement (par. 103);
>
> g) Prévost Holding’s Deed of Incorporation did not obligate it to pay any dividend to its shareholders (par. 104);

> h) when Prévost Holding decides to pay dividends, it must pay the dividends in accordance with the Dutch law (par. 104);
>
> i) Prévost Holding was the registered owner of Prévost shares, paid for the shares and owned the shares for itself; when dividends are received by Prévost Holding in respect of shares it owns, the dividends are the property of Prévost Holding and are available to its creditors, if any, until such time as the management board declares a dividend and the dividend is approved by the shareholders (par. 105).

Leading up to its conclusion, the FCA cited the TCC's determination that "...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" (para. 13) and found that Rip A.C.J.'s interpretation "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" (para. 14). It rejected the government's arguments in the following words:

> Counsel for the Crown has invited the Court to determine that "beneficial owner", "beneficiaire effectif", "mean the person who can, in fact, ultimately benefit from the dividend". That proposed definition does not appear anywhere in the OECD documents and the very use of the word "can" opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve. The Crown, it seems to me, is asking the Court to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian government through the process of objection, have adopted.[29] (para. 15) [emphasis added]

Significantly, the FCA also thought that the TCC's definition of "beneficial owner" accords with what is stated in the OECD Commentaries and in the 1986 OECD Conduit Report. In this respect, at least half of the FCA's judgment deals with the potential role of later OECD materials, such as its 2003 Commentaries, in interpreting a pre-existing treaty (this discussion is

[29] The FCA's reference to "process of objection" is not altogether clear in this context.

obiter in that it was not necessary to decide the case). Early in its decision, at paragraph 9, the FCA declared its agreement with counsel for both parties that a judge is entitled to "rely" on subsequent OECD documents. The FCA proceeded to refer to its decision in *Cudd Pressure Control Inc. v. R.*,[30] where it qualified the relevance of the 1977 Commentary[31] to the interpretation of a treaty adopted in 1942 as being "somewhat suspect", but also noted that Robertson J.A.[32] recognized that OECD Commentaries "can provide some assistance" as to the 1942 Canada-US Treaty. It then somewhat curiously indicated that "[t]o the extent that it might be said that a contrary view [it is unclear what is the "contrary view" referred to] was expressed by that Tax Court in *MIL (Investments) S.A. v. The Queen* […] it does not appear that such a view was in the mind of this Court when it dismissed the appeal from the Bench". The FCA then qualified its position by stating, at paragraph 11, that later commentary may serve to guide the interpretation and application of bilateral conventions "<u>when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partners has registered an objection[33] to the new Commentaries.</u>" [emphasis added]. Finally, the FCA concluded that, for purposes of interpreting the Treaty, the Conduit Report and the 2003 Commentary are a "helpful complement to the earlier Commentaries, insofar as they are eliciting, rather than contradicting, views previously expressed" (para. 12).

D. <u>Comments</u>

---

30 98 D.T.C. 6630.

31 Actually, these were OECD Commentaries adopted in 1994.

32 Actually, it was McDonald J.A.

33 Presumably, the Court meant "observation".

Prévost is significant both in terms of its outcome and its discussion of whether Commentaries to the OECD Model issued following the negotiation and adoption of a particular treaty can be employed to interpret such treaty. The following comments briefly discuss the former point and then focus in detail on the latter matter, which, as discussed further below, may turn out to be determinative of Canada's approach to treaty shopping in the future.

1. "Beneficial Owner" not a Treaty Anti-Abuse Weapon

The importance of *Prévost* cannot be overstated insofar as it confirms, at least in that case, the rejection of the CRA's attempts to challenge what it perceives to constitute objectionable tax treaty shopping by denying the status of "beneficial owner" for treaty purposes. In this respect, the author wholeheartedly agrees with the statement by tax treaty scholar Brian Arnold that "it is preferable for a basic tax rule such as beneficial ownership ... not to be perverted into an anti-avoidance measure."[34] The TCC's convincingly reasonable and common sense interpretation of the expression "beneficial owner" in *Prévost*, which was endorsed by the FCA, arguably reached the right result. *Prévost* exemplifies the fact that treaty shopping is not necessarily abusive. From both a commercial and a tax point of view, the transactions in *Prévost* could be seen as unobjectionable. Commercially, it is perfectly normal for two joint venturers to use a holding corporation for their common investment. Since Volvo and Henlys were based in different countries, forming a holding corporation in a neutral jurisdiction was understandable. From a tax standpoint, using a holding corporation resident in the Netherlands was an easy way to qualify for a dividend withholding tax rate that reflected Canada's most current treaty policy.[35]

---

[34] "Tax Treaty News", *Bulletin for International Taxation* 7 (2008), at 263.

[35] This strategy was acknowledged in the Final Report. In this respect, Canada's traditional approach had been to oppose the low 5% rate on non-portfolio intercorporate dividends. This approach was reflected in the Canada-Sweden tax treaty that was in force at the time the relevant transactions were contemplated. In the

2. Using Later OECD Commentaries in Interpreting Pre-existing Treaties

Of great significance are the FCA's *obiter* statements in *Prévost* regarding the relevance of later OECD materials in interpreting a pre-existing tax treaty.[36]

As outlined above, the FCA expressed the general view (but subject to the qualifications noted below) that later OECD Commentaries may be "relied" on in interpreting a pre-existing tax treaty. In stating this position, the FCA departed from the previous holding of the TCC in *MIL* that "one can only consult the OECD commentary in existence at the time the Treaty was negotiated without reference to subsequent revisions (para. 86)", by suggesting, in a somewhat mysterious turn of phrase, that "it does not appear that such a view was in the mind of this Court when it dismissed the appeal from the Bench." In fact, the FCA, in dismissing the Crown's appeal in *MIL*, did not discuss this issue, and thus, perhaps, Décary J.A. was referring to what was in his own mind, since he sat on the *MIL* appeal.

In any event, it is not entirely surprising that the TCC's holding on this point in *MIL* would be weakened by subsequent decisions. The understandable tendency of a judge is well described by Special Commissioner John Avery Jones, in the 2008 U.K. decision, *Trevor Smallwood Trust* v *Revenue & Customs*:

---

early 1990s, however, Canada changed its treaty policy and began the time-consuming process of renegotiating its treaties to provide the low 5% rate. The choice of the Netherlands as a holding company location was obvious because, at the time the acquisition of Prévost was planned, the Canada-Netherlands treaty had already been renegotiated. The inoffensive nature of the tax planning is demonstrated by the fact that, effective 23 December 1997, the Canada-Sweden tax treaty was also changed to provide the low 5% rate for non-portfolio intercorporate dividends. At the time of the relevant transactions, the Canada-UK tax treaty already provided a (low) 10% rate on such dividends; this rate was reduced to 5% in the protocol signed on 7 May 2003. It is notable that this protocol had been under negotiation since 1995.

[36] The trouble with the FCA's decision in *Prévost* is its attempt (tenuous as it is) to make a link between its reasons for judgment and its observations on the interpretational value of later OECD Commentaries, both generally and in this case. This is because the FCA endorsed the TCC decision, but that decision did not, in fact, rely on the Conduit Report or the 2003 Commentaries, as explained next. See Kandev & Wiener, *supra* note 23.

> The relevance of Commentaries adopted later than the Treaty is more problematic because the parties cannot have intended the new Commentary to apply at the time of making the Treaty. However, to ignore them means that one would be shutting one's eyes to advances in international tax thinking, such as how to apply the treaty to payments for software that had not been considered when the Treaty was made. The safer option is to read the later Commentary and then decide in the light of its content what weight should be given to it. [emphasis added][37]

This "read and then decide" approach seems to be implicit in the FCA's subsequent qualification of its statements, to the effect that later commentaries may be used as a guide to interpretation only where they represent a fair interpretation of the words of the Model Convention, do not conflict with commentary in existence at the time a specific treaty was entered and when neither treaty partner has registered an observation to the new commentary.[38]

The FCA did not elaborate further on this analytical approach to later OECD Commentaries. It would seem though that the FCA has borrowed (without specifically citing) substantially from David A. Ward *et al.*, *The Interpretation of Income Tax Treaties with particular Reference to the Commentaries on the OECD Model*.[39] In this book, the authors express their view on the relevance of later OECD Commentary as follows:

> In our view, later commentaries that represent a fair interpretation of the Model and that clearly arise from the words of the Model (e.g. new amplification commentary) and that do not conflict with commentaries current at the time the tax treaty was negotiated can be given weight as persuasive interpretations by the CFA of the meaning of the particular Article of the Model, but they cannot be

37 [2008] UKSPC SPC00669 (19 February 2008) at para. 99.

38 In fact, it is notable that, despite that it cited paragraph 35 of the introduction to the OECD Commentaries (added in 1992) for its position on the relevance of later OECD documents, the FCA did not endorse the OECD's broad statement that changes to the Commentaries are normally applicable to the interpretation of conventions concluded before their adoption "because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations".

39 (Kingston, Ont.: IFA, 2005) at chapter 6.

> considered to have been adopted by the treaty negotiators for purposes of this particular tax treaty.[emphasis added]

Considering this, it may be implied that the FCA has adopted Ward's detailed analysis on this point. In this respect, Ward's study was based on a classification, initially developed by Mike Waters (former chief of Working Party 1 at the OECD), which divides later commentaries into four categories: (i) those that fill a gap in the existing commentary by covering matters not previously mentioned; (ii) those that amplify the existing commentary by adding new examples or arguments to what is already there; (iii) those that record what states have been doing in practice; and (iv) those that contradict the existing commentary.[40]

According to Ward, there is "little or no legal justification for the use" of the first type of commentaries. Amplification commentary of the second category can be given weight as persuasive interpretations by the OECD of the meaning of the particular Article of the Model. Concerning the third type of commentaries, Ward observes that state practice recorded in the OECD Commentaries "may have effect under international law" as long as the relevant contracting states have adopted that practice, which establishes the agreement of the parties regarding its interpretation and is a genuine interpretation and not effectively a change in the treaty. However, the authors warn that OECD Commentaries do not necessarily evidence a state practice adopted by one or more OECD member states. Finally, regarding Waters' fourth category, Ward indicates firmly that "later commentary contradicting previous commentary should never be taken into account in interpreting existing treaties".

Considering Ward's nuanced approach, it is quite unfortunate that the FCA in *Prévost* did not provide any clear guidance as to the weight to be accorded to the different types of later OECD

---

[40] M. Waters, "The relevance of the OECD Commentaries in the interpretation of Tax Treaties", in *Praxis des Internationalen Steuerrechts, Festschrift für Helmut Lukota,* M. Lang and H. Jirousek eds. (Linde Verlag Wien, 2005) at 680.

commentaries. The FCA merely indicated that later commentary that meets the three requirements set out at paragraph 11 will constitute "a widely-accepted guide to the interpretation and application of existing bilateral conventions".

IV. WHAT DOES THE FUTURE HOLD?

A. Overview

In the Consultation Paper, the Advisory Panel set out the following possible approaches to treaty shopping (Para. 3.23):

> As noted above, certain treaty benefits are afforded to "beneficial owners" who are resident in a treaty country. The CRA has challenged some structures on the basis that the person resident in the treaty country who is receiving the payment is not the beneficial owner, and so the treaty benefits should be denied. One option is to define the term "beneficial owner" in Canada's domestic tax law, specifying the criteria that a person must meet to be considered the beneficial owner of a stream of income. This approach could add some clarity and certainty for taxpayers and the CRA alike. Another option is for Canada to update each of its tax treaties to include a specific, detailed anti-treaty-shopping rule, similar to the rules in most U.S. tax treaties. Alternatively, such an anti-treaty-shopping rule could be adopted in Canada's domestic tax law, although this may raise issues regarding the possible override of existing tax treaties.

In the Final Report, the Advisory Panel elaborated on Canada's approach to treaty shopping as follows (para. 5.65-5.67, footnotes omitted):

> Canada grants access to treaty benefits only to persons who are residents of a country with which Canada has entered into a treaty. A corporation is a resident of a treaty partner if the corporation is liable to taxation in that country. Certain treaty benefits, such as eligibility for reduced rates of withholding tax on dividends, interest and royalties, are limited to residents who are the "beneficial owners" of such income.
>
> Neither Canada's tax treaties nor its domestic law define "beneficial owner". Courts in Canada and other countries have

> attempted to interpret or define what "beneficial owner" means, and the Panel heard that it might be best to wait for a globally agreed definition before taking unilateral action in this regard. Moreover, the OECD Model Tax Convention on Income and on Capital and Commentaries set out numerous counter-measures, based on the concepts of residence and beneficial owner, which member states — including Canada — use in their treaties and domestic law to counter treaty shopping or limit access to treaty benefits. The recent inclusion of a broad anti-treaty shopping provision in the fifth protocol to the Canada-U.S. tax treaty shows that Canada is willing to include such a provision in its tax treaties when it sees fit to do so.
>
> In 2004, Canada extended application of its general anti-avoidance rule to tax treaties. However, a recent court case [*MIL (Investments)*] has cast doubt on the extent to which this rule could be used to counter treaty shopping. A number of tax authorities, including the CRA, seem to be moving toward an implied general anti-abuse rule regarding improper tax treaty use. A body of international jurisprudence is developing on what constitutes an abuse of a tax treaty (although these decisions have produced somewhat mixed results). [emphasis added]

Finally, in the Final Report the Advisory Panel made the following recommendations to the government of Canada (para. 5.68):

> The Panel believes that businesses should be able to organize their affairs to obtain access to treaty benefits. Tax treaties are complex and the relationships among tax treaties even more so. While there may be situations in which inappropriate access to tax treaties can arise, the Panel believes that Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping. However, the government should continue to monitor developments in this area. [emphasis added]

In other words, the Advisory Panel seems to say that treaty shopping is generally benign and the Canadian government should not take any precipitated action in an attempt to halt such tax planning. The Advisory Panel does conceive of treaty shopping structures that could be abusive, but believes that the government has adequate resources to address such situations. What remains to be seen, is to what extent the Canadian government will heed the Advisory Panel's advice. If it

does, it is to be expected that the government will limit itself to bringing to the courts cases that it considers abusive; if it does not, the Department of Finance may chose to amend the Act or renegotiate certain of Canada's treaties to include anti-treaty shopping provisions. The discussion below explores the avenues of possible development of Canada's treatment of treaty shopping in these terms.

B. Possible Bases for Future Court Challenges to Treaty Shopping

1. Under the GAAR

It is understood that the government's expectations about *MIL (Investments)* were very high and the resulting defeat was a disappointment. Yet, despite the taxpayer-favourable outcome of *MIL (Investments),* it is unclear to what extent this decision constitutes a strong adverse precedent against the CRA. The TCC appears to have decided the case on the basis of Sec. 245(3) of the Act, finding as a matter of fact that the relevant transactions were arranged primarily for *bona fide* purposes and not to obtain a tax benefit. Hence, the TCC's analysis of abuse in Sec. 245(4) and its strong statements, in particular that "the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive", were *obiter dicta*. This would make *MIL (Investments)* a weak precedent, because the facts of another case may easily be distinguished from its facts.

The decision of the FCA, however, includes a confusing and slightly mysterious statement that the taxpayer had admitted that its continuance as a Luxembourg corporation was, in fact, an avoidance transaction. This element is absent from Bell J.'s trial decision, which was based on findings of fact contrary to that admission. Nonetheless, it is unlikely that the admission would elevate the TCC's abuse analysis to the level of binding reasoning, because, in any event, the TCC had found that the sale, which crystallized the tax benefit, was not part of the same series of

transactions that included the continuance from the Cayman Islands to Luxembourg; hence, the abuse analysis remains *obiter dictum*.

Considering this, its single defeat in *MIL (Investments)* is not likely to discourage the CRA from using the GAAR to challenge situations that it perceives as offensive treaty shopping. Arguably, the GAAR should be the CRA's principal (if not the only) weapon against tax treaty abuse. In this respect, the author is not aware of any pending court cases that involve a GAAR challenge to inbound treaty shopping, but a 2008 technical interpretation shows that the CRA is prepared to use the GAAR to curb perceived abusive treaty shopping.[41] The CRA document describes a situation where a Dutch resident owns a vessel and leases it, pursuant to a bareboat charter, to a sister corporation resident in Norway, which in turn leases it to a Canadian resident that uses it in Canada's territorial waters. The crewing and operation are provided by another related company resident in Norway. The CRA opined on whether the Canadian withholding tax applies to the rentals from the Canadian lessee of the vessel to the Norwegian corporation and to the rentals from the Norwegian resident to the Dutch owner of the vessel. The CRA was asked to assume that the Norwegian corporation was not an agent or nominee of the Dutch corporation. The CRA stated that both sets of rental payments would be exempt from the Canadian withholding tax pursuant to Canada's treaties with Norway and the Netherlands. At the end of its technical interpretation, however, the CRA stated:

> The application of ... the general anti-avoidance rule ("GAAR") may be considered in the type of situation you describe. ... In reference to the GAAR, if the 2 separate Bareboat Arrangements and/or the separation of the time charter and bareboat activities were created in order to avoid Canadian Part I or Part XIII tax, then GAAR may apply to re-characterize the transactions to eliminate any tax benefit arising from the arrangements.

---

[41] Technical Interpretation 2008-0267201E5, "Part XIII & Bareboat Charters" (18 July 2008).

The reason why the CRA raised the possible use of the GAAR is probably that the situation in the technical interpretation involves a form of treaty shopping. The Canada-Norway tax treaty[42] is Canada's only treaty with a developed country that does not include rents for "industrial, commercial or scientific equipment" in the definition of "royalties";[43] hence, it provides an exemption for rentals that are not attributable to a permanent establishment in Canada.

2. Under Tax Treaty Law

a) Treaty Residence

The Advisory Panel did not identify "treaty residence" as an area of development of the law as it relates to treaty shopping. As mentioned above, the reason may be that the holding in *Crown Forest* has been well-settled law in Canada for over ten years. This was confirmed by the CRA in its *Income Tax Technical News No. 35* (26 February 2007). However, from the same document it appears that the CRA may be preparing the ground for a more aggressive stance on treaty residence where the CRA perceives that a particular situation involves abusive treaty shopping:

> It remains CRA's position that, to be considered "liable to tax" for the purposes of the residence article of Canada's tax treaties, a person must generally be subject to the most comprehensive form of taxation as exists in the relevant country. This, however, does not necessarily mean that a person must pay tax to a particular jurisdiction. There may be situations where a person's worldwide income is subject to a contracting state's full taxing jurisdiction but that state's domestic law does not levy tax on a person's taxable income or taxes it at low rates. In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive (e.g. treaty shopping where the person is in fact only a "resident of

---

[42] The Canada-Norway income and capital tax treaty has been in force since 19 December 2002.

[43] In this respect, since 1992 Art. 12 (Royalties) of the OECD Model has excluded payments for the use of "industrial, commercial or scientific equipment"; hence, such payments are subject to Art. 7 (Business profits). However, Canada entered a reservation on Art. 12 of the OECD Model to the effect that it may include payments for the use of "industrial, commercial or scientific equipment" in the definition of "royalties" in its tax treaties.

> convenience"). Such could be the case, for example, where a person is placed within the taxing jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any material economic nexus to that State. [emphasis added]

This position of the CRA regarding abusive arrangements is unsubstantiated by Canadian legal authority.[44] In fact, the phrase "resident of convenience" seems to first have been coined by the CRA in the above-mentioned technical news document. However, the CRA may now argue that the recent Federal Court decision in *RCI Trust*[45] lends support to such position.

Briefly, the *RCI Trust* case involved a Barbados trust, which, on May 5, 2006, disposed of shares in the capital of a Canadian corporation, RCI Environment Inc. to a related corporation for $145 million. The trust was settled in 2002 for the benefit of a Cayman Island trust, which itself had been formed in 1995 for the benefit of the Canadian-resident children of Lucien Rémillard, the Canadian-resident principal of the Canadian corporation.

Regarding the sale of the RCI Environment Inc. shares, the Barbados trust argued before the Court, that the gain from such sale is exempt from Canadian tax because the trust is a resident of Barbados for the purposes of the Canada-Barbados Tax Treaty and therefore qualifies for a treaty exemption. The government questioned the residency claim on the basis that Canada's non-resident trust anti-deferral rule in section 94 may deem the trust to be resident of Canada and that this may give rise to dual residency under the treaty, which would trigger the competent authority tie-breaker procedure under Article IV(3).

---

44 Administrative policy and interpretation are not determinative, but are entitled to weight and can be an important factor in case of doubt about the meaning of legislation: see *Will-Kare Paving & Contracting Ltd. v. Canada*, [2000] 1 S.C.R. 915, Para. 66.

45 *Robert M.O. Morris and Neville Leroy Smith Trustees of the RCI Trust v. MNR*, 2009 FC 434 ("*RCI Trust*"). The case has been appealed to the Federal Court of Appeal (A-219-09, May 27, 2009). See N. Boidman & M. Kandev, "The Canadian Decision in RCI Trust and Treaty Residence", Tax Notes Int'l, July 27, 2009, p. 299-303.

In deciding the matter, Simpson J. considered where the trust was resident for the purposes of the Canada-Barbados Tax Treaty. She held as follows:

> [37] The Respondent acknowledges that the Barbados Trust is a *prima facie* resident of Barbados.[46] Based on the facts described above, it meets the physical criteria associated with actual residence of the kind described in Article IV, paragraph 1, of the Treaty, which speaks of "domicile", "place of management" and "criterion of a similar nature". In my view, similar criteria would include other aspects of actual physical presence and not more esoteric concepts such as deemed residence.
>
> [38] The question is whether Article 3 [*sic*] of the Treaty allows me to conclude that the Barbados Trust is also a resident of Canada. In my view, such conclusion is not open to me on the facts of the case because Article IV, paragraph 3, limits the assessment to the provisions of paragraph 1 of the Treaty. This means that a finding of dual residence must be based on actual physical factors and there are no such factors linking the Barbados Trust to Canada. Accordingly, the Barbados Trust is only resident in Barbados. [emphasis added]

Based on this case, the CRA may argue that Simpson J.'s description of the treaty residence criteria in the Canada-Barbados Tax Treaty as "physical criteria" lends support to its suggestion, in *Income Tax Technical News No. 35*, that the benefits of a treaty are available only to persons that have "material economic nexus" to one or both of the treaty countries. Arguably, such line of reasoning would not be correct. Simpson J.'s statements should be read to the effect that the treaty residence criteria in the Canada-Barbados Tax Treaty (like in Canada's other treaties) require full tax liability based on territorial jurisdiction as opposed to any other type of jurisdiction (such as nationality). In this respect, corporate taxation based on a corporation's place of management or based on incorporation, which gives rise to domicile,[47] should meet the

---

[46] Although the judge did not refer to it, for Canada's authority on residence of a trust for domestic tax purposes, see *Thibodeau Family Trust* v. *Canada*, 78 DTC 6376 (FC – TD).

[47] A corporation's domicile is in its state or province of incorporation or organization and cannot be changed even if it carries on business elsewhere: see article 307 of the C.C.Q.; *Axis Management* v. *Alsager*, 2000

territorial criteria for treaty residence without the further need of any particular degree of economic nexus to one or both of the contracting states.

In any event, as of yet, it is unclear what exactly the CRA means by the statements in *Income Tax Technical News No. 35* and how it intends to use them in practice.[48] It is hoped that the reference to "abusive" indicates that the CRA will use the GAAR to challenge situations it perceives as a residence of convenience (whatever this means). Besides, in light of the holding of the Canada Supreme Court in *Shell Canada Ltd. v. Canada*,[49] it seems unlikely that the CRA should apply an economic substance approach to determine treaty residence. However, in light of *MIL (Investments)*, it is questionable whether a challenge to treaty residence based on the GAAR could be successful in the courts.

b) Specific Anti-Avoidance Rules: Beneficial Ownership

The decision in *Prévost* is an important victory against the CRA's attempt to use the concept of "beneficial ownership" to address its treaty shopping concerns. Yet, as a consequence of the FCA's observations on the interpretational value of later OECD Commentaries, it may be expected that the CRA will not be discouraged from using the OECD's interpretation of

---

SKQB 382, *Voyage Co. Industries* v. *Craster*, [1998] B.C.J. No. 1884 (Q.L.), *Incorporated Broadcasters* v. *Canwest Global Communications*, [2001] O.J. No. 4882 (Q.L.). See also the UK decision in *Gasque* v. *I.R.C.*, [1940] 2 K.B. 80 for the recognized common law authority on this matter.

48 To the author's knowledge, the only instance of the CRA invoking the concept of "residence of convenience", since *Income Tax Technical News No. 35* was issued, is in Technical Interpretation 2007-0263441E5 (2009-05-19). The CRA was asked whether a Luxembourg *Société de Participation Financière* ("SOPARFI") was a resident of Luxembourg for the purposes of the *Canada-Luxembourg Income Tax Convention* (the "Treaty"). In reaching a positive conclusion, the CRA stated that a SOPARFI will be a resident of Luxembourg if the SOPARFI is liable to tax in Luxembourg based on the criteria described in Article 4 of the Treaty. The CRA would consider a SOPARFI liable to tax within the meaning of Article 4 where the SOPARFI is subject to the most extensive form of taxation that exists in Luxembourg (i.e., subject to Luxembourg’s full taxing jurisdiction on its worldwide income). In addition to being liable for tax, according to the CRA, the SOPARFI must have a material economic nexus to Luxembourg to be a resident of Luxembourg for the purpose of the Treaty. The CRA does not consider that there is a material economic nexus where the SOPARFI is created or used in connect ion with a treaty-shopping arrangement or where the SOPARFI in only a "resident of convenience".

49 [1999] 3 S.C.R. 622, 99 D.T.C. 5669.

"beneficial owner" to challenge perceived abusive treaty shopping.[50] Hence the meaning of the undefined treaty term "beneficial owner" will likely remain a source of contention between taxpayers and the CRA at least until another higher court decision solidifies the authority of *Prévost.* In this respect, to the author's knowledge, another inbound treaty shopping case, *Velcro Canada Inc. v. Canada* (2007-1806(IT)G), concerning the interpretation of the treaty notion of "beneficial owner" is pending before the Tax Court. In *Velcro*, during its 1995 to 2004 taxation years, the taxpayer, Velcro Canada Inc. (VCI), an operating Canadian corporation, paid royalties for intellectual property licensed from Velcro Industries BV (VIBV). On 29 December 1995, VIBV changed its residence to the Netherlands Antilles. Before that, on 27 October 1995, VIBV had assigned the VCI licence to Velcro Holdings BV (VHBV), a substantial Dutch corporation that acted as the exclusive sublicensor of VIBV's intellectual property in some jurisdictions. The CRA reassessed VCI on the basis that VHBV was not the beneficial owner of the royalties from VCI and was a conduit for VIBV, a resident of a non-treaty jurisdiction.

Arguably, the Crown should lose *Velcro* and it is hoped that the CRA heeds Brian Arnold's recommendation (cited above) and abandons further treaty shopping challenges based on the notion of "beneficial owner".

---

50 This appeared to be the thrust of the CRA's comments at the Roundtable during the Seminar, when it was asked to comment on its current views regarding beneficial ownership in respect of "back-to-back" dividends, interest, and royalties. According to the CRA, in *Prévost*, the Court confirmed that the term "beneficial owner" requires more than strict legal title and that where the intermediary acts as a "mere conduit or funnel" in respect of an item of income, the intermediary would not be considered to be the beneficial owner of the interest, dividend or royalty. The CRA stated that it is in the process of preparing a guide that will set out its views on what constitutes abusive treaty shopping. For those cases considered abusive, the CRA will apply "the Limitation on Benefits provisions (in those treaties that contain such provisions), the GAAR, the specific anti-abuse provisions such as those in Articles 10, 11 and 12 of the *Canada-U.K. Income Tax Convention*, as well as the ‘beneficial owner’ principle as now defined by the courts".

c) Inherent anti-abuse rule in tax treaties

In the Consultation Paper, the Advisory Panel did not consider the existence of an inherent anti-abuse rule in tax treaties, but in its Final Report it noted that "[a] number of tax authorities, including the CRA, seem to be moving toward an implied general anti-abuse rule regarding improper tax treaty use."

Certainly, if the only source of such a rule is the 2003 OECD Commentaries, *MIL (Investments)*, the only Canadian case on point, made it clear that the rule would not apply to pre-2003 treaties.[51] However, the subsequent FCA decision in *Prévost* has put into question this position. The court in that case opened the door to the use of later OECD Commentaries in interpreting pre-existing tax treaties and, hence, to the potential application of the OECD-advocated implied general anti-abuse rule in tax treaties.

As pointed out in the Final Report and in light of the FCA's decision in *Prévost*, the CRA may move toward an implied general anti-abuse rule regarding improper tax treaty use. The OECD views on treaty abuse, as reflected in the 2003 OECD Commentaries, would be attractive to the CRA, because they, as opposed to the GAAR,[52] establish a vaguer and potentially broader approach to tax avoidance, rooted in purposive interpretation[53] and economic substance

---

[51] Of course, in cases involving post-2003 treaties, the CRA may certainly argue, *a contrario*, that *MIL (Investments)* supports the existence and applicability of an inherent anti-abuse rule.

[52] The application of the GAAR involves three steps. The first step is to determine whether there is a “tax benefit” arising from a “transaction” under s. 245(1) and (2). The second step is to determine whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being “arranged primarily for *bona fide* purposes other than to obtain the tax benefit”. The third step is to determine whether the avoidance transaction is abusive under s. 245(4). All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit. Hence, as demonstrates the decision in *MIL (Investments)*, a GAAR challenge to treaty shopping may be difficult to succeed.

[53] See e.g.: para. 12 of the Commentaries to Article 10 of the OECD Model: "The term 'beneficial owner' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including […] prevention of fiscal […] avoidance."

characterization,[54] which does not always clearly distinguish between abusive and inoffensive cases.[55]

Certainly, the CRA may be expected to argue the existence of an inherent anti-abuse rule in future cases and will likely seek support in foreign case-law on point. In this respect, in *A Holding Aps v. Federal Tax Administration*, [56] the Swiss Federal Court considered whether in a treaty shopping situation the taxpayer, a Danish resident company, was eligible for the reduced tax rate on dividends paid by a Swiss company under the 1973 Switzerland-Denmark tax treaty. The Danish company was a wholly-owned subsidiary of a Guernsey company, which in turn was wholly owned by a company incorporated in Bermuda. The Swiss Federal Court found the Danish company to be the beneficial owner of the dividend from the Swiss company despite the fact that the Danish company had no staff, offices or other assets and that, upon receipt, it immediately paid the entire dividend to its Guernsey parent. Nonetheless, the claim for the reduced withholding tax rate was denied because the Court held that the tax treaty was abused. The Court held that the 2003 OECD Commentaries, which post-date the Switzerland-Denmark treaty, were relevant in construing the treaty.

Arguably, reliance by the CRA on an inherent anti-abuse rule in tax treaties based on the 2003 OECD Commentaries, should not be successful, at least with respect to pre-2003 treaties. The 1986 Conduit Report and the 2003 Commentaries, which reflect a particular view of the

---

[54] See e.g.: Conduit Report, *supra* note 12, p. 2: "This report deals with the most important situation of this kind, where a company situated in a treaty country is acting as a conduit for channeling <u>income economically accruing to a person in another State</u> who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty." [emphasis added].

[55] See e.g.: Para. 7 of the Commentaries to Article 1 of the OECD Model states that "[it] is also a purpose of tax conventions to prevent tax avoidance" without limiting this statement to instances of abusive tax avoidance. Para. 12 of the Commentaries to Article 10 of the OECD Model is to the same effect.

[56] 8 *International Tax Law Reports* 536 (2005) (Swiss Federal Court).

purposes of tax treaties and the way transactions must be characterised for treaty purposes, if not directly contradicting the OECD's earlier positions, at the very least must be regarded as having added to them something that was not already there before 2003. Therefore, there should be little justification to accord them any weight in the interpretation of Canada's pre-2003 treaties.

C. Changes to the Act or Canada's Tax Treaties

1. Changes to the Act

In the Final Report, the Advisory Panel seems to suggest the Canadian government should not take any legislative action to try to block treaty shopping situations. Nonetheless, in the Consultation Paper, the Advisory Panel discussed the possibility that a specific anti-treaty shopping rule could be adopted in Canada's domestic tax law. The Consultation Paper rightly warned that such an approach raises issues regarding the possible override of existing tax treaties.[57] Nonetheless, other countries have adopted or are considering the adoption of such a rule. For example, Germany has a domestic anti-treaty shopping rule that was strengthened in 2007. The rule denies treaty benefits if the shareholder of an interposed foreign subsidiary would not otherwise receive treaty benefits if it received the payment directly and if (i) the structure has no business purpose; (ii) the interposed foreign subsidiary does not derive more than 10% of its income from its own business activities; *or* (iii) the foreign subsidiary does not have adequate business substance to conduct business activities.[58]

---

[57] In India, the Direct Taxes Code Bill, 2009, released by the Indian Ministry of Finance on 12 August 2009, proposes to add a detailed general anti-avoidance rule to India's direct tax regime (in sections 112-114 of the Code) in order to curb tax avoidance, including the abuse of tax treaties. If enacted, the Direct Taxes Code will come into force on 1 April 2011. Significantly, the proposed GAAR will override most of India's tax treaties pursuant to a later in time provision (Subsection 258(8) of the Code). See http://finmin.nic.in/DTCode/Direct%20Taxes%20Code%20Bill%202009.pdf.

[58] See West, P., "Antiabuse Rules and Policy: Coherence or Tower of Babel?", *Tax Notes International*, 31 March 2008, at 1161, 1171-1172.

In the United States, certain proposed amendments to the Internal Revenue Code that are popular with the Obama administration would apply to deductible related-party payments from a US entity to a foreign entity when both are controlled by a common parent to override US treaties by subjecting the payments to the withholding tax rate that would apply if the payment were made directly to the common parent.[59]

Despite these developments, at present, there has been no suggestion by government officials that Canada has the appetite for such a radical and aggressive approach.

2. Changes to Canada's Tax Treaties

As suggested by the Advisory Panel in the Consultation Paper another approach to treaty shopping is for Canada to update its tax treaties to include a US-style LoB provision. Although the amended bilateral LOB provision in the fifth protocol to the Canada-US treaty is Canada's first treaty anti-abuse rule of this type, comments by the Department of Finance during the Seminar, seem to indicate that, as a general policy, Canada does not intend to include LoB provisions in its other tax treaties.

Although there is no indication to this effect, the Department of Finance may still opt for a more focused approach in order to deal with certain types of treaty shopping.[60] As a recent example of such an approach, the protocol to the UK-Switzerland tax treaty, which entered into force on December 22, 2008, amended that treaty to deny the benefits of the dividend, interest and royalties articles in the context of a "conduit arrangement". This expression is defined in new Article 3(1)(l) of that treaty as follows:

---

[59] See H.R.3200, *America's Affordable Health Choices Act of 2009*, Sec. 451.

[60] See Art. 10(7), 11(10) and (11) and 12(8) of the *Canada-UK Tax Treaty* for an example of specific anti-treaty shopping provisions in a Canadian treaty.

> (l) the term ‘conduit arrangement’ means a transaction or series of transactions which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State and who, if it received that item of income directly from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the State in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State and the main purpose of such structuring is obtaining benefits under this Convention.

V. CONCLUSION

It is clear from the above discussion that Canadian authorities to date support inbound treaty shopping. The TCC in Canada's first decision on point, *MIL (Investments)*, clearly suggested that treaty shopping to minimize tax, on its own, cannot be viewed as abusive. In its Final Report, the Advisory Panel seemed to endorse the idea that treaty shopping is not inherently objectionable, by stating that "businesses should be able to organize their affairs to obtain access to treaty benefits". Most recently, the FCA in *Prévost* clearly rejected the CRA’s attempt to challenge what it apparently perceived as improper treaty shopping by denying the status of “beneficial owner” for treaty purposes.

Nonetheless, this area of the law is changing rapidly and new developments, particularly at the OECD, must be monitored closely. In this respect, *Prévost*'s main significance is that the FCA has opened the door to the use of later OECD Commentaries in interpreting pre-existing tax treaties and, eventually, to the potential application of the various treaty anti-abuse notions advocated by the OECD in the 2003 Commentaries to the OECD Model. As a consequence of this, the CRA may consider it desirable to rely more often on an inherent general anti-abuse rule

regarding improper tax treaty use. Similarly, it may be expected that the CRA will not be discouraged, at least until *Velcro* is decided, from using the OECD's interpretation of "beneficial owner" to challenge perceived abusive treaty shopping. As explained above, however, such possible CRA initiatives should not be successful.

Another avenue of possible development of Canada's tax law in respect of treaty shopping is treaty residence. In this respect, the CRA seems to be preparing the ground for a more aggressive assessing practice in situations of perceived abusive treaty shopping, but so far it is unclear what exactly the CRA intends to do in practice.

Finally, despite the CRA's setback in *MIL (Investments)*, it is expected that the CRA will continue to use the GAAR in cases it regards as abusive treaty shopping. Arguably, this is the only reasonable approach for the Canadian government. In other words, the CRA should "stick to its guns".