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CASE UPDATE

A Comparative Look At Canada's Approach to Treaty Interpretation

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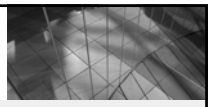

Introduction

- A number of recent Canadian tax cases have involved the interpretation of Canada's tax treaties.
- Similar issues have arisen in recent international cases and it is interesting to compare Canada's approach to these issues with the approach taken by courts in other jurisdictions.

The following cases will be discussed:

- *St. Michael Trust Corp. v. Canada* **(a.k.a. "Garron") 2010 FCA 309**
  - Residence Tie-Breaker Rules
- *HM Revenue and Customs v. Smallwood & Anor*, **[2010] EWCA Civ 778**
  - Residence Tie-Breaker Rules
- *Bayfine UK v. HM Revenue and Customs*, **[2011] EWHC Civ 304**
  - Elimination of Double Taxation
- *Saipem UK Limited v. The Queen,* **2011 TCC 25**
  - Non-Discrimination
- *HM Revenue & Customs v. UBS AG,* **[2007] EWCA Civ 119**
  - Non-Discrimination
- *Lingle v. The Queen,* **2009 TCC 435**
  - Habitual Abode
- *Hankinson v. Revenue & Customs,* **[2009] UKFTT 384 (TC)**
  - Habitual Abode

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Facts:

- Involved a reorganization of the capital of a private Canadian operating company, the shares of which were indirectly held by Canadian individuals through two Canadian holding companies.
- The existing common shares of the operating company were exchanged for "freeze shares" redeemable for an amount equal to the fair market value of the existing common shares.
- New common shares in the operating company were issued to two newly-formed Canadian resident holding companies. The shares of these holding companies were issued to trusts settled in Barbados.
- The trusts sold shares and realized a substantial gain.
- The trusts claimed exemption from Canadian tax on gains under the *Canada-Barbados Treaty*.

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

The Minister's Position:

- Crown argued that the trusts were in fact resident in Canada on the basis that they were managed and controlled in Canada, and that the protection of the Barbados Treaty was therefore not available.
- Crown also argued that, even if the trusts were not resident in Canada, reliance on the Barbados Treaty in this manner would constitute abusive tax avoidance, such that the Treaty benefit claimed by the taxpayers should be denied under the general anti-avoidance rule in section 245 of the Act.

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Decision of the Tax Court of Canada:

- Justice Woods of the Tax Court held that the residence of a trust for tax purposes is to be determined by applying a "central management and control test" similar to that applied in determining the residence of a corporation.
- Prior to this decision, it was generally accepted by the tax community that a trust is resident in the jurisdiction where a majority of its trustees reside or, in cases where the trust has only a single trustee, the jurisdiction where that trustee resides.

Decision of the Tax Court of Canada (cont'd):

- As the Crown did not take a view on the issue of whether the trusts were resident in Barbados, Woods J. stated that the case would not be decided on the basis of whether the trusts were so resident.
- Crown noted that the residence tie-breaker provision in the Treaty had not been engaged by an agreement of the competent authorities.
- Applying the management and control test, Woods J. held that the trusts were resident in Canada and that this conclusion was sufficient to dispose of the Appeal – there was no further discussion of the Treaty tie-breaker.

Decision of the Federal Court of Appeal:

- The Federal Court of Appeal agreed with the conclusion of the Tax Court that a central management and control test should be applied in determining the residence of the trusts.
- The Court concluded that the Tax Court made no error warranting the intervention of the Court of Appeal in concluding that, at the relevant time, the management and control of the trusts resided in Canada.

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Decision of the Federal Court of Appeal (cont'd):

- Unlike the Tax Court, the Federal Court of Appeal, in setting out the relevant provisions of the *Canada-Barbados Treaty*, refers to the tie-breaker provision for persons other than individuals (i.e., the competent authorities shall, by mutual agreement, endeavour to settle the question and to determine the mode of application of the Treaty to such person).
- The Court notes that a person (including a trust) that meets the definition of resident of Barbados but not the treaty definition of resident of Canada is entitled to exemption from Canadian tax on any corporate gains realized on the disposition of shares of a corporation (subject to certain exceptions).

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Decision of the Federal Court of Appeal (cont'd):

- Based on this formulation of the Treaty exemption, the Court concludes that because the trusts are resident in Canada, the Treaty exemption is not available.
- There is no further discussion of the tie-breaker rule.

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Decision of the Federal Court of Appeal (cont'd):

- The Federal Court of Appeal also expressed its views regarding the GAAR, which would have been relevant had it been determined that the trusts were not resident in Canada.
- As in the Tax Court, the Federal Court of Appeal noted that the issue of whether the general anti-avoidance rule applies in this case turns on whether the series of transactions that would have resulted in the trusts becoming entitled to the treaty exemption is a misuse or abuse of the Barbados Treaty.
- The Federal Court of Appeal observed that, in the Barbados Treaty, Canada has agreed not to tax certain capital gains realized by a person who is a resident of Barbados.

SLIDE 10 STIKEMAN ELLIOTT LLP

1 *St. Michael Trust Corp. v. Canada (a.k.a. "Garron")*

Decision of the Federal Court of Appeal (cont'd):

- The Court went on to conclude that if the residence of the trusts is Barbados for treaty purposes, the trusts cannot misuse or abuse the Barbados Treaty by claiming the exemption.
- This approach is broadly consistent with that previously taken by the Federal Court of Appeal, and generally affirms it will be difficult for the Canada Revenue Agency to apply the general anti-avoidance rule to deny treaty benefits where there has been technical compliance with the applicable treaty provisions.

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2 *HMRC v. Smallwood & Anor*

- Smallwood case in the UK also dealt with a situation of dual residence.
- The trust, initially resident in Jersey, adopted "Round the World" scheme to dispose of property of the trust in an attempt to avoid UK tax on the gain.
- The trust needed to be resident in the UK at some point of time in the taxation year in which the property was disposed of in order to avoid the settlor's liability for UK tax on the gain.
- During the year, the Jersey trustees were replaced by trustees in Mauritius and, while purportedly resident in Mauritius, the trust sold the property and realized the gain.

2 *HMRC v. Smallwood & Anor*

- Prior to the end of the year, the trust replaced the Mauritius trustees with UK resident trustees.
- Under UK tax law, because the trust was resident in the UK during the year (even though not at the time the gain was realized), the gain was taxable in the U.K.
- The trust contended that the gain was exempt from tax under the *UK-Mauritius Treaty*.
- The scheme of the *UK-Mauritius Tax Treaty* was similar to the *Canada-UK Treaty*. With certain exceptions, gains realized by a resident of a Contracting State were taxable only in the State of which the alienator is resident.

2 *HMRC v. Smallwood & Anor*

- The UK Court of Appeal held that the trust was liable to tax on the gain in both Contracting States on the basis of residence, notwithstanding that the trust was not resident in the UK at the time the gain was realized.
- For purposes of the gains article in the Treaty, it is necessary to determine the State of which the alienator is resident. The term resident of a Contracting State is defined in Article 4 of the Treaty which includes the tie-breaker provisions and it is this definition which is imported into the gains article.
- Any dual residence should be solved by the tie-breaker rule before one arrives at Article 13 (the gains article).

3 *Bayfine UK v. HMRC*

Facts:

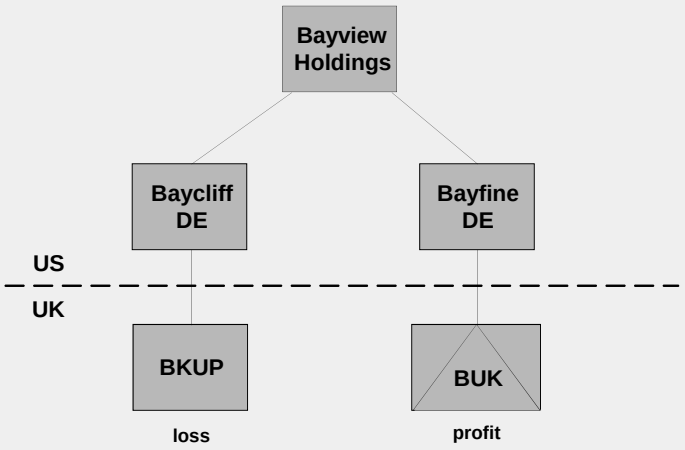
- Involved scheme to create loss for UK tax purposes.
- US company created two UK subsidiaries that entered into forward contracts.
- Contracts ensured gain in one subsidiary equal to loss in the other subsidiary.
- Both subsidiaries would be disregarded for US tax purposes unless check-the-box election made to be treated as a corporation.

Facts (cont'd)

- UK subsidiary realizing loss checked to be treated as corporation for US purposes.
- UK subsidiary realizing gain disregarded for US purposes.
- Therefore, gain subject to tax in UK in hands of UK subsidiary and in US in hands of US Co.

Issue:

- Whether UK domestic law or *UK-US Treaty* provided credit in UK for US tax payable.



Relevant Treaty Provisions

Article 7	**Business Profit** ▪ Resident State has exclusive right to tax business profits unless profits attributable to permanent establishment in the other State
Article 1(3)	**Saving Clause** ▪ A Contracting State may tax its residents as if the treaty had not come into force
Article 1(4)	**1(3) does not affect application of Article 23**
Article 23	**Elimination of Double Taxation** 1) US gives credit for appropriate amount of UK tax 2) UK gives credit for US tax on US source income against UK tax computed on same source of income 3) Income of a resident of a Contracting State that may be taxed in the other State "in accordance with the treaty" is deemed to arise in the other State

Reasons of Court of Appeal

- Treaty must be interpreted to avoid double taxation AND double non-taxation.
- Result that leads to possibility of credit in both states would not be consistent with the purpose of the treaty.
- US experts conclude US tax imposed under savings clause and not under business profits clause.
- On its face, deemed source rule in Article 23(3) would require both states to give relief but this is not the intended application of Article 23 so, by virtue of Article 1(4), the saving clause cannot be applied to reach this result.
- The best way to escape this circle, as suggested by the Special Commissioners, is to require the State levying tax based on the savings clause to give way.

What would happen in Canada?

- Suppose US Co has a disregarded ULC as a subsidiary.
- Subsidiary earns US source business profits that are not attributable to a US permanent establishment.

Relevant Provisions of *Canada-US Treaty*

Article VII	**Business Profits** ▪ Resident State has exclusive right to tax business profits unless profits attributable to permanent establishment in the other State
Article XXIX(2)	**Saving Clause** ▪ Treaty does not affect taxation by a contracting State of its residents
Article XXIX(3)	**XXIX(2) does not affect obligations under Article XXIV (Elimination of Double Taxation)**

3 *Bayfine UK v. HMRC*

Relevant Provisions of *Canada-US Treaty* (cont'd)

Article XXIV **Elimination of Double Taxation**

1)US gives credit for appropriate amount of Canadian tax.

2)Income tax paid on income arising in the US shall be deducted from any Canadian tax payable in respect of such income.

3)Income of a resident that may be taxed in the other State (without regard to Article XXIX(2)) deemed to arise in that other State AND income of a resident that may not be taxed in the other State (without regard to Article XXIX(2)) is deemed to arise in the resident State.

Differences between the deemed source rule in Article XXIV of the *Canada-US Treaty* and the deemed source rule in Article 23 of the *US-UK Treaty* likely avoid the circularity faced by the Court in *Bayfine.*

SLIDE 22 STIKEMAN ELLIOTT LLP

4 *Saipem UK Limited v. The Queen*

Facts:

- The taxpayer, a corporation incorporated and resident in the UK, carried on business in Canada through a permanent establishment from 2004 to 2006.
- The taxpayer's subsidiary, Saipem Energy International Limited ("**SEI**"), also a corporation incorporated and resident in the UK, carried on business in Canada through a permanent establishment from 2001 to 2003 and had non-capital losses in those years.
- In 2003, SEI was wound up into the taxpayer.
- In computing its taxable income earned in Canada, the taxpayer deducted the non-capital losses of SEI that would have been transferred to the taxpayer on the winding-up if the taxpayer and SEI were Canadian corporations.

SLIDE 23 STIKEMAN ELLIOTT LLP

4 *Saipem UK Limited v. The Queen*

- The Minister denied the deductions of the non-capital losses of SEI on the basis that the taxpayer and SEI were not "Canadian corporations" as required under the subsection 88(1.1).
- The taxpayer appealed on the basis that the restriction in subsection 88(1.1) to "Canadian corporations" amounts to discrimination that is precluded by the non-discrimination provisions in Article 22 of the *Canada-UK Treaty.*

4 *Saipem UK Limited v. The Queen*

Legal Framework – Article 22 of Canada-UK Treaty:

"Non-Discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith *which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected*.

Legal Framework – Article 22 of Canada-UK Treaty

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State *shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities*. This provision shall not be construed as obliging either Contracting State to grant to individuals not resident in its territory those personal allowances and reliefs for tax purposes which are by law available only to individuals who are so resident. "

Decision of the Tax Court of Canada:

- Angers J. noted that there is no previous Canadian case on the application of a non-discrimination provision in a tax treaty and, therefore, reviewed other sources including OECD Commentary and held that paragraph 1 of Article 22 was intended to preclude discrimination on the basis of nationality (which, in the case of a corporation, means place of incorporation) which is distinct from discrimination based on residency.
- Subsection 88(1.1) is restricted in its application to "Canadian corporations"; however, a "Canadian corporation" is a corporation that is resident in Canada and either incorporated in Canada or resident in Canada since June 18, 1971.
- Therefore, a Canadian corporation need not be incorporated in Canada with the result that subsection 88(1.1) does not impose a nationality requirement.

Decision of the Tax Court of Canada:

- In addition, the non-discrimination provision requires a comparison of the taxpayer with a Canadian incorporated company in the same circumstances as the taxpayer.
- The taxpayer is a non-resident of Canada and, therefore, the appropriate comparison is to a Canadian incorporated company that is not resident in Canada. Subsection 88(1.1) would not apply to such company and, therefore, it cannot be said that subsection 88(1.1) discriminates on the basis of nationality.

4 *Saipem UK Limited v. The Queen*

Decision of the Tax Court of Canada:

- Regarding paragraph 2 of Article 22, Angers J. considered the OECD Commentary, and Article 7 of the Treaty dealing with business profits, and held that non-discriminatory treatment is required only with regard to the taxation of the PE's own activities and does not extend to provisions that look to the relationship between the enterprise that has the permanent establishment and other enterprises.
- The proper comparison is between the permanent establishment and a Canadian corporation carrying on the same activities. The Court noted that a Canadian corporation would not get the benefit of losses of a wound-up non-resident subsidiary with a permanent establishment in Canada.

5 *HMRC v. UBS AG*

Facts:

- UBS AG carried on business in the UK through its London branch.
- The branch sustained significant losses.
- The branch also received dividends in the relevant years and these dividends would have entitled the branch to tax credits if it were a company resident in the UK.
- The branch claimed the credits but they were denied.

5 *HMRC v. UBS AG*

Facts (cont'd)

- UBS contended that the refusal was discrimination prohibited by the non-discrimination clause of the *UK-Switzerland Treaty.*
- Article 23(2) of the Treaty provided that the taxation on a permanent establishment which an enterprise of a Contracting State has in the other State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

Decision of the UK Courts:

- The Special Commissioners, the High Court Judge and one of the judges in the Court of Appeal held that the refusal of the credits was discrimination precluded by the Treaty.
- One judge in the Court of Appeal held that there was no discrimination because the tax credits do not reduce the UK charge to tax and, therefore, do not form part of the levying of taxation on UK companies. The third judge in the Court of Appeal decided the case on other grounds and, therefore, did not reach a conclusion on the non-discrimination clause.
- In the view of the judges that held that the refund of the credit constituted discrimination, the non-discrimination clause simply requires a comparison of the results of the tax provision as applied to the permanent establishment and the results applicable to a UK company in the same position.
- The UK resident can, upon making a claim, receive cash from the Revenue in respect of the tax credit while UBS could not.
- In the words of the Special Commissioners, "That is clearly taxation less favourably levied".

Decision of the UK Courts (cont'd):

- The credits received under the relevant UK legislation depended upon the surplus of dividends received over dividends paid.
- HMRC argued that, in applying the rule to UBS, the branch should be considered to have paid all of its after-tax earnings as dividends.
- This argument was rejected on the basis that it is the nature of a permanent establishment that it cannot pay dividends and so the profit distributions are outside the comparison.
- The Special Commissioners stated, with the concurrence of the High Court Judge, that such a comparison would imply that a State could impose a branch profits tax as equivalent to withholding tax on dividends without breaching the non-discrimination article, which cannot be right. The judges in the Court of Appeal did not address this argument.

6 *Lingle v. The Queen*

Facts:

- Taxpayer was a US citizen working as an independent contractor in Canada.
- Throughout the relevant period, the Taxpayer had a home available to him in both the US and Canada.
- In one of the relevant years, the Taxpayer spent 321 days in Canada and 45 days in the US and, until September 14 in the other year, the Taxpayer spent 233 days in Canada and 24 days in the US.
- The Taxpayer claimed exemption under the *Canada-US Treaty* in respect of income earned in Canada on the basis that the Taxpayer was resident in the US under the tie-breaker rules in the *Canada-US Treaty*.

6 *Lingle v. The Queen*

Tie-Breaker scheme in *Canada-US Treaty* for an individual is as follows:

- Deemed resident in Contracting State where individual has permanent home available to him.
- If permanent home available in both jurisdictions or neither, deemed resident in Contracting State in which personal and economic relations are closer (centre of vital interests).

Tie-Breaker scheme in *Canada-US Treaty* for an individual is as follows (cont'd):

- If centre of vital interests cannot be determined, deemed resident of the Contracting State in which the individual has an habitual abode.
- If habitual abode in both Contracting States or neither, deemed resident of the Contracting State of which individual is a citizen.
- If citizen of both Contracting States, residence settled by agreement of Competent Authorities.

- Based on facts, critical issue was whether Taxpayer had an habitual abode in the US.
- Tax Court held Taxpayer had habitual abode only in Canada, not in US and, therefore, was resident in Canada under the tie-breaker.
- Federal Court of Appeal agreed with Tax Court.

6 *Lingle v. The Queen*

- Tax Court rejected Crown's argument that habitual abode was determined solely by a comparison of the number of days spent in each Contracting State, that is by determining where the individual stays more frequently.
- The Court referred to the Commentary to the OECD Model Convention and concluded that the Commentary clearly contemplated situations in which individuals would have an habitual abode in both Contracting States and this could not arise under a simple day count test except in limited circumstances.
- The Tax Court concludes that an individual has an habitual abode in a Contracting State if, in the settled routine of his life, he regularly, normally and customarily lives in that State.
- Federal Court of Appeal generally agreed with the Tax Court's analysis.

7 *Hankinson v. HMRC*

- Issue was whether appellant was ordinarily resident in UK in relevant year.
- First tier tribunal held that Appellant was resident in the UK so it was necessary to determine if Appellant was resident in UK or The Netherlands for purposes of the Treaty.
- *Dutch-UK Treaty* tie-breaker similar to *Canada-US Treaty* tie-breaker discussed in *Lingle.*
- The tribunal finds that the Appellant's centre of vital interests was in the UK but discusses habitual abode in any event.
- The tribunal cites *Lingle* and concurs in its interpretation of habitual abode holding that the appellant, staying 130 nights in The Netherlands and 82 nights in the UK in the relevant period, had an habitual abode in both States.

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