canadian tax journal / revue fiscale canadienne (2010) vol. 58, no 3, 631-52

Current Cases

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FEDERAL COURT OF APPEAL

THE PROPER ROLE OF THE SUBSECTION 87(4) ANTI-AVOIDANCE PROVISION

Husky Oil Limited v. Canada
2010 FCA 125

KEYWORDS: CAPITAL GAINS ■ ROLLOVERS ■ AMALGAMATIONS ■ ANTI-AVOIDANCE

In *Husky Oil Limited v. Canada*, the Federal Court of Appeal, in reasons written by Sharlow J and concurred in by Blais and Pelletier JJ, considered whether a specific anti-avoidance rule in the Income Tax Act[1] could apply to address what Sharlow J described as an "unstated premise." The unstated premise was that it is improper to defer recognition of the capital gain on a disposition of property by an agreement to postpone for a period of time the right to receive the consideration in cash. The specific anti-avoidance provision invoked by the Crown was the gifting rule contained in subsection 87(4) ("the subsection 87(4) exception") or, in the alternative, subsection 69(4).

The subsection 87(4) exception is an exception to the rollover that is generally available in a qualifying amalgamation of taxable Canadian corporations, where a shareholder exchanges its shares of a predecessor corporation ("old shares") and receives, as consideration, only shares of the amalgamated corporation ("new shares"). Where the rollover applies, the old shares are deemed to have been disposed of at their adjusted cost base (ACB) to the holder and the new shares are deemed to have

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

been acquired at the same amount, such that no gain arises on the exchange. The subsection 87(4) exception provides that where the fair market value (FMV) of the old shares immediately before the amalgamation exceeds the FMV of the new shares immediately after the amalgamation and it is reasonable to regard any portion of the excess (referred to as "the gift portion") as a benefit that the shareholder desired to have conferred on a person related to the shareholder, the disposition of the old shares is deemed to occur not at the ACB of the old shares but rather at that ACB plus the gift portion.[2] The ACB of the new shares generally remains the ACB of the old shares. The subsection 87(4) exception is similar to the gifting rules contained in other corporate reorganization provisions that otherwise provide rollover treatment—for example, subsection 51(2), paragraph 85(1)(e.2), and subsection 86(2).

Subsection 69(4) deals with property of a corporation appropriated to or for the benefit of a shareholder of the corporation for no consideration or for less than its FMV, and deems property so appropriated to have been disposed of for proceeds equal to that FMV.

Facts

The facts are complex. The case involved numerous transactions undertaken in 1998 that centred around three corporate groups: "the Balaclava group," "the Husky group," and "the Mohawk group." All the members of these groups were taxable Canadian corporations. The Balaclava group consisted of the parent corporation, Balaclava Enterprises Ltd. ("Balaclava"), its wholly owned subsidiary "BAI," and BAI's wholly owned subsidiary "347."

The Husky group was headed by Husky Oil Ltd. ("Old Husky"). Its most relevant subsidiary for the purposes of the appeal was HB Acquisition, described below.

The Mohawk group was headed by Mohawk Canada Ltd. ("Mohawk"). Its only relevant subsidiary for the purposes of the appeal was "Lubricants," which carried on the business of re-refining and distributing recycled oil.

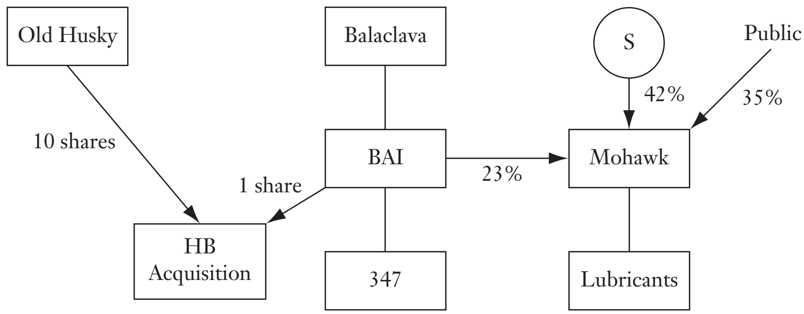
In 1997, Mohawk started actively soliciting bids for a takeover. At that time, 23 percent of its shares were held by BAI (in the form of shares and convertible debt), 42 percent of the shares were held directly or indirectly by a single individual ("S"), and the remaining 35 percent of the shares were widely held by the public.

In April 1998, Old Husky expressed an interest in acquiring Mohawk for $103 million; however, Old Husky was not interested in certain of Mohawk's assets ("the residual assets") held by the Lubricants subsidiary. Balaclava was willing to acquire the residual assets by purchasing the shares of Lubricants ("the Lubricants shares"), in addition to selling its shares in Mohawk to Old Husky.

In 1998, to facilitate the takeover, Old Husky and BAI created HB Acquisition Inc. ("HB Acquisition"). Old Husky acquired 10 common shares and BAI acquired 1 common share. The corporate structures and relationships between the three groups on completion of these transactions are illustrated in figure 1.

2 But not at an amount in excess of the FMV of the old shares.

FIGURE 1 Corporate Structures and Relationships Prior to the 1998 Agreement



On June 1, 1998, in a joint bid agreement ("the agreement"), HB Acquisition agreed to make a takeover bid for all of the Mohawk shares (except those held by any member of the Balaclava group) for $7.25 per share. As part of the agreement, BAI would convert its debentures of Mohawk into Mohawk shares and then transfer all of its Mohawk shares (which would then total 2,854,267) to HB Acquisition. The total agreed price (also at $7.25 per share) of $20,693,436 was to be payable in the form of $5,193,436 in cash and the balance of $15.5 million by way of a demand promissory note in the principal amount of $5,934,598 ("the BAI note") (which, however, BAI agreed not to make demand on until 2023) and $9,565,402 through the issuance of common shares of HB Acquisition. Any capital gain on BAI's disposition of the Mohawk shares was to be deferred through a joint election under subsection 85(1) of the Act.

The agreement initially entered into also provided for an option and put agreement under which BAI would have an option to purchase the Lubricants shares from Mohawk for $15.5 million, payable in 25 years without interest, and Mohawk would have a put right to require BAI to acquire the Lubricants shares from Mohawk on the same terms. After the agreement was entered into, it was realized that, as a result of having less than expected tax shelter, such a sale would result in Mohawk incurring a tax liability of approximately $1.5 million. As a result, the option and put agreement was amended to substitute an amalgamation of Lubricants and 347 to form "Lubes Amalco" ("the amalgamation"). The capital structure of Lubes Amalco would result in Mohawk holding preferred shares of Lubes Amalco ("the Lubes Amalco preferred shares") and BAI holding the only common share of the company. The Lubes Amalco preferred shares would be redeemable at Mohawk's call for $15.5 million, payable by a non-interest-bearing promissory note due June 1, 2023.[3]

3 This is the description of the Lubes Amalco preferred shares in paragraph 37 of the Federal Court of Appeal's reasons, 2010 FCA 125. As noted by the court, these shares represented, in economic terms, the same consideration as Mohawk would have received if BAI had purchased the Lubricants shares for $15.5 million in 2023 without interest.

Certain other changes in the arrangements were also negotiated, including a provision that BAI would receive preferred shares of HB Acquisition that were similarly redeemable for a non-interest-bearing note maturing in 2023.

The transactions to implement the revised arrangements were completed in July 1998.

In certain post-closing transactions, BAI exchanged its common shares of HB Acquisition for 9,565,403 preferred shares of a subsidiary of Old Husky, "HMLT," ("the HMLT preferred shares") redeemable at BAI's option at $1 a share on terms and conditions similar to those of the Lubes Amalco preferred shares.

Reducing the facts to their simplest form, the Lubes Amalco preferred shares would be redeemable for a total of $15.5 million, payable by delivery of a non-interest-bearing promissory note not due until 2023, and the HMLT preferred shares would similarly not be redeemable until 2023. Certain setoffs of the obligations between the two remaining corporate groups (Balaclava and Husky) occurred in the post-closing transactions, as a result of which the respective positions of the parties were as shown in figure 2.

In many respects, the transaction steps resemble (with some modifications) the steps that would be implemented in order to carry out a butterfly transaction, except that the final step in a typical butterfly, the cross-redemption of the shares, was deferred for some 25 years.

The minister reassessed Husky Oil Ltd. ("Husky Oil"), created in 1999 by an amalgamation of Old Husky and Mohawk, to include in Mohawk's 1998 income a taxable capital gain based on deemed proceeds of disposition for the Lubricants shares of $15.5 million. Husky Oil filed an objection and the minister confirmed the reassessment. Husky Oil then appealed to the Tax Court of Canada,[4] where Hogan J upheld the minister's reassessment. Hogan J's decision was reversed on appeal to the Federal Court of Appeal.

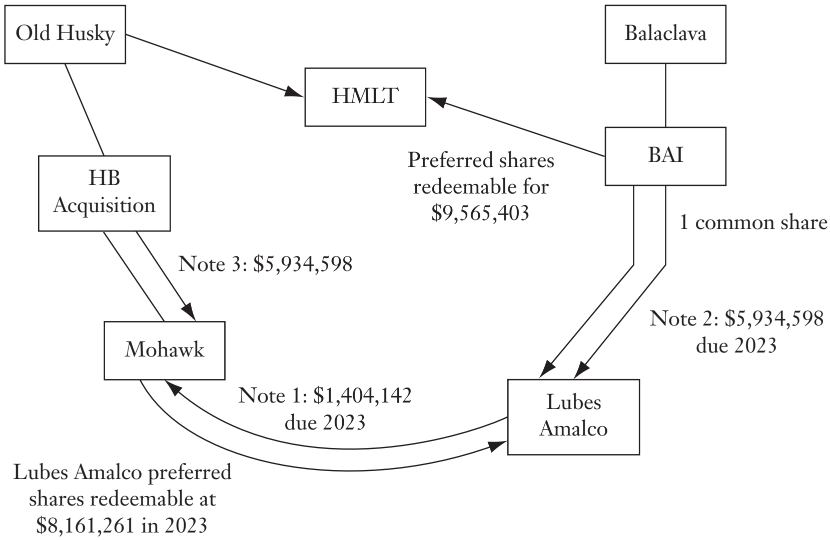
The Tax Court Decision

The Crown's principal argument at the Tax Court (and the Federal Court of Appeal) was that the subsection 87(4) exception applied to include in Mohawk's 1998 income a taxable capital gain based on deemed proceeds of disposition of $15.5 million with respect to Mohawk's disposition of the Lubricants shares on the amalgamation.

Hogan J held that the minister's assumption that the Lubricants shares were worth $15.5 million and that the Lubes Amalco preferred shares had nil value must stand. He noted that the Lubes Amalco preferred shares lacked any dividend entitlement and their redemption price could be satisfied by a non-interest-bearing promissory note maturing in 2023. Hogan J stated that it was "incontrovertible" that an arm's-length purchaser of the shares would place a significant discount on the principal amount of the note, and Husky Oil had failed to adduce any evidence on the valuation point.

4 2009 TCC 118.

FIGURE 2 Corporate Structures and Relationships on Completion of Post-Closing Transactions



With respect to the subsection 87(4) exception requirement of conferral of a benefit, rather than finding that a benefit had been conferred on BAI (which was in fact not related to Mohawk), Hogan J found that a benefit had been conferred on HB Acquisition and hence on Old Husky, both of which were related to Mohawk at the time of the amalgamation. The benefit was that the amalgamation was a necessary step for the completion of Old Husky's acquisition of Mohawk.[5]

According to Hogan J, Old Husky and HMLT promised Balaclava that they would cause Lubricants to amalgamate with 347 and Mohawk gave effect to this promise for the benefit of HB Acquisition and Old Husky. In Hogan J's opinion, the subsection 87(4) exception was "designed to prevent this very result by providing that the shareholder of the predecessor corporation must act in its own interest and not for the benefit of a related party, such as a controlling shareholder."[6] Hogan J expressly stated that he found nothing offensive about the parties ending up with cross-shareholdings allowing a potential 25-year deferral of capital gains tax.[7]

Hogan J was also of the view that the deeming rule in subsection 69(4) provided that Mohawk must pay tax on the full value that had been appropriated for the

5 The Tax Court also viewed the amalgamation as benefiting HB Acquisition and Old Husky in a second way: in the event that the amalgamation was not completed by September 29, 1998, HB Acquisition could have been required to acquire the securities it issued to BAI for $15.5 million. This obligation of HB Acquisition was supported by a guarantee by Old Husky that would also be terminated on completion of the amalgamation.

6 Supra note 4, at paragraph 58.

7 Ibid., at paragraph 61.

benefit of its shareholder HB Acquisition. He characterized this provision as being much broader than the subsection 87(4) exception and essentially concluded that, as controlling shareholder of Mohawk, HB Acquisition had caused Mohawk to transfer property to someone else in order to free HB Acquisition or Old Husky from the risk of having to pay cash to BAI for the securities issued by HB Acquisition to BAI.

The Federal Court of Appeal Decision

Fair Market Value of the Relevant Shares

The Federal Court of Appeal noted that the reassessment under appeal was based on two valuations, the pre-amalgamation FMV of the Lubricants shares and the post-amalgamation FMV of the Lubes Amalco preferred shares, which the minister had assumed to be $15.5 million and nil respectively. The court observed that the parties had agreed at the outset that the price for the Lubricants shares would be $15.5 million payable in 2023 without interest, which suggested that the pre-amalgamation FMV of the Lubricants shares was the value in 1998 of $15.5 million payable in 2023 without interest.

With respect to the Lubes Amalco preferred shares, the court observed that it would have been open to the trial judge to take judicial notice of the fact that the present value of a sum of money payable in 25 years without interest, while undoubtedly less than the stated sum, is probably more than zero. If Husky Oil had suggested this approach, the minister's assumption that the Lubes Amalco preferred shares had no value would have been rebutted and, according to the court, the minister would then have borne the onus of establishing what the FMV was.

Despite its apparent misgivings with respect to the Tax Court's analysis on the matter of valuation, the Court of Appeal chose not to determine the appeal on the basis that the trial judge had made a palpable and overriding error in accepting $15.5 million as the pre-amalgamation FMV of the Lubricants shares or on the basis that the minister had not discharged the onus of proving the post-amalgamation FMV of the Lubes Amalco preferred shares.

The Subsection 87(4) Analysis

With respect to the subsection 87(4) exception, the Court of Appeal rejected Hogan J's finding that the subsection 87(4) exception was designed to require that the shareholder of the predecessor corporation act in its own interest and not for the benefit of a related party. Instead, the court held that the objective of the subsection 87(4) exception was more specific—namely,

> [to] deter a taxpayer from using the device of a corporate amalgamation to shift part or all of the value of a predecessor corporation to the amalgamated corporation if, but only if, a person related to the taxpayer has a direct or indirect interest in the amalgamated corporation that will be enhanced by the shift in value.[8]

8 Supra note 3, at paragraph 58.

The court did not accept that the amalgamation was a critical step in the completion of the contractual arrangement between Mohawk, Old Husky, and Balaclava. It noted that the amalgamation was first proposed only after the takeover bid had been mailed and at a time when all the parties were bound by the agreement, including the original option and put agreement requiring BAI to purchase the Lubricants shares for $15.5 million payable in 2023 without interest. The court found that the amalgamation was agreed to only in order to defer tax on the capital gain that might otherwise arise on the disposition of the Lubricants shares, resulting in a tax saving to Mohawk (and indirectly to HB Acquisition).

The court held that the appropriate interpretation to be given to the subsection 87(4) exception was one that required that the relevant benefit for the purposes of the subsection 87(4) exception be all or part of the shift in value represented by the gift portion. On this basis, any benefit to Old Husky in the form of its ability to complete its acquisition of the Mohawk shares or any tax saving that might have indirectly resulted in a saving for HB Acquisition would not be a relevant benefit for the purposes of the subsection 87(4) exception. The shift in value of the gift portion accrued to Lubes Amalco and BAI as the owner of the only common share of Lubes Amalco. Since neither BAI nor any person with a direct or indirect interest in BAI was related to Mohawk, the subsection 87(4) exception could not apply to the gift portion; instead, Mohawk's proceeds of disposition of the Lubricants shares must be determined by the deeming rule in paragraph 87(4)(a).

Subsection 69(4)

With respect to the Crown's alternative argument that subsection 69(4) should apply to deem Mohawk's proceeds of disposition of the Lubricants shares to be $15.5 million, Husky Oil argued that because paragraph 87(4)(a) already applied to deem the proceeds of disposition of the Lubricants shares to be equal to their ACB, subsection 69(4) could not also apply.

The court determined that even if subsection 69(4) would otherwise apply, subsection 87(4) would take precedence. It noted that a statutory deeming rule creates a statutory fiction and that when two deeming rules create two different statutory fictions, one of the provisions must be interpreted to override the other. The court resolved this dilemma by ruling that the specific provisions of subsection 87(4) must trump the more general rule in subsection 69(4). Given that the subsection 87(4) exception did not apply, the deemed proceeds of disposition of the Lubricants shares must be determined under paragraph 87(4)(a).

Significance of the Court of Appeal Decision

The Court of Appeal seemed skeptical of the amounts attributed by the minister with respect to the pre-amalgamation FMV of the Lubricants shares and the post-amalgamation FMV of the Lubes Amalco preferred shares. It appeared to hint at the possibility that Husky Oil might have successfully asserted that there was no difference between the FMV of the pre-amalgamation Lubricants shares (which, in the original transaction agreed to, would have been disposed of by Mohawk to BAI for a non-interest-bearing promissory note not due for 25 years) and the Lubes Amalco preferred shares, which had similar attributes.

In its decision, the court took the opportunity, albeit in obiter, to make some sensible observations regarding the determination of the FMV of property. Its statement that normally, absent evidence to the contrary, there is a presumption that the FMV of property sold is equal to the FMV of the agreed consideration when the parties to the proposed transaction deal with each other at arm's length, is in keeping with earlier jurisprudence of the court, such as *The Queen v. Husky Oil Limited*.[9] Further, it is difficult to find fault with the court's statement that although a promise to pay $15.5 million in 2023 would necessarily have an FMV of less than $15.5 million, such amount was probably more than zero.

The court's analysis of the application of the subsection 87(4) exception is interesting for several reasons. First, the discussion provides useful guidance as to the workings of the provision and what will and will not be a relevant benefit for the purposes of the exception. The decision is authority for the position that the only relevant benefit for the purposes of the subsection 87(4) exception is the shift in value represented by the gift portion.

In describing the provisions of subsection 87(4) and the subsection 87(4) exception, the court gave an example to illustrate its operation. The example involves a father who owns all of the shares of Fco, with an ACB of $1 and an FMV of $100, and his son, who owns all of the shares of Sco, with an ACB of $60 and an FMV of $100. Fco and Sco amalgamate to form Aco, the shares of which are worth $200. On the amalgamation, the father is issued 20 shares of Aco with an FMV of $20 and the son is issued 180 shares of Aco with an FMV of $180. The result of the amalgamation is that $80 of value is shifted from father to son. The court noted that the consequence of applying the subsection 87(4) exception in these circumstances is that there is a punitive double taxation effect. The son's ACB of the shares that he receives in the amalgamation is $60, even though the shares have an FMV of $180. Therefore, if he sells his shares, he has a $120 capital gain. The father is considered to have disposed of his shares for their ACB plus the "gift portion" of $80. However, the shares that he receives on the amalgamation still have an ACB of $1. In effect, the $80 gift portion is taxed twice.

Clearly, in the view of the Federal Court of Appeal, the purpose of the subsection 87(4) exception is much narrower than the purpose ascribed to it in the Tax Court decision, and the provision should be interpreted in a manner consistent with that purpose. The application of the subsection 87(4) exception by the Tax Court was found to be based on an interpretation that "[the words] cannot reasonably bear, and that is not consistent with its purpose as disclosed by those words."[10] While the

9 95 DTC 5244; [1995] 1 CTC 460, at paragraph 11 (FCA).

10 Supra note 3, at paragraph 66.

Court of Appeal did not explicitly say so, it seems reasonable to infer that its view that the provision, when it operates, has a punitive effect may have informed its view of how the provision should be interpreted.

While neither Husky Oil nor the Federal Court of Appeal seems to have made an issue of this, on the eventual unwind of the cross-shareholdings, there would presumably be further tax consequences to both parties even though these tax consequences were deferred to a date far in the future. The court alluded to this deferral in the following passage:

> Underlying the Crown's position in this case is an unstated premise that it is improper for a taxpayer to attempt to defer the recognition of a capital gain on the disposition of property by means of an agreement of one kind or another to postpone for 25 years the right to receive the consideration in cash. That may be a valid premise.[11]

The court noted that the propriety or impropriety of planning to defer a gain in this manner could have been raised if the minister had reassessed on the basis of the general anti-avoidance rule, but this was not done. While not dismissing the possibility that the "unstated premise" might be a valid one, the court made it clear that the use of a specific anti-avoidance rule with an entirely different objective is not the proper method for addressing such perceived impropriety.

Finally, with respect to the subsection 69(4) argument, the court chose to dispose of this argument by finding that subsections 87(4) and 69(4) conflict by creating two different statutory fictions (one a deemed disposition at ACB and the other a deemed disposition at FMV) and that the specific rule trumps the more general rule. Arguably, it might have been more straightforward for the court to have simply concluded that there was no appropriation of property of Mohawk for the benefit of HB Acquisition.

Judith Gorman

INTEREST STRIPPING NOT SUBJECT TO GAAR

Lehigh Cement Limited v. Canada
2010 FCA 124

KEYWORDS: GAAR ■ INTEREST ■ WITHHOLDING TAXES ■ TAX AVOIDANCE ■ ONUS

The Federal Court of Appeal in *Lehigh Cement Limited v. Canada* ruled that the general anti-avoidance rule (GAAR) contained in section 245 of the Act did not apply to prevent the avoidance of withholding tax on the interest payments stripped from the underlying principal. In addition to the planning opportunities that this decision may potentially present, it is also serves as a clear illustration of the high standard to which a court may hold the minister in discharging the onus of establishing by

11 Ibid., at paragraph 73.

evidence and reasoned argument the object, spirit, and purpose of the provision that is alleged to have been abused.[12]

Transactions Under Scrutiny

The Canadian corporate taxpayer ("LCL"), which was a member of a German-owned corporate group ("the HZ group"), borrowed, at the outset of the series of transactions under scrutiny, $140 million from a syndicate of Canadian banks for the purpose of acquiring assets from an unrelated party. Shortly thereafter, the bank loan was assigned, first to another Canadian member of the HZ group and subsequently to a Belgian member of the group ("Belgianco"). Interest payments to Belgianco, computed on a floating Canadian prime-rate basis, attracted a 15 percent withholding tax (by operation of paragraph 212(1)(b) of the Act and the Canada-Belgium tax treaty),[13] which LCL remitted to the Crown.

In August 1997, the loan was "restated" in the form of a subordinated note ("the note"), on terms that the Crown conceded satisfied all of the criteria set forth in former subparagraph 212(1)(b)(vii)[14] to exempt the interest from withholding tax, including a provision that LCL would not be obligated (other than upon the occurrence of a specified event of default) to repay more than 25 percent of the principal amount of the note within five years from its issue date. The restated terms also included a fixed interest rate of 7 percent for the first five years (the floating rate of interest on the borrowing at the time of the restatement had been 4.75 percent), a withholding tax gross-up obligation on the part of LCL, and an entitlement on the part of the note-holder (Belgianco) to separate and sell the rights to receive future interest payments under the note to a third party. Belgianco exercised the interest assignment right and sold the next 20 future interest payments to a Belgian financial institution ("BBL").

LCL took the position that interest paid to BBL in respect of the note was exempt from part XIII tax by virtue of subparagraph 212(1)(b)(vii). The minister, despite accepting the legal efficacy of the aforementioned interest-stripping transaction in favour of BBL, applied GAAR to deny the parties' entitlement to the exemption on the basis that the arrangement was inconsistent with the object, spirit, and purpose of subparagraph 212(1)(b)(vii), namely, facilitating access to funds in international capital markets.[15]

12 In accordance with the principles set forth in *Canada Trustco Mortgage Co. v. Canada*, 2005 DTC 5523; [2005] 5 CTC 215 (SCC).

13 Convention Between Canada and Belgium for the Avoidance of Double Taxation and the Settlement of Other Matters with Respect to Taxes on Income, signed at Ottawa on May 29, 1975.

14 Paragraph 212(1)(b) was amended by the Budget and Economic Statement Implementation Act, 2007, SC 2007, c. 35 to eliminate part XIII tax in respect of non-participating interest paid to arm's-length non-residents (and any payments of "fully exempt interest"). As a consequence, subparagraph 212(1)(b)(vii) was repealed.

15 Since the taxpayer had conceded that the loan restatement and subsequent interest-stripping transaction were avoidance transactions intended to give rise to a tax benefit, the sole question for the court was whether the arrangement was abusive within the meaning of subsection 245(4).

The Tax Court Decision

At the Tax Court of Canada, Mogan J, relying on the Supreme Court of Canada decision in *Canada Trustco*[16] for guidance, examined whether, "having regard to the text, context and purpose" of subparagraph 212(1)(b)(vii), the impugned transactions could be said to frustrate or defeat the "object, spirit or purpose" of that provision.[17] After examining the text of the provision and citing several scholarly articles relied upon by the minister, he concluded that the "exemption was intended to help Canadian corporations borrow from foreign arm's length lenders who would receive interest free from withholding tax" and that its purpose is "to help Canadian corporations needing to borrow money by increasing their access to international capital markets."[18]

Mogan J went on to uphold the minister's GAAR assessment on the basis that the transactions under scrutiny, being "wholly dissimilar to the arm's length borrower/lender relationship contemplated by subparagraph [(212)(1)(b)(vii)]," frustrated the object, spirit, and purpose of that provision.[19]

The taxpayer appealed the Tax Court's decision.

The Federal Court of Appeal Decision

The Federal Court of Appeal opened its GAAR analysis by referring to the principles set forth in *Canada Trustco* for the purposes of determining abuse within the meaning of subsection 245(4).[20] Briefly, those principles require the ascertainment of the "object, spirit or purpose" of the relevant provisions, determined on the basis of a "textual, contextual and purposive interpretation" of such provisions, recognizing that the burden of establishing such object, spirit, or purpose ultimately rests with the minister, and with any doubts that may exist in this regard being resolved in favour of the taxpayer.[21]

In its textual analysis, the court set forth what it viewed as the two main conditions for eligibility under subparagraph 212(1)(b)(vii), namely, the arm's-length test and the five-year test. With respect to the first-mentioned test, the court noted the clear and unambiguous wording in subparagraph 212(1)(b)(vii) to the effect that it is the party entitled to receive *the interest payment* with which the obligor must be dealing at arm's length at the time the interest payment is made. The court then went on to make the following key findings relevant to its misuse or abuse analysis: the splitting of interest and principal has long been a normal aspect of commercial financing transactions; Parliament was aware of such transactions in 1975 when

16 Supra note 12.

17 2009 DTC 776; 2009 TCC 237, at paragraph 33.

18 Ibid., at paragraph 39.

19 Ibid., at paragraphs 45-46.

20 2010 FCA 124, at paragraph 21 (Sharlow J).

21 *Canada Trustco*, supra note 12, at paragraph 66.

subparagraph 212(1)(b)(vii) was first enacted;[22] and the Crown had provided no evidence that there was anything "commercially unusual, in form or in substance," with respect to the splitting transaction under consideration.[23] The court observed that the Crown's GAAR position was "not based on any statutory provision or jurisprudence," but on "an echo of a sentence" appearing in the Department of Finance budget paper produced when subparagraph 212(1)(b)(vii) was first proposed, which suggested that the provision was intended to "facilitate access to funds in international capital markets."[24]

Rejecting the Crown's argument, the court concluded that the evidence put forward by the minister was insufficient to support a finding or inference that there had been any legislative intent to exclude interest-splitting transactions from the scope of the subparagraph 212(1)(b)(vii) exemption, and as a result that evidence constituted a "shaky foundation" for a GAAR assessment.[25] Turning to the burden-of-proof principles established in *Canada Trustco*, the court determined:

> When Parliament adds an exemption to the *Income Tax Act*, even one as detailed and specific as subparagraph 212(1)(b)(vii), it cannot possibly describe every transaction within or without the intended scope of the exemption. Therefore, it is conceivable that a transaction may misuse a statutory exemption comprised of one or more bright line tests such as, in this case, the arm's length test and the 5 year test. However, the fact that an exemption may be claimed in an unforeseen or novel manner, as may have occurred in this case, does not necessarily mean that the claim is a misuse of the exemption. It follows that the Crown cannot discharge the burden of establishing that a transaction results in the misuse of an exemption merely by asserting that the transaction was not foreseen or that it exploits a previously unnoticed legislative gap.[26]

The court concluded that the Crown's insistence that the object of subparagraph 212(1)(b)(vii) required the accessing of international capital suffered from an

22 The court cited the predecessor to section 240 as an example of a provision contemplating the stripping of interest coupons that predated the introduction of subparagraph 212(1)(b)(vii).

23 Supra note 20, at paragraph 30.

24 Ibid., at paragraph 32, quoting from Canada, Department of Finance, 1975 Budget, Highlights and Supplementary Information, June 23, 1975. The full sentence from the budget paper read, "The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilitate access to funds in international capital markets" (ibid., at 22). Unlike the Tax Court judge, Sharlow J, rightly in our view, found that the academic commentary provided no incremental assistance in clarifying the fiscal policy underlying the subparagraph 212(1)(b)(vii) exemption. Curiously, however, the court appeared to accord little, if any, weight to a preceding sentence in the budget paper indicating that "the new exemption for interest on private-sector loans is restricted to interest paid by a corporation resident in Canada to an [arm's length] *lender*" (ibid., at 21, emphasis added), which, it could be argued, implies that splitting transactions were in fact not contemplated by the drafters of the exemption.

25 Supra note 20, at paragraph 35.

26 Ibid., at paragraph 37.

irreconcilable inconsistency. The Crown conceded that a sale to Belgianco of both the principal and the interest under the note would not have provided any basis for the application of GAAR, and yet, as noted by the court, such a hypothetical transaction would not result in any more foreign capital being provided to a Canadian entity than the transaction under review.

Discussion

The *Lehigh* decision is of interest to tax practitioners for the insights it offers into the application of the subsection 245(4) abuse principles outlined in *Canada Trustco*. In particular, the judgment provides further enlightenment as to the nature of the minister's burden to establish the purpose of the statutory provisions that are alleged to have been abused, and it underscores the potential vulnerability of the minister in this regard where there is a dearth of cogent and concise extrinsic evidence with respect to such provisions.[27]

We wonder if the Crown may have erred in focusing its abuse arguments on the purpose of subparagraph 212(1)(b)(vii) as a whole rather than focusing separately on its key constituent elements. After all, if one accepts the Crown's proposition that the purpose of subparagraph 212(1)(b)(vii) was to facilitate access to funds in international capital markets, it is hard to fathom how a transaction that relied upon subparagraph 212(1)(b)(vii) to avoid withholding tax could ever be considered *inconsistent* with that purpose (particularly if "access" were viewed as including both direct and indirect access), since reducing the after-tax cost of foreign funds will incrementally facilitate access by Canadian corporations to such funds.

In particular, it would be interesting to see how the court's subsection 245(4) abuse analysis might have been affected if the court had given further consideration to the purpose of the arm's-length test component of the subparagraph 212(1)(b)(vii) exemption.[28] As it stood, the court provided its views with respect to the significance of this test only in the limited context of its dismissal of the Crown's contention that the restatement of the subject note and subsequent interest-splitting transaction had resulted in increased borrowing costs to LCL, contrary to, as the Crown asserted, the primary objective of subparagraph 212(1)(b)(vii) of reducing the borrowing costs of Canadian corporations. As stated by the court,

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27 On the other hand, there appear to have been other occasions since *Canada Trustco* when courts have been prepared to make findings as to the legislative purpose of a provision or a series of provisions in the Act in the absence of compelling extrinsic evidence or statutory or jurisprudential backup. This was arguably the case, for example, in the Supreme Court of Canada's decision in *Lipson et al. v. The Queen*, 2009 DTC 5528; [2009] 1 CTC 314 (which dealt with the application of GAAR in the context of the attribution rules contained in section 74.1 and following).

28 Relying, for example, on the sentence contained in the 1975 budget paper quoted in note 24, supra, which emphasized that the paragraph 212(1)(b)(vii) exemption was restricted to interest paid by a Canadian-resident corporation to an arm's-length lender.

> [the arm's-length test] is an indication that Parliament intended the exemption to be available only where the relationship between the payer and payee provided some assurance that the rate of interest would reflect a fair market rate.[29]

It could be argued that the purpose of the arm's-length test in subparagraph 212(1)(b)(vii) expands beyond that of ensuring that only reasonable interest payments benefit from the exemption. After all, had Parliament intended for the arm's-length test to serve only this limited function, it could simply have used language similar to that contained in former subsection 69(2), a provision that limited the deductibility of certain payments to non-arm's-length non-residents where the amount of the payment was not reasonable in the circumstances, and that, by the time subparagraph 212(1)(b)(vii) was enacted, had existed, in one form or another, in the Act and its predecessors for decades.[30]

Parliament may have been concerned, for example, that an exemption in respect of non-arm's-length interest might distort the choice of foreign investors between the use of debt or equity to capitalize their Canadian subsidiaries. In a regime where interest is exempt from tax but dividends are not, Parliament may have had grounds for concern that such a disparity would induce foreign investors to prefer debt financing to equity financing for their Canadian subsidiaries, causing them, to the extent permitted by the thin capitalization rules,[31] to convert equity in their Canadian subsidiaries to debt.[32]

Alternatively, it could be suggested that the arm's-length test was at least partly intended to complement the five-year test, in that the existence of a non-arm's-length relationship between the borrower and the lender may not result in market repayment terms in respect of the subject loan and could in some circumstances allow a lender, by virtue of the relationship, to circumvent the five-year test by causing the borrower to "voluntarily" repay its obligation within a five-year term.

While the decision in *Lehigh* may spawn significant planning opportunities, there are a number of considerations that taxpayers and their advisers should take into

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29 Supra note 20, at paragraph 43. Curiously, the court reached this conclusion on the sole basis of the language of subparagraph 212(1)(b)(vii), without reference to any other provision of the Act or to any other jurisprudence or other authority stating or suggesting that this was a purpose for the arm's-length requirement—despite the court's admonishment to the Crown (at paragraph 39) that such evidence was necessary to support its abuse analysis.

30 The various predecessor provisions of former subsection 69(2), which dealt with unreasonable amounts paid to non-arm's-length non-residents, can be traced to section 23B of the Income War Tax Act, 1917, RSC 1927, c. 97, as amended.

31 It could be argued that the very existence of the thin capitalization rules in subsection 18(4) suggests that Parliament had a real concern that non-resident shareholders would, in the absence of such rules, overleverage their Canadian subsidiaries. Presumably it would have been open to the Crown to assert that these rules formed part of the statutory framework within which the subparagraph 212(1)(b)(vii) exemption could be analyzed.

32 Granted, on the facts of *Lehigh*, there is no evidence that the impugned transactions in any way modified (or were intended to modify) the capitalization of LCL.

account when attempting to structure similar transactions. One possible consideration is the risk that the Canada Revenue Agency (CRA) might take the position that the purported interest-splitting transaction simply amounts to a direction on the part of the vendor of the purported interest rights to have interest paid to the purchaser.[33] We are aware of similar transactions, albeit involving Canadian purchasers of interest receipts, where the CRA has (inappropriately, in our view) taken such a position. Presumably such concerns can be mitigated by ensuring that the legal relationships between the parties are properly documented and reflect an actual assignment.

Another concern may be an attempt on the part of the CRA to characterize a purportedly arm's-length purchaser of an interest receipt as an "accommodation party" along the lines envisaged by Bowman J in *RMM Canadian Enterprises Inc. et al. v. The Queen*.[34] That case involved a series of transactions intended to effect a windup of the Canadian subsidiary ("Subco") of a US corporation ("the vendor"), without incurring any Canadian dividend withholding tax. Rather than winding up Subco into the vendor, a new Canadian company ("RMM") was formed by an unrelated person to purchase the Subco shares from the vendor. In ruling against the taxpayers, Bowman J concluded, inter alia, that RMM and the vendor were not, in fact, dealing at arm's length. In his view, RMM was a "vehicle or instrumentality to assist in extracting [the vendor's] surplus,"[35] with no independent role in the transactions.

Although it may be difficult to attribute these sorts of findings to the Belgian financial institution under the facts in *Lehigh*, such concerns may be heightened in scenarios where the purportedly arm's-length purchaser of interest takes on little or no risk in the transaction (as was the case in *RMM Canadian*).[36]

Conclusions

Subject to any subsequent appeal and legislative changes to the present version of paragraph 212(1)(b), the Federal Court of Appeal's decision in *Lehigh* appears to have opened up the possibility of using interest-splitting transactions as a means of monetizing interest receipts in respect of related-party indebtedness without attracting Canadian withholding tax. However, with the recent elimination of withholding tax on most arm's-length debt,[37] which presumably has made it even easier for Canadian

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33 See *Curragh Inc. v. The Queen*, 94 DTC 1894 (TCC).

34 97 DTC 302; [1998] 1 CTC 2300 (TCC).

35 Ibid., at 310; 2319.

36 For example, concerns may arise where a non-arm's-length creditor sells an interest receipt to an arm's-length party the day before the interest is to become due and payable. In *Lehigh*, BBL purchased interest coupons covering a five-year period and bore a risk (mitigated to some extent by a guarantee) that such interest might not be paid.

37 The withholding tax exemption now available under an amendment to paragraph 212(1)(b) is applicable to most arm's-length interest payments. The enactment of the amendment appears to have been motivated by similar policy considerations to those underlying former subparagraph 212(1)(b)(vii), namely, to reduce the cost of capital to Canadian borrowers. See Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 241.

subsidiaries of foreign corporations to obtain loans directly from arm's-length sources, and the elimination of withholding tax on most non-arm's-length debt under the Canada-US income tax treaty,[38] it is unclear how meaningful this possibility will be in the future. Nevertheless, it will be interesting to see whether the *Lehigh* GAAR analysis and the Crown's failure to challenge the commercial efficacy of the transactions in *Lehigh* might embolden taxpayers wishing to engage in other types of stripping transactions.[39]

Todd Miller and Carl Irvine

TAX COURT OF CANADA

US LLC ENTITLED TO TAX TREATY BENEFITS (SOMETIMES)

TD Securities (USA) LLC v. The Queen
2010 TCC 186

KEYWORDS: LLC ■ TREATIES ■ BENEFITS ■ CANADA-US ■ RESIDENCE ■ FLOWTHROUGH

In *TD Securities (USA) LLC v. The Queen*, the Tax Court of Canada was asked to decide on the validity of the CRA's longstanding position that US limited liability corporations (LLCs) were not residents of the United States for the purposes of the Canada-US income tax convention[40] (as it existed prior to the fifth protocol amendments) and were therefore not entitled to its benefits. After a detailed analysis, Boyle J ruled that TD Securities (USA) LLC ("TD LLC") was indeed entitled to the benefits of the treaty because all of its income was fully and comprehensively taxed by the United States, albeit at the LLC member level. This case generated a favourable reaction in the tax community, where the CRA's position had long been questioned but grudgingly followed.

That position was stated in 1997 when the CRA explained:

> As you are aware a LLC, as it is not liable to tax in the U.S., cannot be a resident of the U.S. for the purposes of the Canada-U.S. Income Tax Convention (the Convention) even where all the members of the LLC are residents of [the] U.S. for the purposes of the Convention. As a result, the LLC is not entitled to the benefits of the Convention

38 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 27, 1997, and September 21, 2007.

39 For example, a non-resident owner of intellectual property could sell the right to receive the royalty stream from the property to a Canadian-resident purchaser or to a non-resident purchaser entitled to a more favourable rate of withholding tax under an applicable tax treaty.

40 Supra note 38 (herein referred to as "the treaty").

> and income of the LLC sourced to Canada is taxed in Canada at the rate of tax provided in the Act.[41]

With TD LLC's challenge, the CRA was about to discover whether this policy would be upheld.

Facts

TD LLC was a limited liability company incorporated under the laws of the state of Delaware and, according to US and Canadian law, was recognized as a distinct legal entity from its members (which are analogous to shareholders). The sole member of TD LLC was TD Holdings II Inc. ("Holdings II"), a resident of the United States. Under US tax law, an LLC may "check the box" and make an election to be taxed at the entity level. Alternatively, it may elect to be treated as a disregarded or flowthrough entity, and its income will then be attributed to its members and taxed accordingly. Where the LLC has only one member and neglects to elect one way or the other, it will, by default, be treated as a flowthrough entity. This was the situation for TD LLC; all of its income was attributed to Holdings II and taxed accordingly.

In order to serve its US customers in making Canadian investments, TD LLC operated a branch in Canada. It was TD LLC's opinion that its American customers preferred to deal with a US company rather than a Canadian subsidiary. As a non-resident carrying on business in Canada, the branch was therefore subject to part XIV "branch tax" as set out in the Act, which imposes a 25 percent surtax on the net after-tax income of the branch.[42] This tax serves as a proxy for the 25 percent withholding tax on dividend payments from Canadian residents to non-residents found in part XIII of the Act. The treaty reduces the rate of the branch tax to 5 percent;[43] however, in order to qualify for this reduction, the shareholder has to, inter alia, establish that it is a resident of the United States.

For the 2005 and 2006 taxation years, TD LLC reported its Canadian branch profits and claimed the reduced treaty rate of 5 percent. The CRA assessed TD LLC to deny the benefit of the reduced rate and assessed the branch tax at the statutory rate of 25 percent.

The Applicable Law

Article I of the treaty provides that the treaty "is generally applicable to persons who are residents of one or both of the Contracting States." Article IV provides that

> the term "resident" of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.

41 CRA document no. 9713120, May 20, 1997.

42 Section 219.

43 Article X(6) of the treaty.

In 2007, Canada and the United States agreed to the fifth protocol amendments, which added new paragraph 6 to article IV of the treaty. That paragraph provides that an amount paid to a fiscally transparent entity is generally considered to be paid to a resident of a contracting state deriving the amount through such activity if the ultimate treatment of the amount in the resident country is the same as if the amount had been paid directly to such resident.[44] These treaty amendments were not retroactive to years prior to 2007 and thus did not apply to TD LLC in 2005 and 2006.

Position of the Parties

The CRA argued that it had been correct all along and that the words of the treaty are clear and unambiguous. In order to obtain the benefit of the treaty, an LLC must be a resident of the United States, and in order for this to be true, it must be "liable to tax" in the United States. Since TD LLC was a flowthrough entity and was not subject to US tax at the LLC level, it was not "liable to tax"; therefore, it was not a US resident for treaty purposes and was not entitled to treaty benefits. In the CRA's view, the treaty "cannot be interpreted in a manner which will entitle TD LLC to the benefits of the treaty without either ignoring some of the words used or reading some words into it."[45] The CRA also argued that if TD LLC were successful, the fifth protocol amendments to the treaty would be rendered meaningless, since any US LLC could simply claim treaty benefits based on residence rather than on the terms of the fifth protocol amendments.

For its part, TD LLC argued that since "liable to tax" is not defined in the treaty, it falls to the courts to interpret the phrase. TD LLC argued that the meaning of "liable to tax" is different from the determination under US law of whether a particular person or entity has to pay tax on its income. Thus, TD LLC urged the court to determine that it was indeed "liable to tax" since all of its income was thoroughly taxed in the hands of Holdings II.

Alternatively, TD LLC argued that the court could interpret the treaty liberally, relying on the model tax treaty of the Organisation for Economic Co-operation and Development (OECD),[46] the related commentaries, and other relevant resources in order to give effect to the intentions of the signatory parties and achieve the purpose of the treaty.

44 Boyle J points out in his judgment (2010 TCC 186, at paragraph 46) that, applied literally, the fifth protocol amendments do not resolve TD LLC's problem in establishing that it is a US resident for the purposes of the treaty. In light of such concerns, the Canadian and US tax authorities have agreed to interpret the amendments purposively in order to give effect to the intention of the countries. Nevertheless, in TD LLC's case, the CRA sought to convince the court to do otherwise in applying the treaty as it existed prior to the amendments.

45 Ibid., at paragraph 22.

46 Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital (Paris: OECD) (looseleaf) (herein referred to as "the model treaty").

The Court's Perspective

From the outset, the Tax Court's approach to interpreting and applying the treaty was liberal and purposive. Boyle J referred to the Vienna Convention on the Law of Treaties, which "provides that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."[47] He noted that there is a tension between these principles where the strict ordinary meaning of the words is in conflict with how the signatory countries have interpreted and applied a treaty. Citing the Supreme Court of Canada's decision in *The Queen v. Crown Forest Industries Limited et al.*[48] and the Federal Court of Appeal's judgment in *Coblentz v. The Queen*,[49] Boyle J reiterated that "literalism has no role to play in the interpretation of treaties."[50] He also relied on *Crown Forest* to establish that the intended purpose of the treaty was that it apply to those bearing full tax liability in either of the contracting states.

Boyle J then proceeded to analyze the US authorities' position regarding the applicability of US tax treaties to partnerships, the OECD commentary pertaining to the residence of partnerships, and the OECD partnership report.[51] He found that the OECD commentary recognized that it was anomalous to maintain that a flowthrough partnership should not be considered liable to tax in the country of its establishment (and therefore not a resident for treaty purposes) but should still be entitled to treaty benefits, but that this interpretation was necessary and accepted in order to achieve the object and purpose of the model treaty. Boyle J noted that neither Canada nor the United States had expressed any reservation to this paragraph of the commentary. He concluded that

> the OECD Model Treaty is intended to, and should be interpreted and applied in a manner that nonetheless extends the benefits of the Convention to the income of such a partnership notwithstanding that it is not, strictly speaking, a resident of its home country.[52]

The Decision

At trial, it was not disputed that the CRA's practice has long been to extend treaty benefits to partners of a partnership, notwithstanding that the partnership itself is a flowthrough entity. In addition, Boyle J noted, the CRA will extend treaty benefits to S corporations that elect to be treated as flowthrough entities and the income of which is taxed in the hands of its shareholders.

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47 Vienna Convention on the Law of Treaties, signed at Vienna on May 23, 1969, UN doc. A/Conf. 39/27, fourth annex, UNTS 1155/331, paragraph 50.

48 95 DTC 5389; [1995] 2 CTC 64 (SCC).

49 96 DTC 6531; [1996] 3 CTC 295 (FCA).

50 Supra note 44, at paragraph 54, citing *Coblentz*, supra note 49, at 6534; 300-1.

51 *TD Securities*, supra note 44, at paragraphs 34 and 60-77.

52 Ibid., at paragraph 75.

Thus, LLCs were the sole exception to what was otherwise a consistent approach to the treatment of flowthrough entities. The CRA, aware of its inconsistent treatment of LLCs, admitted that it regretted the inconsistency, but even at trial, it refused to offer a reconciliation or a convincing explanation as to why the differences were necessary. Boyle J rejected the idea that LLCs and partnerships should receive this divergent treatment.

As to the US perspective, Boyle J referred to the position of the chief counsel of the US Treasury on whether or not the Internal Revenue Service should certify that an LLC is a resident of the United States. He found that the clearly stated intention was that income derived by an LLC should be entitled to treaty benefits from US treaty partners. In a gentle rebuke, Boyle J reminded the CRA that

> Canada gets to choose who to tax under the Canadian Act, a US LLC or its members, a partnership or its partners. However, when deciding how to apply its international convention with its treaty partner, Canada must consider as part of the context that the US also gets to choose at which level to impose its domestic tax under the US Code on that income, partnership or partner, LLC or member. This was clearly intended by the treaty countries in order to give effect to the US Treaty's object and purpose. It makes little sense to think that treaty entitlement should be affected by a US LLC's exercise of its right under the US Code to elect to have its income taxed in its hands or flowed through and taxed in the hands of its US resident members.[53]

The reproach from the court became somewhat sharper when Boyle J observed that Canada (and the United States) had been attempting to "walk both lines"—in the treaty text refusing to accept that flowthrough entities are residents for the purposes of the treaty, yet still wishing to extend treaty benefits to the payments that are flowed through such entities.[54] The CRA had not been forthcoming with clear explanations to taxpayers as to why this seeming contradiction was necessary. Finally, its litigious tactics in defence of its outlier position on LLCs was perhaps too much for Boyle J, who declared that "having forced this matter to court, Canada can perhaps no longer leave it ambiguous."[55]

The fallback position of the CRA was that if TD LLC's appeal were allowed, the treaty would be left open to abuse and frustration of its purpose. However, Boyle J dismissed those concerns by noting that the outcome of the decision would be the same if the fifth protocol amendments had applied to the years in question. The "floodgate" argument was dead in the water.

Boyle J concluded that TD LLC was entitled to the benefits of the treaty for its 2005 and 2006 fiscal years and therefore was subject to branch tax at the rate of 5 percent instead of 25 percent. This conclusion was based on the fact that TD LLC's

53 Ibid., at paragraph 98.

54 Ibid., at paragraph 101.

55 Ibid.

income was comprehensively taxed, albeit not at the entity level but in the hands of its members.

The Tax Court's decision was not appealed by the CRA.

Discussion

The CRA wished to rely on a literalistic, technical interpretation to kill potential abuse of the treaty. Yet this was admittedly a case without even a whiff of abusive tax avoidance. As Boyle J pointed out, there was no suggestion "that there was any potential avoidance of Canadian taxes or abuse of the Canadian tax régime resulting from the decision by the TD Bank group to use a US LLC to operate a Canadian branch."[56] It is one thing to employ aggressive tactics, accepting a certain amount of collateral damage (in the form of heavy tax burdens on taxpayers not involved in abusive tax planning), when the case at hand clearly necessitates intervention. It is quite another thing to employ such devices when the desired outcome would result in nothing but collateral damage. Had the CRA won this decision, TD LLC would have paid full tax in Canada on the profits realized by its Canadian branch. It would also have paid an additional 25 percent part XIV tax. That same income would then have been fully and comprehensively taxed in the United States in the hands of Holdings II. This is precisely the sort of double-taxation situation that the treaty sets out to alleviate.

Still, Boyle J was responsive to the CRA's concerns about potential abuse. He pointed out that different facts might have yielded a different outcome (for example, if the use of the LLC had been allegedly abusive). Furthermore, he stressed that any future cases would be interpreted in light of the fifth protocol amendments. He also clearly and rather narrowly defined the ratio of the case going forward:

> The decision in this case stands for no more than the proposition that, properly interpreted and applied in context in a manner to achieve its intended object and purpose, the US Treaty's favourable tax rate reductions apply for years prior to the Fifth Protocol Amendments to the Canadian-sourced income of a US LLC if all of that income is fully and comprehensively taxed by the US to the members of the LLC resident in the US on the same basis as had the income been earned directly by those members.[57]

Boyle J wryly admitted a certain irony in the fact that the issue in this case had been statutorily addressed prior to its having been decided. Nevertheless, it will certainly be of great interest to any US LLCs that have filed Canadian tax returns prior to the coming into force of the fifth protocol on the basis that they are not afforded the benefits of the treaty.

Additionally, this decision is helpful since it stands as an example of how the courts should apply and interpret the treaty—that is, purposively—especially when

56 Supra note 44, at paragraph 105.

57 Ibid., at paragraph 107.

faced with inconsistent administrative positions that seemingly defeat the treaty's intent. Moreover, the decision serves as a hopeful indicator that the courts will not always uphold interpretations of the law—and Canada's tax treaties in particular—that are overly literalistic in order to prevent undefined abusive outcomes or "floodgates." As we are all aware, GAAR exists to prevent abusive transactions. Thus, it should reduce the need for draconian rules that just as often squash commercially legitimate, non-abusive structures such as TD LLC's.

Joel Scheuerman