Treaty Shopping

Following-up on certain policy statements contained in last year's federal budget, along with a consultation paper (the "**Consultation Paper**") released this past August,[1] Budget 2014 outlines the framework of a proposed rule designed to curb what the Government views to be inappropriate "treaty shopping" in the context of certain transactions involving non-resident parties. "Treaty shopping" is described in Budget 2014 as involving a set of circumstances under which a person makes use of an entity resident in a jurisdiction with which Canada has a favorable tax treaty in order to access benefits that are more favourable than those benefits that the person would otherwise have been entitled to claim. If substantially enacted in the form described in Budget 2014, the proposed rule (the "**Treaty Shopping Rule**") could have a wide-ranging and immediate impact on existing inbound investment structures and the means by which future inbound investments, acquisitions and business start-ups by foreign parties are structured, and, in broader terms, the economic viability of certain cross-border investments. Submissions from interested stakeholders with respect to the Treaty Shopping Rule have been requested by not later than April 12, 2014.

Initial Consultation Process

The Consultation Paper invited stakeholder responses to seven fundamental questions relating to the design features of a rule to combat treaty shopping, with particular emphasis on questions as

[1] Department of Finance, *Consultation Paper on Treaty Shopping – The Problem and Possible Solutions* (August 12, 2013). A copy of the Consultation Paper is available here: http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp.

to whether the new rule should: (a) be general in nature (as opposed to targeting particular transactions or taxpayers); and (b) addressed unilaterally by incorporation into Canadian domestic law (and, thus, apply equally, both in substance and in timing, to all Canadian treaties) or, alternatively, on a treaty-by-treaty basis (consistent with Canada's traditional approach). Identified design feature objectives included certainty for taxpayers, effectiveness, simplicity, and ease-of administration.

Budget 2014 sets forth the Government's apparent conclusion coming out of the initial consultation process that a general anti-treaty shopping rule contained in domestic legislation represents the optimal approach. Particular reasons supporting this conclusion include the perceived implementation delays associated with any treaty-by-treaty initiative and the Government's view (with cited support from OECD model tax treaty commentary) that a domestic (and unilateral) solution to treaty shopping does not conflict with the object and spirit of treaties previously enacted into Canadian law.[2]

Key Components of Treaty Shopping Rule

As indicated above, the Treaty Shopping Rule, as proposed, would be incorporated into Canadian domestic law,[3] and would operate to deny treaty benefits otherwise arising from one or more transactions where one of the "main purposes" of the transaction or transactions was to obtain such treaty benefits (the "**Main Purpose Test**").[4]

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[2] OECD Commentary on Article 1 of the Model Convention at para 9.2; however, see objections by Ireland, Luxembourg and the Netherlands at paras. 27.5-27.7.

[3] Through an amendment to the *Income Tax Conventions Interpretation Act* (Canada).

[4] Budget 2014 documents seek to assure taxpayers that treaty benefits will continue to be made available in respect of what the Government refers to as "ordinary commercial transactions" (no definition provided). The documents also indicate, without elaboration, that if the Treaty Shopping Rule applies to a particular transaction, benefits that would be "reasonable" under the circumstances will nevertheless still be available.

Of particular importance, the Treaty Shopping Rule provides that the Main Purpose Test will be presumed (in the absence of proof to the contrary) to have been satisfied in circumstances where a person resident in a treaty country has acted as a "conduit" with respect to a particular income amount for which treaty benefits are being sought ("**relevant treaty income**"). For the purposes of this presumption (the "**Conduit Presumption**"), a conduit entity is broadly cast as any person receiving relevant treaty income that is *primarily* used to pay, distribute or otherwise transfer, directly or indirectly, at any time or in any form, an amount to another person or persons who would not have been entitled to treaty benefits that are at least equivalent to those being sought. The Conduit Presumption's use of the term "primarily" should (among other things) mean that the presumption would not be operative in circumstances where the relevant treaty income is used to make payments to a group of "recipients", more than 50% of whom were resident (and eligible for benefits) in the same treaty jurisdiction as the alleged conduit entity, or in other treaty jurisdictions offering comparable benefits in the circumstances. However, it is observed that there may be practical challenges associated with particular "recipients" availing themselves of this apparent "no more than 50%" exception, including in circumstances where large numbers of investors are involved (e.g., investors in a private equity fund) or where the identities of ultimate investors in a particular structure may not be known or capable of clear determination (e.g., a "fund of funds").[5]

The Treaty Shopping Rule offers two potential relieving measures in respect of the Main Purpose Test set forth above. The first is the so-called "**safe harbour presumption**", which creates a presumption against the application of the Main Purpose Test (in the absence of proof to the contrary and so long as the Conduit

[5] Moreover, the recipients would still be required to demonstrate that the Main Purpose Test was not satisfied with respect to the transaction or transactions in question.

Presumption is not operative), in circumstances where the prospective benefit claimant:

(a) carries on (or a related party carries on) an active business (other than managing investments) in the jurisdiction with which Canada has concluded the subject tax treaty and, where the relevant treaty income is derived from a related person in Canada, the active business is "substantial" compared to the activity carried on in Canada giving rise to the relevant treaty income;

(b) is not controlled, directly or indirectly in any manner whatever, by another person or persons that would not have been entitled to an equivalent or more favourable benefit had the other person or persons received the relevant treaty income directly; or

(c) is a corporation or a trust the shares or units of which are regularly traded on a recognized stock exchange.[6]

The second proposed relieving measure is more general in nature and would appear to be reserved for the Canadian competent authority's discretion. The measure provides that if the Main Purpose Test applies (whether by operation of the Conduit Presumption or otherwise) in respect of a benefit under a tax treaty, the benefit is to be provided, in whole or in part, "to the extent that it is reasonable having regard to all the circumstances". The inclusion of this measure may signal a recognition on the Government's part of the potential breadth that could be accorded to the Main Purpose Test and the Government's desire to minimize unintended consequences that could otherwise result in its absence. However, it is suggested

[6] The terms of the safe harbor presumption appear in some respects to parallel the "limitation on benefits" clause contained in Article XXIX-A of the *Canada-United States Income Tax Convention* (1980), as amended (for example, the so-called "active trade or business" exception in paragraph 3 of Article XXIX-A), although there is no indication in Budget 2014 as to whether similar interpretative approaches would necessarily be followed.

that taxpayer anxieties will remain until such time as further clarification with respect to the intended scope of the Treaty Shopping Rule is provided, including additional visibility around exactly what the Government means by terms such as "ordinary commercial transactions".

Treaty Shopping Rule Examples

Budget 2014 provides five examples of instances where the Treaty Shopping Rule may (or may not) be engaged, three of which involve fact patterns substantially similar to those at issue in recent cases before the courts where the Government unsuccessfully attempted to apply existing anti-avoidance rules to combat what it viewed to be abusive treaty benefit situations - namely, *Velcro Canada Inc. v R.*[7] (receipt of royalty income by perceived conduit), *Prévost Car Inc. v R.*[8] (receipt of dividend income by perceived conduit) and *MIL (Investments) S.A. v. R.*[9] (change of residence on eve of sale to access more favoured capital gains treatment). While the other two examples provide some insight into certain fact patterns where the Treaty Shopping Rule would likely not be engaged – one where the Conduit Presumption is rebutted (in the case of a portfolio investment manager resident in a favourable treaty jurisdiction with the majority of investors being resident in jurisdictions without Canadian tax treaties) and the other where the safe harbour presumption is operative (and not rebutted) – further examples and elaborations from the Government would be extremely helpful in the interest of taxpayer certainty and simplicity, as consultations with respect to the Treaty Shopping Rule progress.

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[7] 2012 TCC 57.

[8] 2009 FCA 57.

[9] 2006 TCC 460, aff'd 2007 FCA 236.

Conclusions

Budget 2014 highlights the Government's strong continuing support of several international initiatives designed to combat what it perceives to be inappropriate income-shifting techniques, including the OECD's currently ongoing Base Erosion and Profit Shifting or "BEPS" initiative, and portrays the Treaty Shopping Rule as a domestic measure contributing significantly to the fulfillment of such objectives. Even though many questions remain as to the intended scope of the Treaty Shopping Rule, it seems abundantly clear at this point that it will, if enacted in substantially the same form as proposed, have a dramatic impact on the means by which cross-border investments are structured (or indeed, whether such investments are undertaken at all). At minimum, further elaboration and certainty from the Government as to the sorts of circumstances under which the broadly worded Main Purpose Test will be applied (or not applied) will be essential in the coming months, as the consultation process around the measures continues.

As currently proposed, the Treaty Shopping Rule would apply to taxation years that commence after the enactment of the rule into Canadian law. The Government is soliciting comments as to whether any transitional relief would be appropriate. Taxpayers with existing structures that may be affected by the Treaty Shopping Rule should carefully monitor developments in this regard.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.