Supreme Court of Canada dismisses General Anti-Avoidance Rule in Tax Treaty Decision

December 15, 2021

On November 26, 2021, the Supreme Court of Canada (the Court) released its decision in *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49.

What you need to know

- The Court dismissed the Minister's appeal, which sought to tax approximately $380 million in capital gains realized by Alta Energy Luxembourg S.A.R.L. (Alta Luxembourg) on a sale of shares of its Canadian subsidiary, Alta Energy Partners Canada Ltd. (Alta Canada).
- Alta Luxembourg claimed that its gain was exempt from Canadian tax pursuant to Canada's bilateral treaty with Luxembourg (the Treaty).[1]
- The Minister argued that the "General Anti-Avoidance Rule" (the GAAR) applied to deny the Treaty benefit.[2]

Background

In 2011, Alta Canada was established by a Delaware LLC, which in turn was owned by a diverse group of investors from various countries. In 2012, a restructuring resulted in the transfer of all of the shares of Alta Canada to Alta Luxembourg. Thereafter, Delaware LLC owned (indirectly, through a partnership) all of the equity and debt of Alta Luxembourg. In 2013, Alta Luxembourg sold the shares of Alta Canada to an unrelated third party, realizing a substantial capital gain. Alta Luxembourg claimed an exemption from Canadian income tax under Article 13(4) and (5) of the Treaty:

> (4) Gains derived by a resident of a Contracting State from the alienation of shares …forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State … may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" does not include property (other than rental property) in which the business of the company…was carried on …

> (5) Gains from the alienation of any property, other than that referred to in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator **is a resident** .

The Minister initially reassessed on the basis that Alta Canada did not carry on a business through its Canadian immovable property, and therefore the "business property" carve-out in Article 13(4) did not apply. In the alternative, the Minister applied GAAR to deny the treaty benefit. The Minister accepted that Alta Luxembourg was a resident of Luxembourg for purposes of the Treaty. After the Tax Court level, the Minister abandoned its position that Alta Canada did not carry on a business on the immoveable property, leaving only its GAAR position for the appeal.

The Minister claimed that even though the Treaty allocated taxation rights under Article 13(4) and (5) based on the residence of the taxpayer, since there was an avoidance transaction, it was insufficient to simply apply the words of the Treaty - the underlying rationale of the Treaty must also be considered. The Minister argued that the rationale underlying the distributive provisions of the Treaty allocates taxing rights to the country with the closer economic connection to the income in question. The Minister argued that even the business property carve-out in Article 13(4) was based on the same underlying rationale. In the facts of this case, the Minister argued, Canada did not surrender the right to tax the gain to Luxembourg, since Alta Luxembourg did not have any close economic connections with Luxembourg.

The courts below both found in favour of the taxpayer. The Tax Court of Canada held that Alta Luxembourg's gains were Treaty-protected and that the GAAR did not apply to deny the tax benefit under the Treaty.[3] At the Federal Court of Appeal, the only issue was whether the avoidance transaction was abusive under the GAAR. Again, the Minister's appeal was dismissed. The FCA found that "…the object, spirit and purpose of the relevant provisions of the [Treaty] is reflected in the words chosen by Canada and Luxembourg. Since the provisions operated as they intended to operate, there was no abuse."[4]

GAAR framework

The application of the GAAR is a three-part process that asks whether:

1. There is a tax benefit;
2. There is an avoidance transaction; and
3. The avoidance transaction is abusive.

Since Alta Luxembourg did not dispute that there was a benefit and an avoidance transaction, the Court was only tasked with deciding whether the transaction was abusive to the provisions of the Treaty.

The Court followed a two-step process in determining whether the avoidance transaction was abusive:

1. Determine the object, spirit, and purpose of the relevant provisions; and
2. Determine whether the transaction is abusive in light of the first step.

GAAR vs. Duke Principle

The "Duke Principle" is the general proposition that a Canadian taxpayer may arrange their affairs to minimize the amount of tax payable contingent on a taxpayer's compliance with the provisions of the Act.[5] The GAAR functions as a limit on the Duke Principle, to prevent abusive tax avoidance transactions and deny tax benefits that are inconsistent "with the object, spirit, or purpose of the provisions relied upon by the taxpayer."[6]

In determining whether a beneficial avoidance transaction is abusive, the Minister has the onus of demonstrating that the outcome achieved, while compliant with the Act, "defeats the underlying rationale of the provisions that are relied upon."[7] The Court is required to undertake a "textual, contextual, and purposive analysis" in determining whether a transaction is abusive in light of the underlying rationale of the provisions relied on.[8]

GAAR's restricted scope

In deciding whether to apply the GAAR, the Court's contextual analysis centered on general principles of treaty interpretation and sought to identify both countries' intentions in entering into the provisions of the Treaty. The majority decision by Justice Côté was quick to caution against conflating the application of the GAAR with a value statement on tax avoidance, noting that:

> First and foremost, tax avoidance is *not* tax evasion, and there is no suggestion by either party that the transaction in this case was evasive. In addition, tax avoidance should not be conflated with abuse. Even if a transaction was designed for a tax avoidance purpose and not for a *bona fide* non-tax purpose, such as an economic or commercial purpose, it does not mean that it is necessarily abusive within the meaning of the GAAR.[9]

The Court cautioned against findings of abuse merely because there was little tax paid in Luxembourg:

> The fact that Alta Luxembourg paid less tax in Luxembourg on this gain than it would have paid if it were a Canadian resident paying tax in Canada changes nothing in this determination. As noted by this Court in *Copthorne*, "determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do."[10]

The Court considered the interpretive relevance of the Organisation for Economic Co-operation and Development (OECD) Commentaries to the OECD Model Treaty.[11] The Minister had relied on revisions to the Commentaries to the OECD Model Treaty in 2003, which stated that domestic anti-avoidance measures implemented by treaty countries could take precedence over the provisions of a bilateral tax treaty. The Minister argued that it was not, therefore, necessary for Canada and Luxembourg to include specific anti-avoidance measures in the Treaty, because it was open for both of them to simply apply domestic anti-avoidance rules, including GAAR, to prevent abuses. However, the 2003 Commentaries were revised *after* the signing of the Treaty between

Canada and Luxembourg in 1999, and did not previously include the discussion on domestic anti-abuse rules. While the Court acknowledged the persuasive value of the OECD Model Treaty and its Commentaries, the Court found that revisions subsequent to the negotiation of a treaty “do not reflect the intentions of the drafters of the treaty” and in this case, “contradict the views previously expressed.”[12] In fact, Luxembourg had registered an observation to the Commentaries stating that it disagreed that there is no conflict between domestic anti-abuse provisions and treaties, noting that such measures should either be expressed in a treaty itself or negotiated between the parties pursuant to the treaty’s mutual agreement procedures.[13]

Without clear evidence of a contrary rationale, the Court held that the true intention of the parties was found in the words of the Treaty itself, reflecting the original bargain struck between the countries. The Court stated that courts should not “usurp the role of the Governor in Council by allowing for judicial amendment... against the expressed wishes of the contracting states.”[14]

Further, the Court held that GAAR cannot turn on broad policy rationales or the objectives of a particular treaty as a whole. The Court noted that the abuse analysis should be focused and specific, rather than a “search for an overriding policy” such as “avoiding double taxation or encouraging trade and investment.”[15]

“Rationale ” of the Treaty provisions

Central to the Minister’s argument was that that the benefits of the Treaty, including distributive provisions in Article 13(4), were intended to be available only to a person with sufficient substantive economic connections to their state of residence.[16]The Minister argued that the stronger economic connection between Alta Luxembourg and Canada should allow Canada to tax the gain despite the wording of Article 13(4) and despite acknowledging Alta Luxembourg having a legal seat and residence in Luxembourg. The court found this interpretation as too much of an expansion on the conditions of residency.

The Court refused to read-in a condition that Treaty benefits are available only to those residents with a sufficient substantive economic connection to the residence country. There were no such words in the Treaty itself, and there was a broad international acceptance of a formal residency requirement, as opposed to a requirement for “sufficient substantive economic connections” to the country of residence.[17] The Court acknowledged that treaty partners do not have “unfettered liberty to alter or redefine residence as they wish for purposes of a tax treaty”[18]. In addition, they recognized that domestic law definitions of residence should not redefine “residence in a way that takes the words unmistakably past their accepted usage”, which includes “the definitions of residence that were in effect in the two states at the time the Treaty was drafted.”[19]

The Court found that Canada made a deliberate choice to enter into Article 13(4) with an absence of safeguards related to tax-avoidance, which reflected Canada’s economic priorities at that time:

> In conclusion, the object, spirit, and purpose of the carve-out provided for in art. 13(4) and (5) of the Treaty are to foster international investment by exempting residents of a contracting state from taxes in the source state on capital gains realized on the disposition of immovable property in which a business was carried

> on, or on the disposition of shares whose value is derived principally from such immovable property. The fact that the capital gains may not be taxed in Luxembourg, leading to double non-taxation, and the fact that conduit corporations can take advantage of the carve-out are tax planning outcomes consistent with the bargain struck between Canada and Luxembourg. Although Canada had a greater claim to tax such income based on the theory of economic allegiance and would have most likely received more tax revenues without the carve-out given its traditional status as a source state, Canada agreed to forego its right to tax such capital gains, regardless of whether they would be taxed in Luxembourg, in order to attract foreign investment in business assets embodied in immovable property located in Canada (e.g. hotels, mines, or oil shales) and to reap the economic benefits generated by that investment. This is what was actually agreed upon. It appears that Canada was aware of tax planning strategies using conduit corporations in Luxembourg but that it made a deliberate choice not to include anti-avoidance provisions that would have addressed this situation in the Treaty.[2]

Since the avoidance transaction did not defeat the underlying rationale or the "object, spirit, or purpose" of the relevant provisions of the Treaty, the GAAR did not apply.

Future implications

Although the decision paves the way for companies that have previously used the Luxembourg Treaty and other similar international legal regimes as a means of achieving desired tax benefits, this type of holding structure will likely become less common. In the Liberal Party of Canada's 2021 Platform "Forward for Everyone," the current Federal government pledged to modernize the GAAR regime in Canada and focus on "economic substance. In addition, Canada has entered into the Multilateral Instrument[21] (MLI) with numerous other OECD countries including Luxembourg, which amends tax treaties entered into before the date of the MLI. Under the MLI, tax authorities may deny tax treaty benefits if one of the principal purposes of an arrangement or transaction was to obtain the treaty benefits.

Regardless, the decision provides clarity and sets a precedent for both treaty interpretation and GAAR analysis.

For more information on this decision, or the application of the GAAR, please reach out to any of the authors or key contacts listed below.

Footnotes

[1] Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Can. T.S. 2000 No. 22 (the "Treaty").

[2] *Income Tax Act*, RSC 1985, c 1 (5th Supp) s 245.

[3] *Alta Energy Luxembourg S.A.R.L. v. The Queen*, 2018 TCC 152

[4] *The Queen v. Alta Energy Luxembourg S.A.R.L.*, 2020 FCA 43 atpara 80.

[5] *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, [2005] 2 S.C.R. 601 at para 11, citing *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] AC 1 (HL).

[6] *Ibid.*

[7] *Supra* note 4, citing *Canada Trustco* at para 45.

[8]> *Canada v. Alta Energy Luxembourg S.A.R.L.*, *supra* note 1 at paras 29-30.

[9] *Ibid* at para 47.

[10] *Ibid* at para 92.

[11] *Ibid* at para 38-45; see also Organisation for Economic Co-operation and Development. Model Tax Convention on Income and on Capital: Condensed Version. Paris, 2003 and 2017.

[12] *Ibid* at paras 42-43.

[13] *Ibid* at para 44, citing Luxembourg's registered observation on the "Commentary on Article 1" of the 2003 OECD Model Treaty.

[14] *Ibid* at para 45.

[15] *Ibid* at para 49.

[16] *Ibid* at para 57.

[17] *Ibid* at para 62

[18] *Ibid* at para 59.

[19] *Ibid*.

[20] *Ibid* at para 89

[21] The MLI was implemented in Canada by the *Multilateral Instrument in Respect of Tax Conventions Act*, SC 2019, c 12.

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