Canadian Tax Court Rejects CRA's Treaty-Shopping Arguments For Canada-Luxembourg Tax Treaty

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In this article, the authors discuss *Alta Energy*, in which the Tax Court of Canada held that a Luxembourg company's sale of shares in a Canadian shale development company to Chevron Inc. was exempt from capital gains tax as treaty-protected property under the Canada-Luxembourg treaty.

On August 22 the Tax Court of Canada released its judgment in *Alta Energy Luxembourg SARL v. The Queen*, 2018 TCC 152. Appellant Alta Energy Luxembourg (Alta Lux) successfully appealed the Canada Revenue Agency's tax assessment on its disposition of shares of Alta Energy Partners Ltd., a Canadian corporation (Alta Canada).

Alta Canada carried on an unconventional shale oil business in the Duvernay shale oil formation in Northern Alberta. The government of Alberta granted the company the right to explore, drill, and extract hydrocarbons from an area of that formation designated under licenses and leases (the working interest).

The parties agreed that the shares of Alta Canada constituted taxable Canadian property under the Income Tax Act (Canada).[1] Consequently, absent an exemption under the Canada-Luxembourg income tax convention, the gain on the disposition of the Alta Canada shares would be subject to Canadian tax under the ITA.

The CRA premised its rejection of Alta Lux's position that the gain was exempt under the treaty on two alternative arguments. First, it said Alta Lux was not entitled to an exemption from Canadian tax under article 13 of the treaty (the capital gains clause). Article 13(4) generally preserves Canada's right to tax a Luxembourg resident on a disposition of shares whose value is derived principally from immovable property in Canada. However, an exception provides that property that would otherwise qualify as immovable property under the treaty is deemed not to be immovable property if the corporation's business is carried on in the property. Alta Lux claimed the excluded property exception applied because Alta Canada's business was carried on in the working interest. The CRA disagreed.

Second, the CRA said the general antiavoidance rule in ITA section 245 applied to deny the benefit of the exemption Alta Lux claimed under the treaty. The parties disagreed on whether the transactions entered into by Alta Lux resulted in a misuse or abuse of the ITA or the treaty, which is required to trigger the application of the GAAR.

The Tax Court of Canada's decision has significant precedential value. Many of Canada's tax treaties contain an excluded property exception that nonresident taxpayers making real estate or resource investments in Canada frequently rely on. *Alta Energy* is the first reported Canadian decision to interpret the excluded property exception in any Canadian tax treaty. The court adopted a liberal interpretation of the excluded property exception that accorded with settled principles of treaty interpretation as well as relevant commercial considerations and industry practice.

Further, the decision provides the court's most recent view on the GAAR's application to a tax

[1] The parties filed an agreed statement of facts, which is appended to the judgment as Appendix A.

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treaty, an issue that has been relatively infrequently considered by courts. The other major Canadian decision that considered that question was *Canada v. MIL (Investments) SA*, 2007 FCA 236.[2] In that case, the CRA unsuccessfully attempted to apply the GAAR to what it argued was a treaty-shopping arrangement. *Alta Energy* is generally consistent with the reasoning in *MIL*.[3]

The CRA has until September 30 to appeal the Tax Court's decision.

Facts

In 2011 Alta Energy Partners LLC, a Delaware limited liability company (Alta LLC), incorporated Alta Canada as a wholly owned subsidiary to carry out the development of its working interest in the Duvernay Formation in Northern Alberta.

Although the case involved a treaty provision that addressed real or immovable property, Alta Canada did not hold any direct ownership or title to real or immovable property as a matter of private law. The working interest itself was intangible property that consisted of several licenses and leases that did not grant legal title to the surface of the land, beneath which the government of Alberta owned the oil and gas. Despite that private law characterization, the working interest consisted of Canadian resource property under the ITA and immovable property under the treaty (subject to the application of the excluded property exception).[4]

A series of transactions was undertaken in April 2012 to reorganize the holding structure of Alta Canada, whereby the shares of Alta Canada were sold to Alta Lux, a newly formed Luxembourg SARL. Specifically, the steps of the restructuring were as follows:

1. Alta Energy Canada Partnership (AECP) was formed to hold the assets and shares previously held by Alta LLC, and Alta Lux was formed as a wholly owned subsidiary of AECP.

2. Alta LLC then sold the shares of Alta Canada to Alta Lux. That disposition did not trigger any gain, and the CRA issued a clearance certificate under ITA section 116.

Between 2012 and 2013, Alta Canada actively exploited some of the licenses and leases under the working interest by drilling wells, and set aside others for future development, a practice the Tax Court found was common in the resource sector.

On September 10, 2013, Alta Lux sold its shares of Alta Canada to Chevron Canada Ltd. and realized a gain of almost C $382 million.

Issue 1: The Application of the Treaty

The first part of the judgment considers Alta Lux's sale of the Alta Canada shares solely by reference to the treaty without considering the GAAR. For the shares to be treaty-protected property under the ITA, the gain on their sale had to be exempt under the treaty, which as noted required the excluded property exception to apply to the working interest.

In determining whether the exception applied, the Tax Court used a textual, contextual, and purposive interpretation of treaty article 13(4) and associated relevant provisions. It read article 13 as evidencing a series of distributive decisions or compromises by the two contracting states regarding when the source country can tax gains realized by residents of the other country. As a deviation from the principle that the source state has jurisdiction to tax gains arising directly or indirectly from the increase in value of immovable property, the excluded property exception reflected a deliberate policy choice to encourage foreign investment in domestic real estate and resource property operating business ventures, according to the court.

The government attempted to circumscribe the scope of the exception, arguing that the

[2] The application of the GAAR to a Canadian tax treaty was also considered in *Fundy Settlement*, [2012] 1 SCR 520 (also known as *Garron* or *St. Michael Trust Corp.*); and *Antle v. Canada*, 2010 FCA 280, although in neither case was that at issue before the court of final instance (the Supreme Court of Canada in *Garron* and the Federal Court of Appeal in *Antle*). That question is also at issue in pending Tax Court appeals in *Husky Energy Inc. v. The Queen*, No. 2017-1252(IT)G; and *Hutchison Whampoa Luxembourg Holdings SARL v. The Queen*, No. 2017-3776(IT)G.

[3] Although the court did not rely on *MIL*, its conclusions in *Alta Energy* are generally consistent with those of the Tax Court and Federal Court of Appeal in *MIL*. In *MIL*, the CRA sought to apply the GAAR to what it argued was treaty shopping and abuse. A change of residence by a corporate taxpayer from Canada to Luxembourg happened on the eve of a sale of shares, the value of which was derived principally from Canadian immovable property. That allowed the taxpayer to access the treaty's capital gain exemption under the substantial interest test. The Federal Court of Appeal decided the GAAR should not apply in that kind of situation.

[4] Income Tax Conventions Interpretation Act (Canada), section 5, on immovable property.

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immovable property of Alta Canada being tested for eligibility for the exception should have been each separate license, not the collective ensemble of licenses constituting the working interest. Further, for any one property to qualify under the exception, it must be under active exploitation, rather than merely held for future potential exploitation or development.

The court found that interpretation too narrow, saying it would require conducting development and exploration in a manner inconsistent with industry best practices. It said a commercially prudent manner of developing an oil reserve geological formation is first to acquire a sufficient number of licenses to secure access to a large part of the formation to maximize the chances of economic success, followed by the process of delineating the geology of the reserve. After that would come drilling on selected sections of the formation to establish the best way to drill and stimulate production elsewhere in the formation. The court accepted Alta Lux's evidence that activities conducted on selected sections of the formation are preliminary to, and can be leveraged for, exploration and exploitation of the formation as a whole.

The Tax Court reasoned that if the excluded property exception was intended to encourage foreign investment in the real estate and resource sectors, the treaty negotiators would have intended for a resource property to fall under the exception when developed in accordance with industry best practices. In particular, that meant construing the exception in a manner that makes the tax incentive (here, the treaty exemption) available at the early, risk-taking stages of development of a resource property and not just at the mature production stage. On that basis, the court rejected both of the government's proposed limits of the scope of the excluded property exception. Consequently, it held that the working interest as a whole (including the sections being held for future exploitation) was immovable property where Alta Canada's business was carried on; thus, the gain on the sale of Alta Canada's shares was exempt from Canadian tax under the treaty.

That analysis has many notable aspects. The government questioned whether intangible property can ever qualify under the excluded property exception because it cannot be occupied, which the government suggested is what the treaty requires by phrasing the exception in terms of property "in which" the business of the corporation is carried on. The court rejected that argument as overly literal and not in accordance with industry practice, clarifying that the excluded property exception can apply to intangible rights that for treaty purposes are classified as immovable property.

The prominent role of tax policy in the interpretation of the treaty is also notable. Following well-settled law, the court observed that a tax treaty must be liberally interpreted with a view to implementing the parties' true intentions. Although no extrinsic evidence was presented to show what that intention was for the scope of the excluded property exception, the court made some reasonable inferences regarding the underlying policies, and at times invoked one of those inferred policies to reject the government's literal and formal interpretation. For example, in addition to references to the excluded property exception being intended to promote foreign direct investment, the court said the exception should be read to promote investment that involves entrepreneurial risk-taking and sustainable development of domestic resources. Those policies are used, for example, to construe the excluded property exception as not requiring occupation of all parts of the relevant immovable property nor as precluding holding property for future development. It thus turns out that one intermediate step in the statutory interpretation of a treaty is similar to what the court described as the end-goal of GAAR statutory interpretation, which:

> differs from traditional word-based interpretation. Whereas, under the modern rule of statutory interpretation, the analysis seeks to determine what the meaning of a provision is, under the GAAR, statutory interpretation is used to determine the object, spirit or purpose of the provision.

In light of the court's approach to discovering the meaning of article 13(4), the distinction between non-GAAR and GAAR statutory interpretation may be overstated. What the court in effect does in the treaty (non-GAAR) section of

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the judgment is use the text and context of article 13 to ascertain its purpose and then use that inferred purpose to home in on the more specific meaning of the article.[5]

Finally, the extensive references to and nuanced role of industry practice in the interpretation of the treaty is striking. It appears that the interpretation and application of the excluded property exception should be informed by industry practice and by reference to the particular type of real or resource property, so that in a particular case, the requisite level of activity to qualify for the exception might differ depending on several factors.[6]

Issue 2: The GAAR

Having concluded that the gain on the sale of the Alta Canada shares was exempt under treaty article 13, the court moved on to consider whether the GAAR could override the application of the treaty.

Alta Lux conceded that the restructuring constituted an avoidance transaction and that it derived a tax benefit. The CRA alleged that it constituted an abuse of both the ITA (specifically, numerous provisions addressing taxation of capital gains) and the treaty. The only question before the Tax Court was therefore whether the restructuring constituted a misuse or abuse.

The court dispatched the CRA's argument regarding the ITA in a single paragraph, holding that the ITA provisions relied on by the CRA (requiring nonresidents to pay Canadian tax on capital gains in specified circumstances) were clearly not intended to operate when a nonresident realizes a gain from the disposition of treaty-protected property. Thus, because the Alta Canada shares were found to constitute treaty-protected property, the provisions in question operated "in the manner intended by Parliament" — that is, by not applying.

The court then considered the CRA's treaty argument, summarizing it as being to the effect that although Alta Lux was a resident of Luxembourg,[7] it paid no tax there and was interposed only to avoid Canadian tax. Thus, the CRA claimed that the restructuring misused or abused the treaty, the rationale and purpose of which is to prevent or reduce double taxation, as set out in the preamble.

The Tax Court said the first step in the treaty GAAR analysis — namely, identifying the object, spirit, and purpose of the relevant rule — must not be restricted to the vague policy in the preamble. Instead, the focus should be on the rationale of the specific treaty provisions at issue, which in this case included article 13(4). According to the court, the excluded property exception is a "limit to Canada's power to tax capital gains pursuant to the ITA in the event there is a sufficient level of economic activity exercised in owning the Canadian immovable property."

In determining the object, spirit, and purpose of the excluded property exception, the court also emphasized that parties to a tax treaty are presumed to know the general tax regime in the other country. Specifically, it pointed out that the Canadian treaty negotiators were aware "that Luxembourg allowed its resident [sic] to avoid Luxembourg income tax on gains arising from the sale of shares of foreign corporations in broad circumstances." The implication seems to be that the CRA should therefore be unable to reverse the outcome under the treaty using a GAAR argument premised on the fact that the gain was not subject to tax in Luxembourg, when Canada was aware of that when entering into the treaty.

In light of the foregoing, the court essentially concluded that Canada intended to strike a bargain whereby it carved out from the definition of immovable property "properties where economic activities were carried on," giving up its right to tax the value of those properties in exchange for the economic stimulus fostered by

[5]That is not a criticism of the court's reasoning, which makes more obvious the often circular role of legislative-treaty purpose in statutory interpretation.

[6]See, for instance, the comments on exploration of conventional oil fields versus exploration of shale oil deposits at paras. 60 and 61, which present unique facts relevant to whether it is enough to focus activities only on select parts of the taxpayer's property.

[7]The CRA's position appears to have evolved between filing and trial. In its reply, the CRA alleged that Alta Lux had not established that it was a resident of Luxembourg entitled to treaty benefits, and that Alta Canada did not carry on business at all. In the later-filed agreed statement of facts, the CRA agreed that Alta Lux was a resident of Luxembourg for purposes of the treaty and that Alta Canada carried on a business (seemingly conceded by the CRA by accepting that Alta Canada constituted a principal business corporation under ITA section 66(15)).

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foreign direct investment in Canada. That intention is all the more apparent, given that the excluded property exception deviates from the OECD model treaty.

The court then addressed several collateral CRA arguments, presumably offered to add context to its GAAR argument, none of which disturbed the court's ultimate conclusion that the treaty had not been misused or abused. It first addressed the CRA's assertion that Alta Lux was acting as a conduit, finding that term inconsistent with the CRA's clear acceptance that Alta Lux was the beneficial owner of the Alta Canada shares, as evidenced by its taxing Alta Lux on the disposition of those shares.

Next, the Tax Court found nothing unusual in Alta Lux's holding the shares for a short time, selling the shares when the shareholders wanted, and distributing the proceeds to the shareholders, noting that it was commercially common to use a single-purpose holding corporation that way. Further, the court said nothing in the treaty suggests that a single-purpose holding corporation resident in Luxembourg cannot avail itself of treaty benefits, nor that a holding corporation should be denied those benefits because its shareholders are not Luxembourg residents. Indeed, as the court pointed out earlier, it is typical in private equity structures for investors to invest in pooled structures.

Finally, the Tax Court dismissed the CRA's argument that the restructuring was abusive because its overall result was treaty shopping. It pointed out that the only concept in the treaty that could be construed as an anti-treaty-shopping rule was the beneficial ownership concept, which Canadian courts have held to be of limited application. It therefore rejected the CRA's contention that treaty shopping clearly constitutes treaty abuse, noting the contrasting example of the Canada-U.S. tax treaty, which contains a comprehensive anti-treaty-shopping rule in the form of the limitation on benefits clause. It also pointed out that Canada's Department of Finance abandoned its attempts to enact a broad anti-treaty-shopping rule, emphasizing that the department said that if adopted, a rule like that would apply only prospectively. The court concluded that the CRA was trying to achieve the same result indirectly under the GAAR as that intended to be achieved directly by the proposed anti-treaty-shopping rule, now abandoned by the Department of Finance — a result that was unacceptable based on prior case law.

The Tax Court said the rationale underlying the excluded property exception "is to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business," and because that is what occurred in this case, the GAAR did not apply.

That broad determination seems to be informed by the policy analysis the court conducted in reviewing the application of treaty article 13, which suggests that the legislative intent in entering into the treaty is clear: Canada gave up its right to tax gains derived from immovable property in Canada in exchange for capital inflows from Luxembourg to fund business operations in Canada. In the trial court's view, that must have been Canada's intent irrespective of whether those gains would be taxable in Luxembourg, because Canada must be presumed to know Luxembourg's tax system (and thus that those gains may not be taxed anywhere). Canada cannot then protest when that turns out to be the case, the court said.

Conclusion

Alta Energy provides some helpful guidance for periods both before and after the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) comes into effect to amend most of Canada's tax treaties.[8] It provides a commercially informed and purposive approach to interpreting the excluded property exception in treaties that generally allow Canada to tax gains on shares that derive their value mainly from Canadian real or resource property. More broadly, the case calls into question other CRA attempts to override the commercial objectives of tax treaties in favor of specific policy goals regarding base erosion and profit shifting in treaties the MLI does not apply to.

[8] Canada signed the MLI in June 2017 and has begun taking steps toward ratification.

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Further, once the MLI amends a treaty, some of the court's findings about the policy decisions embedded in the distributive articles of a treaty should be considered when applying the MLI's principal purpose test. Under that test, a treaty benefit may be denied if it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to gain the treaty benefit unless it is established that granting the benefit would be in accordance with the treaty's object and purpose. If the object and purpose of Canada's agreeing to cede source-country taxing rights in a particular treaty is, for example, to encourage foreign direct investment, then Canadian treaty benefits in respect of some post-MLI inbound commercial arrangements should not be denied by the principal purpose test — even if the ultimate investors might not be resident in the same country.

In *Alta Energy*, the Tax Court acknowledged that private equity and other collective investments often have ultimate investors who are resident in many different countries. It will often be commercially expedient for a diverse group of investors to invest through a treaty-based holding company, and while the level of potential tax leakage will be a consideration in virtually any large-scale cross-border investment, tax minimization should not necessarily be considered a principal purpose that is outside the object or purpose of a treaty provision.

While the OECD has acknowledged that there have been many concerns raised regarding how the principal purpose test should apply to private equity funds and other collective investors, it has offered little practical guidance to provide investors with the certainty, predictability, and fairness needed in making investment decisions. It is hoped that other courts will follow a commercial-minded approach similar to that in *Alta Energy* when interpreting the test's potential application. ■

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