Supreme Court releases Alta Energy decision: taxpayer wins, application of GAAR to tax treaties clarified

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In this Update:

- On November 26, 2021, the Supreme Court of Canada released its decision in *Alta Energy* regarding the application of Canada's general anti-avoidance rule (GAAR) to tax treaties
- The Supreme Court rejected the government's argument that the taxpayer, a Luxembourg resident, should be denied the benefit of the Canada-Luxembourg tax treaty because it engaged in treaty shopping and its economic ties to Luxembourg were insufficient
- The reasons contain useful guidance on how the GAAR might apply to other tax disputes involving a tax treaty
- The impact of the MLI on future tax treaty GAAR cases, and in particular the principal purpose test (PPT) - the broad anti-avoidance rule in the MLI - remains to be seen

Earlier today, the Supreme Court of Canada released its decision in *Canada v. Alta Energy Luxembourg S.A.R.L.*, 2021 SCC 49. This is the first time the Supreme Court has considered the application of the general anti-avoidance rule (GAAR) to a tax treaty. In dismissing the Crown's appeal, a majority of the Supreme Court confirmed the decision of the lower courts that the GAAR did not apply where the taxpayer, a Luxembourg-resident company, relied on the tax convention between Canada and Luxembourg to exempt a capital gain from Canadian income tax. Wagner CJ and Rowe and Martin JJ dissented in favour of the Crown.

Background to the appeal

The taxpayer, a Luxembourg company, was owned by a limited partnership. The members of the limited partnership were generally not Luxembourg residents. The taxpayer held shares in a Canadian company (Canco). Canco, in turn, held a working interest in Canadian resource properties (oil and gas leases in Alberta), in which it carried on exploration and production activities. When the taxpayer sold the shares of Canco in 2013, it realized a capital gain of more than $380 million and took the position that this gain was exempt from tax in Canada.

Article 13(4)(a) of the tax convention between Canada and Luxembourg (the Treaty) entitles Canada to tax a resident of Luxembourg on gains arising from the alienation of shares if the value of such shares is derived principally from immovable property situated in Canada. The term "immovable property" expressly excludes property in which the business of the corporation is carried on.

At trial, the Tax Court of Canada (TCC) found that, absent the application of the GAAR, the taxpayer qualified for an exemption under the Treaty. Specifically, the TCC found that the shares were not "immovable property" as the underlying assets were property in which the business of the corporation was carried on under Article 13(4)(a). The TCC also concluded that the GAAR did not apply to deny the resulting Treaty benefit. As a result, Canada could not tax the capital gain. The Crown appealed the trial decision to the Federal Court of Appeal (FCA) only in relation to the GAAR.

The FCA upheld the conclusion of the TCC that the GAAR did not apply, finding that the purpose of the relevant Treaty provisions was clear from its text and that the Treaty benefit - the exemption from tax in Canada on the capital gain - should be available to any resident of Luxembourg that otherwise met the requisite conditions in the

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Treaty. For a more detailed discussion of the FCA's decision, please see the Osler Update dated February 19, 2020.

On appeal to the Supreme Court, the Crown took the position that the FCA had erred in its application of the GAAR, having grounded its analysis in the text of the relevant Treaty provisions rather than its underlying rationale or policy. The Crown argued that the policy of the Treaty provisions was to allocate taxing rights based on economic connections to each contracting state. Although the Crown conceded that the taxpayer was a resident of Luxembourg for purposes of the Treaty, it took the position that the taxpayer had limited economic or commercial ties to Luxembourg and therefore had engaged in abusive "treaty shopping," contrary to the policy of the Treaty provisions on which the taxpayer relied.

In response, the taxpayer argued that the policy of the relevant Treaty provisions was no broader than the text itself and that a textual, contextual and purposive analysis of those provisions evidenced no intention to depart from the carefully defined criteria negotiated and agreed upon by Canada and Luxembourg. The taxpayer also argued that the Crown, in seeking to have the GAAR applied, was effectively adding an unexpressed condition to the test for residency under the Treaty (i.e., sufficient economic connections).

Majority decision of the Supreme Court

Justice Côté, writing for a six-member majority of the Supreme Court, agreed with the taxpayer that the policy of the relevant Treaty provisions was clear from the text and was supported by the context and purpose of these provisions. The majority thus concluded that the Treaty benefit in question should not be denied to a resident of Luxembourg that has otherwise met the requisite conditions in the Treaty on the basis that its economic ties to Luxembourg are somehow insufficient.

The majority pointedly rejected the Crown's argument that treaty shopping is inherently abusive and declined the Crown's invitation to read in additional requirements not grounded in the text of the Treaty and effectively allow Canada to "revisit its bargain" with Luxembourg such that certain residents may be precluded from obtaining Treaty benefits. Instead, the majority focused on the requirement of residency in the Treaty and the need to respect the manner in which the treaty partners choose to define this requirement under their domestic law.

In reaching this conclusion, the majority observed that the GAAR was intended to apply to unforeseen tax strategies. Since the use of conduit corporations was not unforeseen at the time the Treaty was concluded, it could have been addressed by any number of additional anti-avoidance provisions, including those suggested in the OECD Model Treaty. None of those provisions was included in the Treaty. Instead, Canada chose to foster competitiveness and international investment, and the carrying on business exclusion in Article 13(4)(a) was integral to this choice.

In a preface to the GAAR analysis, the majority also cautioned that courts should not conflate a transaction being primarily (or even solely) tax motivated with it being abusive, and suggested that this conflation had coloured the dissenting judges' entire analysis (discussed below). The need to distinguish the tax avoidance analysis from the misuse and abuse analysis is inherent to the structure of the GAAR itself, where purpose is considered under the second step of the GAAR analysis, but is not sufficient to establish a misuse or abuse under the third step. The majority also reiterated the Supreme Court's earlier admonition in *Copthorne* and *Canada Trustco* to avoid infusing the misuse and abuse analysis with value judgments and to ground that analysis in the specific provisions at issue rather than on broader policy statements..

The dissent

Writing for a three-member dissent, Rowe and Martin JJ held that treaty shopping is abusive where there is an absence of a "genuine economic connection with the state of residence." The dissent found there to be an absence of such a "genuine" connection in this case and that the taxpayer's "patent lack of economic connection" to Luxembourg frustrated the policy of the relevant Treaty provisions. It is curious in this regard that the dissent characterized the taxpayer's presence in Luxembourg as being "mere gossamer" and "manufactured out of whole cloth", given the Crown's concession that the taxpayer was in fact a resident of Luxembourg for purposes of the Treaty.

On the carrying on business exclusion specifically, the dissent was of the view that the policy of this exclusion is based on situations where the business activity, not the immovable property itself, drives the value of the property. The dissent also stated, without references, that "the common intention of Canada and Luxembourg could not have been to provide an avenue for residents of third-party states to indirectly obtain tax benefits they could not obtain directly absent any real economic connection with Luxembourg."

Implications and takeaways

The majority decision in *Alta Energy* provides a welcome confirmation that the alleged misuse or abuse in GAAR cases must be clear, and that it is possible for the policy of a provision to be no broader than the text itself. Taxpayers can therefore be reassured that *Alta Energy* supports the expectation that any application of the GAAR

to past transactions that resulted in treaty benefits will proceed in a manner that is predictable, consistent, and fair.

The decision also gives rise to two important considerations: the impact of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), and the application of the GAAR more broadly.

MLI and the PPT

In passing, the majority noted that at the time Canada entered into the Treaty, the international community had not made significant efforts to curb treaty shopping. Such efforts have occurred more recently, resulting most notably in the MLI, which Canada, Luxembourg and many of Canada's other treaty partners have signed and ratified. As implied by the majority, the impact of the Supreme Court's decision on future transactions has been tempered by the introduction of the MLI and, in particular, the introduction of the principal purpose test (PPT), as well as the amended preamble (which indicates that treaties are not intended to create opportunities for non-taxation or reduced taxation through treaty-shopping arrangements).

The PPT is a broad anti-avoidance rule that is applicable to many of Canada's bilateral treaties pursuant to the MLI. Largely similar to the GAAR, the PPT denies a treaty benefit where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction in question was to gain the benefit, unless it is established that granting that benefit would be in accordance with the object and purposes of the relevant provisions of the treaty.

Going forward, the interaction between the GAAR and the PPT will be a key issue as tax disputes arise involving treaties covered by the MLI. The U.S., Canada's most important trading partner, is not a signatory to the MLI and at this time is not expected to become one. The decision in *Alta Energy* will therefore continue to be particularly relevant to treaty issues involving the Canada-U.S. tax treaty, subject to consideration of the limitation on benefits article in that treaty. However, 96 other countries have signed the MLI to date, including the U.K., Mexico, China, and other significant trading partners (although not all signatories have ratified it domestically yet—see the current list of signatories and status of entry into force [PDF]).

Despite the similarity between the GAAR and the PPT, the CRA has not ruled out applying both provisions to the same transaction or benefit. For more information about the MLI, the PPT, and the CRA's proposed approach to the application of the PPT, please see the Osler Update dated March 1, 2021.

Application of the GAAR

The GAAR is only intended to apply in situations where the perceived misuse or abuse is clear, with any residual doubt to be resolved in favour of the taxpayer. The markedly diverging views of the majority and the dissent are noteworthy in this regard.

Six judges of the Supreme Court found that there was no abuse at all. The remaining three dissenting judges began their reasons by acknowledging that gaps and mismatches in international tax rules result in billions of lost revenues, and ultimately concluded that the alleged abuse in this case was "clear". In the face of these diverging approaches, it is difficult to see how the minority concluded that the high threshold of clarity required for the application of the GAAR was met in these circumstances, and it is interesting that the majority specifically referred to the fundamental errors that led to the dissenting views.

Budget 2021 stated that the government would take steps to strengthen and modernize the GAAR, as had been announced in the 2020 Fall Economic Statement. It remains to be seen what, if any, modifications are made in response to *Alta Energy* and other recent GAAR decisions.

For further information on the implications of *Alta Energy*, the MLI, or other tax matters, please contact any member of our National Tax Group.

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