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Taxpayer Wins Treaty Shopping Challenge in *Alta Energy Luxembourg*

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INTRODUCTION

On August 22, 2018, the Tax Court of Canada rendered its decision in the eagerly anticipated alleged treaty shopping case of *Alta Energy Luxembourg S.a.r.l. v. Canada*[1] delivering a resounding victory to the taxpayer. Although the decision may very well be appealed and possibly ultimately reversed, the Tax Court judgment provides cross-border tax planners with some good ammunition to fight ongoing treaty shopping challenges. It is less clear whether the Tax Court reasoning in this case, if it stands, would provide taxpayers with ongoing defenses under tax treaties as modified by the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the ''MLI'').[2] This short article summarizes and comments on the *Alta Energy* case.

THE ALTA ENERGY LUXEMBOURG DECISION

The *Alta Energy* case arose out of the divestment of a private equity fund–backed shale oil venture in Alberta. In 2011, Blackstone Group LP and Alta Resources LLC partnered to form Alta Energy Partners LLC in order to acquire and develop unconventional oil and natural gas properties in North America. Later that year, Alta Energy Partners LLC formed Alta Energy Partners Canada Ltd. (''Alta Canada''), a wholly owned Canadian subsidiary. From June 2011 to April 2012, Alta Canada assembled resource licenses in respect of some 62,000 acres in the Duvernay shale formation in Alberta. Admittedly, however, the initial holding structure for the Canadian business was ''a mistake''[3] thus motivating a restructuring whereby, in April 2012, the shares of Alta Canada were sold to a newly formed Luxembourg company, the Appellant, owned by a partnership, Alta Energy Canada Partnership. Though the reorganization was effected on a taxable basis, the CRA accepted that the fair market and the adjusted cost base of the Alta Canada shares were equal at that time. Alta Canada then proceeded with further exploration and development activity. Ultimately, in 2013 the Appellant sold its shares in Alta Canada to Chevron Canada Ltd. for proceeds of $679,712,251, giving rise to a capital gain of nearly $400 million. The Appellant claimed an exemption from Canadian income tax under Article 13(5) of the *Canada-Luxembourg Income Tax Convention 1999* (the ''Treaty''). The Canadian government denied the exemption.

The two issues in dispute before the Tax Court were whether the gain on the sale of the Alta Canada shares was exempt under the Treaty and, if so, whether the general anti-avoidance rule (GAAR) in §245 of the *Income Tax Act* (Canada) applied to deny the benefit of the Treaty exemption. The court sided unequivocally with the Appellant.

On the first issue, it was conceded that, absent a treaty exemption, the capital gain on the sale of the Alta Canada shares would be taxable in Canada; the

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[1] 2018 TCC 152 (''Alta Energy'').

[2] On June 21, 2018, a bill was presented in the Canadian Parliament for the enactment of the MLI in Canadian law.

[3] *Id.* at ¶19.

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Alta Canada shares were "taxable Canadian property" because they derived their value principally from Canadian resource property. The taxpayer argued that Article 13(5) of the Treaty applied to allow only Luxembourg to tax the gain, while the government retorted that Article 13(4) also gave Canada the right to tax. This provision of the Treaty reads as follows:

> (4) Gains derived by a resident of a Contracting State from the alienation of:
> (a) shares (other than shares listed on an approved stock exchange in the other Contracting State) 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*; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company. [emphasis added]

The narrow issue was whether Alta Canada's business was carried on "in" its Canadian resource property. Initially, the government questioned how Alta Canada's business could be carried on within the physical limits of incorporeal property, being the resource exploitation licenses issued by the Alberta government. It ultimately took the position that, for purposes of the exception in Article 13(4), a business is carried on "in" a resource license only where the company's activities exercise the rights granted by the license. On this basis, the government argued that the Treaty exemption must be applied on a strict license-by-license basis to the effect that a license would qualify only if drilling or extracting actually occurred in the section covered by that license.

Justice Hogan, however, held that the Respondent's position reflected a lack of understanding of how resource assets are developed and exploited in Canada. Giving the example of a forestry operation, the court found that industry practice in the resource sector often involves activity only in respect of part of the resource property. Justice Hogan went on to state that since the purpose of the Article 13(4) carve-out is to attract foreign direct investments, it is reasonable to assume that the treaty negotiators wanted the exception to be granted in accordance with industry practices.[4] According to the court, they would not have intended that the exception only apply where the reserve is fully exploited on a strict license-by-license basis, because such a literal and formal interpretation would not have favored foreign investment.[5] Consequently the capital gain realized by the Appellant as a result of the disposition of the Alta Canada shares was held to not be taxable in Canada on the basis of the exclusion in Article 13(4).

On the second issue, it was conceded that the 2012 restructuring of the Alta Canada holding structure to interpose the Appellant was an avoidance transaction that gave rise to a tax benefit. Thus, the only issue before the court was whether the restructuring was abusive under the terms of the GAAR. This determination requires an identification of the object, spirit and purpose of the underlying provisions to decide whether same has been frustrated by the avoidance transaction.

The government argued that the misuse or abuse at hand results from the fact that the Appellant, although a resident of Luxembourg for the purposes of Article 4 of the Treaty, was created and became the owner of the Alta Canada shares for no purpose other than avoiding Canadian income tax on the gain while not paying any Luxembourg tax on it either. According to the Respondent, the rationale and purpose of the Treaty is to prevent or reduce double taxation on activities or transactions that potentially may be subject to tax in both Contracting States at the same time. In support of this statement, the government pointed to the preamble of the Treaty. However, Justice Hogan held that the preamble is too vague to be indicative of the rationale of the specific provisions relied upon by the taxpayer, being Articles 1, 4, and 13 of the Treaty. Non-taxation in Luxembourg was also irrelevant in the absence of a specific Treaty provision that takes into account tax treatment in the residence country.

The court also rejected the argument that the benefits of the Treaty should be denied because the Appellant was allegedly a "conduit." The court adopted an agency-based interpretation of this term and noted that Canadian courts have refused to adopt a broader view.[6] Justice Hogan went on to state (at para. 91):

> There is nothing in the Treaty that suggests that a single purpose holding corporation, resident in Luxembourg, cannot avail itself of the benefits of the Treaty. There is also nothing in the Treaty that suggests that a holding corporation, resident in Luxembourg, should be denied the benefit of the Treaty because its shareholders are not themselves residents of Luxembourg.

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[4] *Id.* at ¶68.

[5] *Id.*

[6] *Canada v. Prévost Car Inc.*, 2009 FCA 57 and *Velcro Canada v. The Queen*, 2012 TCC 57.

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Finally, the court addressed the argument that the overall result of the 2012 restructuring amounted to abusive ''treaty shopping.'' Justice Hogan noted that, other than the ''beneficial ownership'' test in Articles 10, 11, and 12, the Treaty does not include an anti-treaty-shopping rule similar to the limitation on benefits provision in the Canada-U.S. tax treaty. The judge went on to review certain government initiatives in 2013 and 2014 that recommended the adoption of a domestic anti-shopping rule but were ultimately abandoned. The court concluded that the GAAR cannot be used to achieve the results of an inexistent domestic or treaty-based limitation of benefits rule, and cited the Tax Court and Federal Court of Appeal decisions in *Garron Family Trust v. The Queen*[7] in support.

The Tax Court concluded as follows (at para. 100):

> The Minister argues that the Restructuration constitutes an abuse of Articles 1, 4 and 13, because, absent the Restructuration, the gain would have been taxable in Canada. I do not find this result contrary to the rationale underlying Articles 1, 4 and 13. The rationale underlying the carve-out is to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business. The significant investments of the Appellant to de-risk the Duvernay shale constitute an investment in immovable property used in a business. Therefore, I conclude that the GAAR does not apply to preclude the Appellant from claiming the exemption provided for under Article 13(5) of the Treaty.

COMMENTARY

While the subject of treaty shopping has been enjoying a high level of exposure with the OECD BEPS project and the recent adoption of the MLI, Canada has seen only very few court cases dealing with the issue.

Canada's first-ever treaty shopping case, *MIL (Investments) S.A. v. Canada*,[8] reached the courts some 12 years ago. The Tax Court's decision in this case, affirmed by the Federal Court of Appeal (FCA) on June 13, 2007, was a clear victory for the taxpayer. Like *Alta Energy*, *MIL* dealt with an exemption from Canadian tax under Article 13 of the Treaty. The claim related to a capital gain of approximately CAD 425 million realized by the taxpayer on the sale of its shares in a resource company, Diamond Field Resources Ltd. (DFR), on its storied 1996 takeover by mining giant, Inco, after DFR had discovered one of the world's largest nickel mines at Voisey Bay in Newfoundland.[9] MIL (Investments), a corporation owned by a non-resident of Canada, was initially incorporated in the Cayman Islands. Before June 1995, it owned 11.9% of DFR. On June 8, 1995, MIL (Investments) exchanged, on a tax-deferred basis, 703,000 DFR shares for 1,401,218 common shares of Inco, thereby reducing its shareholding in DFR below the substantial interest threshold in the Treaty. On July 17, 1995, MIL (Investments) was continued under the laws of Luxembourg. After a series of intervening smaller share sales by the taxpayer, on May 22, 1996, the DFR shareholders approved the Inco takeover of DFR to take effect on August 21, 1996 and, as a result, MIL (Investments) received CAD 427,475,645 for the disposition of its DFR shares. It claimed an exemption from Canadian tax on the resulting capital gain of CAD 425,853,942 under Article 13. This claim was the subject of the appeal.

The court held in favor of the taxpayer and rejected the government's claims that the transactions constituted abusive treaty shopping which should be struck down either under the GAAR or as violating an alleged inherent anti-treaty-shopping rule in the Treaty.

With respect to the GAAR, the court found that none of the relevant transactions was an avoidance transaction under §245(3) of the Act. Justice Bell stated that he accepted the taxpayer's contention that the continuation of MIL (Investments) from the Cayman Islands to Luxembourg was primarily for *bona fide* commercial reasons because Luxembourg was a better jurisdiction than the Cayman Islands from which to carry on a mining business in Africa. Hence, the court found that the GAAR had no application to the case.

Furthermore, the court stated in obiter that, in any event, it would not be able to find abusive avoidance under §245(4). On this point, the government had argued that treaty shopping is an abuse of bilateral tax treaties and is recognized as such by the Supreme Court of Canada. In this respect, the government quoted from *Crown Forest*[10] to argue that if the Supreme Court had access to §245, it would have used that provision to deny a benefit from treaty shopping. Dealing with these arguments, Justice Bell stated as follows (para. 69):

> I do not agree that Justice Iacobucci's *obiter dicta* can be used to establish a prima facie finding of

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[7] 2009 TCC 450, *aff'd*, *St. Michael Trust Corp. v. Canada*, 2010 FCA 309.

[8] 2006 D.T.C. 3307 (TCC), *aff'd*, 2007 D.T.C. 5437 (FCA) (''*MIL*'').

[9] For a page-turner recount of the story of DFR and its takeover, see Jacquie McNish, *The Big Score: Robert Friedland, Inco, and the Voisey's Bay Hustle* (Doubleday Canada, 1999).

[10] [1995] 2 S.C.R. 802.

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> abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined.

Ultimately, the Federal Court of Appeal unanimously affirmed the Tax Court's decision from the bench.

Surprisingly, *Alta Energy* made no mention of *MIL*. A factual difference between the cases relates to how the alleged treaty shopping was achieved. While in *MIL* the taxpayer was continued from the Cayman Islands to Luxembourg in a tax-disregarded transaction, in *Alta Energy* the interposition of the Luxembourg resident taxpayer was effected on a taxable basis. Obviously, as suggested by Justice Hogan, Alta Energy was fortunate to not have suffered a valuation challenge from the CRA, especially in light of the quick divestment at a substantial gain from the purchase price used as part of the reorganization a year earlier. In any event, this factual distinction does not explain the lack of any reference to *MIL* in *Alta Energy*.

The first issue in *Alta Energy* was not relevant in *MIL*. The decision of the Tax Court of Canada on this point is favorable and highly valuable to tax planners. This is because, to a layman reader, the carve-out of Article 13(4) may not be seen as clearly applicable to most resource businesses. While a manufacturing company clearly carries on its business ''in'' a plant or a hotel operator carries on its business ''in'' a hotel building, it is less natural in English to say that an oil company carries on its business in an oil well or that a shale gas company carries on its business in a shale formation. As pointed out in the case, such a statement becomes even more arduous where the immovable property at issue is actually an intangible resource license. Nonetheless, the CRA has historically adopted a favorable and purposive interpretation of Article 13(4) of the Treaty and other similar Canadian treaties. Justice Hogan has now chastised the government for trying to repudiate its prior views on this point. In fact, the government's position in *Alta Energy* was not completely adverse in that the government did not argue in favor of a complete disallowance of the treaty exemption. Instead, the government took a highly technical license-by-license approach, which met with the judge's stern repudiation. In addition, obiter comments relating to timber property operations add value to the court's reasoning.

The second, alternative issue in *Alta Energy* was the GAAR challenge to the structure. Here, the Tax Court could have relied on its prior decision in *MIL*, but maybe chose not to because the abuse analysis in *MIL* was obiter. In any event, the court on this point reached a very similar conclusion to *MIL*, which can be summed up as follows: in the absence of a limitation on benefits clause in a particular treaty, treaty shopping cannot be struck down under the GAAR. Without belaboring any of the points, Justice Hogan dismissed each one of the government's arguments under the GAAR: the Treaty's preamble was too vague to be indicative of the specific purpose of the rules at issue and actual double non-taxation is irrelevant unless specific rules account for whether tax was paid in the residence country; ''conduit'' is a meaningless concept in the absence of an agency relationship; and invoking the notion of ''treaty shopping'' is futile in the absence of an anti-shopping rule negotiated into a treaty.

If the Tax Court decision on this point stands, the fascinating question is what impact it would have on the interpretation in Canada of the minimum standards of the MLI, being the new expanded tax treaty preamble that specifically condemns double non-taxation and treaty shopping and the principal purpose general anti-abuse test (the ''PPT''). Under Justice Hogan's judgment, a treaty's preamble is too vague in the absence of specific rules that are reflective of the preamble's statements. Furthermore, if the PPT were seen as very similar to the GAAR, taxpayers may argue, further to *Alta Energy*, that the wording of Article 4 establishes that treaty shopping is not contrary to the spirit and purpose of the Treaty. In other words, in the absence of either a rule that changes the liable-to-tax test to a subject-to-tax test or a limitation-on-benefits clause, it could still be argued that the clear wording of a treaty would be too powerful an evidence of a treaty's object and purpose to be overridden by a vague preamble or a subjective PPT.

In conclusion, it is uncertain what impact the reasoning of the Tax Court in *Alta Energy* would have on MLI-modified tax treaties, but the taxpayer's victory in this case may explain why the government of Canada indicated in the documents announcing its signing of the MLI that it would, over the longer term, seek to include LOB provisions in relevant treaties.[11]

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[11] Department of Finance Canada, *Backgrounder: The Next Step in the Fight Against Aggressive International Tax Avoidance*.

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