immovable property situated in Quebec seemingly add another chapter to Quebec's taxation of trusts.

HARMONIZING TAX TREATY EXEMPTIONS AND TAXABLE CANADIAN PROPERTY: DEMISE OF THE BUSINESS PROPERTY EXEMPTION

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The Department of Finance roundtable session at the May 17, 2012 IFA International Tax Seminar in Ottawa covered several interesting tax treaty topics, including the Canadian taxation of gains realized by non-residents from the sale of indirect interests in Canadian real property or resource property.

It was stated that the current policy of the Department of Finance is for new tax treaties to contain capital gains articles that parallel or mirror domestic Canadian law with respect to the definition of taxable Canadian property. While many existing tax treaties contain exemptions for gains on listed shares or shares deriving their value from Canadian immovable property "in which the business was carried on", the Department of Finance intends that new tax treaties will not have these exemptions. As a result, treaty relief for share dispositions can be expected over time (perhaps a very long time) to generally become more closely harmonized with the Canadian taxation of gains as determined under the taxable Canadian property rules.

This article discusses some background context underlying these Department of Finance comments and considers some possible implications of this aspect of Canada's tax treaty policy, particularly with respect to foreign investment in shares of companies with significant Canadian real property or resource property assets.

Canada's Assertion of Source-Country Taxing Jurisdiction — Taxable Canadian Property

Paragraph 2(3)(c) of the *Income Tax Act* (Canada) (the "Act")[1] imposes Canadian tax on non-residents that realize gains from the disposition of "taxable Canadian property". This recognizes that Canada may assert only a limited jurisdiction to tax non-residents of Canada. The income of non-residents that is taxed in Canada is income with a Canadian source, and with respect to property dispositions, the Canadian source — i.e., the connection to Canada that gives rise to the jurisdiction to tax — is determined by the scope of "taxable Canadian property".

"Taxable Canadian property" is defined in subsection 248(1) in a manner that describes properties with a clear Canadian source or nexus. For instance, it includes real property situated in Canada, most property used in a business carried on in Canada, and Canadian resource property, among other things.

With respect to shares of a corporation, the definition of taxable Canadian property was amended following the March 2010 federal Budget and now includes a share of a corporation (whether resident or non-resident) that is not listed on a designated stock exchange if, at any time during the 60-month period before the particular time, more than 50% of the fair market value of the share was derived directly or indirectly from one or any combination of (i) real or immovable property situated in Canada, (ii) Canadian resource properties, (iii) timber resource properties, and (iv) options in respect of, or interests in, any of such properties (collectively, "Canadian properties"). Before the 2010 amendments, all private company shares (shares of a Canadian-resident corporation not listed on a designated stock exchange) were taxable Canadian property. In most respects, the definition is now considerably narrower, meaning that the Act attempts to impose tax on non-resident taxpayers who dispose of such private company shares in a much narrower range of circumstances: namely, when the shares derive more than 50% of their value from Canadian properties at some point during the five-year look-back period.[2]

For shares of a corporation that are listed on a designated stock exchange, an additional condition applies before the public company shares constitute taxable Canadian property. In particular, following the March 2010 Budget amendments, the definition requires that, during the five-year look-back period, not only must the non-resident (in combination with non-arm's length persons) have owned 25% or more of the issued shares of any class of the capital stock of the corporation (which was the only condition prior to the amendments), but at some time during that period, the shares must have derived more than 50% of their fair market value from the listed Canadian properties. Whereas Canada previously asserted source-country taxing jurisdiction over any non-resident with a significant interest (more than 25%) in a Canadian public company during the five-year look-back period (and, by corollary, relinquished

source-country taxing jurisdiction over non-residents owning relatively small interests of Canadian public companies), Canada now taxes non-residents owning significant interests in public companies (whether Canadian or foreign) only where more than 50% of the fair market value of the public company shares was derived directly or indirectly from the Canadian properties.

The theme common to shares of private companies and public companies, with respect to the definition of taxable Canadian property, is that the 50% of value test is now the key threshold for Canada's assertion of source-country jurisdiction to tax non-residents on their gains from disposition of the shares.

Tax Treaty Exemptions for Share Dispositions — Variations on the Theme

There is an inherent conflict between Canada's assertion of source-country jurisdiction to tax the non-resident on its capital gain from disposing of shares that qualify as taxable Canadian property, and the assertion by the foreign country in which the shareholder is resident to tax the non-resident on the same capital gain. If left unregulated, this source-country/residence-country conflict would lead to frequent instances of double taxation of the same capital gain. Minimizing or avoiding this potential double taxation is the principal purpose of the capital gains articles of Canada's tax treaties (of which there are currently 89 in force).[3] Typically, this is achieved by placing limits on the source-country jurisdiction to tax gains other than in specifically described circumstances. As will be seen, with respect to the treatment of share dispositions, Canada's tax treaties have historically adopted a number of different formulations to circumscribe the source-country jurisdiction to tax.

Article 13(4) of the OECD Model Convention provides that gains derived by a resident of a contracting state from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other contracting state may be taxed in that other state. In other words, the OECD Model Convention contemplates source-country jurisdiction to tax capital gains from share dispositions in circumstances that are very similar to the conditions in the analogous part of the taxable Canadian property definition, following the March 2010 federal Budget amendments. However, the taxable Canadian property definition applies this test over the five-year look-back period (potentially capturing a wider category of shares than the OECD Model Convention), and for public company listed share dispositions, taxable Canadian property includes only significant (more than 25%) interests over the five-year look-back period (potentially capturing a narrower category of shares than the OECD Model Convention).

Canada's tax treaty with the United States has long had a similar formulation. Article XIII(3)(*b*) of the *Canada–U.S. Income Tax Convention* effectively permits Canada to tax gains realized by a resident of the United States from a disposition of a share of a company that is a resident of Canada, the value of whose shares is derived principally from real property situated in Canada (where real property is defined broadly in Article VI(2) and would generally include Canadian resource property, among other things). In addition to the absence of a look-back period and significant interest requirement as discussed above, one further difference is that taxable Canadian property now captures shares of a non-resident corporation where the value of those shares is derived sufficiently from Canadian-source real property/resource property etc., whereas the *Canada–U.S. Income Tax Convention* permits Canada to tax only shares of a Canadian-resident corporation that meets the value test.

Many of Canada's other tax treaties contain wording that limits Canada's source-country jurisdiction to tax gains from share dispositions in several further ways. A commonly relied upon treaty exemption is Article 13(4) of the *Canada–Luxembourg Tax Treaty*[4] (which is substantively similar to Article 13(5)(*a*) of the *Canada–U.K. Income Tax Convention*). This restricts Canada to taxing gains derived by a resident of Luxembourg from the alienation of shares (other than shares listed on an approved stock exchange in Canada) 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 Canada. For this purpose, 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 Luxembourg resident and related persons own 10% or more of the shares of any class of the capital stock of a company.

Thus, the *Canada–Luxembourg Tax Treaty* provides a capital gains exemption that carves back Canada's source-country jurisdiction to tax share dispositions (beyond the already narrowed scope of taxable Canadian property) in three respects:

- all shares listed on a Canadian stock exchange are exempt;
- all shares in a minority interest under the 10% substantial interest threshold are exempt; and

- even where the shares derive more than 50% of their value from the Canadian properties, the gain can be exempt if that is property "in which the business of the company was carried on" (referred to as the "business property exemption").

Business Property Exemption

This last aspect of the capital gains exemption in the *Canada-Luxembourg Tax Treaty* for property "in which the business of the company was carried on" appears in 45 of Canada's tax treaties[5] and in practice has been broadly relied on for "exit planning" by non-residents investing in shares of Canadian corporations owning Canadian real property or resource property.

As noted above, the business property exemption is a departure from the standard form of the capital gains article of the OECD Model Convention. Paragraph 28.7 of the Commentary only briefly refers to this common formulation as follows: "some States consider that the paragraph should not apply . . . to gains derived from the alienation of shares . . . where the immovable property from which the shares derive their value is immovable property (such as a mine or a hotel) in which a business is carried on". The connotation is that the property excluded from the scope of "immovable property" is property that is physically capable of being entered, that contains the business, and that is the premises where the business is actually carried on.

The Canada Revenue Agency ("CRA") has confirmed in a number of tax rulings and commentaries[6] that this formulation of the business property exemption can apply broadly in a range of circumstances beyond those in which shares derive their value from the buildings that house the business. It can apply to shares where the value is derived from farmland used in a farming business;[7] to shares where the value is derived from processing plants, buildings, machinery, and equipment used in a mining and processing business;[8] to shares where the value is derived from mineral and timber rights actively exploited by the company;[9] and to shares where the value is derived from actively exploited oil and gas interests.[10] Where the Canadian resources contributing to the value of the shares are *in situ* reserves of oil, gas, or mineral properties, for example, it might appear at first blush that a broad and generous reading is required to say these are properties "in which the business is carried on". However, this interpretation is arguably consistent with the intentions of the treaty negotiators, provides consistent treatment for different types of natural resource properties, and presumably is desirable from a policy perspective because it promotes foreign capital investment in Canada's resource industries.

More generally, the CRA has stated that the business property exemption in these tax treaties can apply to shares deriving their value from Canadian resource property (the particular property considered was oil and gas reserves and royalty interests in the context of the *Canada–Netherlands Tax Treaty*) "if the owner is actively engaged in the exploitation of natural resources and if such assets are actively exploited or kept for future exploitation by such owner . . . In our view, in order for a company to be 'actively engaged' in the exploitation of natural resources, the company must be directly involved in the management and daily activities of the exploitation process on a regular, continuous and substantial basis, and the company's employees must devote time, work and energy to the exploitation."[11]

Consequently, it has become common for a non-resident investor in a Canadian corporation owning significant Canadian real property or resource property to structure the acquisition through an entity resident in one of the countries with which Canada has a tax treaty containing this business property exemption. Subject to a possible "treaty shopping" attack by the CRA, under the general anti-avoidance rule or otherwise,[12] this inbound investment structure can put the non-resident in a position to potentially claim in the future that, if and when the shares of the Canadian company are disposed of, the value is derived at that time from real property or actively exploited resource property "in which the business is carried on". In such circumstances, the capital gain would be exempt from Canadian tax even though the shares would be taxable Canadian property over which Canada asserts source-country taxing jurisdiction.

Possible Implications of Harmonizing Treaty Relief with Taxable Canadian Property

The Department of Finance has stated that its current policy is to not include in new tax treaties broad capital gains exemptions for listed shares or for immovable property in which the business is carried on. This is borne out by recent tax treaties (those recently signed with Poland (May 14, 2012), New Zealand (May 3, 2012), and Serbia (April 30,

2012)), which have capital gains articles that, in their treatment of share dispositions, are closely aligned with the OECD Model Convention and the definition of "taxable Canadian property".

The interesting question is whether the Department of Finance will seek changes to existing treaties to conform the capital gains articles more closely to the scope of the recently amended "taxable Canadian property" definition. So far, that does not appear to be the case. Recently signed protocols to treaties with Luxembourg (May 8, 2012) and Austria (March 9, 2012) are focused on the addition of exchange of information provisions, leaving the business property exemptions in those treaties intact. Similarly, recently amended treaties with Switzerland (in force December 19, 2011) and Italy (in force November 25, 2011) leave the pre-existing business property exemptions unchanged.

Nonetheless, non-resident taxpayers should consider the impact of this statement of tax treaty policy before structuring their investment in shares of a Canadian company that qualify as taxable Canadian property, where it is contemplated that the business property exemption in one of Canada's existing tax treaties will apply to relieve the non-resident from Canadian capital gains tax on the eventual sale of the shares. It is now clear that the current tax treaty policy for share dispositions is to harmonize the tax treaty capital gains exemptions with the recently amended taxable Canadian property definition. The older tax treaties with broad exemptions for business property, listed shares, and minority "non-substantial" interests no longer manifest Canada's current tax treaty policy and could potentially be amended by the time the disposition occurs, eliminating the anticipated treaty relief from Canadian capital gains tax.

Notes:

[1] RSC 1985, as amended. Statutory references in this article are to the Act, unless indicated otherwise.

[2] The August 27, 2010 draft legislation proposes to clarify the mechanics of the indirect or "look-through" rule in applying the 50% of value test as applied to unlisted shares. In particular, where a parent corporation owns shares or interests in a partnership or trust and those shares or interests are not themselves taxable Canadian property, there is no look-through to the underlying assets of the subsidiary corporation or partnership or trust. At the May 17, 2012 IFA International Tax Seminar, the Canada Revenue Agency (the "CRA") discussed a number of examples applying the look-through test under the existing and proposed rules.

[3] The Department of Finance website contains a full list of Canada's tax treaties, including those in force and additional treaties signed but not yet in force and treaties under negotiation. See http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp.

[4] For instance, the taxpayer in *The Queen v. MIL (Investments) SA*, 2007 DTC 5437 (FCA) (affirming the Tax Court of Canada decision in 2006 DTC 3307) successfully used the *Canada–Luxembourg Tax Treaty* to exempt its capital gain from a disposition of shares of a Canadian corporation owning Canadian resource property.

[5] Canada's tax treaties with various formulations of the broad business property exemption include those with Armenia, Austria, Azerbaijan, Belgium, Bulgaria (see the protocol), Croatia, Czech Republic, Ecuador, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Kazakhstan, Kuwait, Kyrgyzstan, Latvia, Lebanon (see the protocol), Lithuania, Luxembourg, Malta, Mexico, Moldova, Mongolia, Namibia (not yet in force), Netherlands, Norway, Oman, Peru, Romania, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Tanzania, Ukraine, United Kingdom, Uzbekistan, Venezuela, and Zimbabwe.

[6] For examples of CRA commentary on the business property exemption in different circumstances, see CRA Document Nos. E940304, 952821, 9506785, E9633803, 9609153, 963869, 9703965, 1999-0010583, 2000-0042545, 2000-0015753, and 2001-0112133.

[7] CRA Document No. 2000-0042545.

[8] CRA Document No. 1999-0010583.

[9] CRA Document No. 9703965.

[10] CRA Document Nos. 9506785 and 2000-0015753.

[11] CRA Document No. 9506785.

[12] As noted above, in *MIL (Investments)* the CRA attempted to deny the capital gains exemption in the *Canada–Luxembourg Tax Treaty* on treaty shopping grounds, but was not successful.

IFA 2012 TAX SEMINAR ROUNDTABLES

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On May 17, 2012, as part of the International Fiscal Association's ("IFA") (Canadian Branch) International Tax Seminar, officials from the Canada Revenue Agency (the "CRA") and the Department of Finance ("Finance") participated in roundtable discussions providing updates in respect of various tax matters. This article summarizes some highlights from those discussions.[1]

Beneficial Ownership

The issue of "treaty shopping" (i.e., utilizing an international structure with a view to securing treaty benefits in a third country) is relevant to tax administrations around the world. In the absence of limitations on benefits provisions in an applicable bilateral income tax convention, a challenge to a structure viewed as entailing "treaty shopping" may be grounded in the position that the recipient of an amount is not the "beneficial owner" of such amount for the purposes of the relevant treaty. This challenge by the CRA has been front and centre in at least two tax cases: *Prévost*