TAX

From treaty shopping to FAPI and transfer pricing: Notable international tax cases

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Three decisions of the Federal Court of Appeal (FCA) released during the COVID-19 pandemic have caused renewed interest in certain fundamental aspects of Canada's international tax system. Two of these decisions will be before the Supreme Court of Canada (SCC) in 2021. As a result, these aspects of the tax system will be the subject of review and guidance from Canada's highest court next year.

In *Canada v. Alta Energy Luxembourg S.A.R.L.* (2020 FCA 43), the FCA concluded that the general anti-avoidance rule (GAAR) in the Income Tax Act (Tax Act) 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. In *Canada v. Loblaw Financial Holdings Inc.* (2020 FCA 79), the FCA concluded that the income earned by a Barbados subsidiary of the Canadian taxpayer was not foreign accrual property income (FAPI) and therefore

was not taxable in Canada. Finally, in *Canada v. Cameco Corporation* (2020 FCA 112), the FCA determined that the taxpayer's transactions with its Swiss subsidiary were on arm's length terms and, therefore, compliant with Canada's transfer pricing rules and their underlying policy.

The Crown has obtained leave to appeal both *Alta Energy* and *Loblaw* to the SCC. While the Crown is also seeking leave to appeal the FCA decision in *Cameco* to the SCC, it remains to be seen whether leave will be granted in a third tax case.

GAAR and tax treaties: *Canada v. Alta Energy Luxembourg S.A.R.L.*

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

Article 13(4)(a) of the Canada-Luxembourg income tax convention (the Can-Lux 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.

The Tax Court of Canada (TCC) found that the taxpayer was a resident of Luxembourg and that the Canco shares derived their value principally from immovable property in which its oil and gas exploration and production business was carried on. The TCC also concluded that the GAAR did not apply to deny the applicable treaty benefits. The Crown's appeal to the FCA related only to the GAAR.

On appeal, the FCA held that the object and purpose of the relevant provisions, including Article 13(4) of the Can-Lux Treaty, were fully reflected in the plain language of these provisions. The FCA also rejected the Crown's position that Article 13(4) effectively requires the taxpayer to have strong economic or commercial ties to Luxembourg, since the sole criterion to be eligible for the exemption is residence in Luxembourg, which turns on liability to tax.

The Crown was granted leave to appeal the FCA's decision on August 6, 2020. As such, in 2021, the SCC will have the opportunity for the first time to consider the application of the GAAR to a tax treaty.

Also, as the FCA observed, measures taken by the Department of Finance to curtail treaty shopping were not applicable to its decision (i.e., the OECD's multilateral instrument (MLI) was not in force in Canada or Luxembourg at the time) and may affect future transactions. The MLI became effective for Canada's tax treaties with many countries, including Luxembourg, (a) for withholding taxes on January 1, 2020, and (b) for other taxes (including capital gains taxes), for tax years beginning on or after June 1, 2020 (which, for calendar year taxpayers, would be January 1, 2021).

FAPI: *Canada v. Loblaw Financial Holdings Inc.*

The issue in this case was whether Loblaw Financial Holdings Inc. was taxable in Canada on approximately $475 million of income earned by its Barbados resident subsidiary, Glenhuron Bank Limited. The Minister of National Revenue (the Minister) assessed Loblaw on the basis that Glenhuron carried on an "investment business," as defined in subsection 95(1) of the Tax Act, and that its income was therefore FAPI. Under the FAPI regime, a Canadian resident taxpayer may be required to pay tax on certain (generally passive) income earned in a non-resident subsidiary. As an alternative to her primary assessing position, the Minister also relied on the GAAR.

Loblaw's position was that Glenhuron's business qualified for the financial institution exception to the "investment business" definition and, therefore, its income was not taxable in Canada. Loblaw also argued that the GAAR did not apply.

The TCC found that Glenhuron satisfied all but one of the conditions necessary to qualify for the financial institution exception – namely, the requirement to conduct business principally with arm's length persons. Glenhuron therefore could not benefit from the exception. The TCC nevertheless concluded in *obiter* that the GAAR did not apply because there was no avoidance transaction.

The TCC determined that a proper interpretation of the arm's length test in a banking context requires an examination of both the receipt and use of funds. The TCC also found that an unexpressed competition requirement in the arm's length component of the financial institution exception was relevant to its conclusion, and that this competition requirement justified an emphasis on the receipts side of the equation. The TCC therefore placed significant emphasis on Glenhuron's non-arm's length sources of capital, especially equity capital received from its shareholder.

In allowing Loblaw's appeal, the FCA found several legal errors in the TCC's decision.

Applying the plain meaning of the phrase "business conducted … with," the FCA held that the focus should be on business relationships, and not on receipts and uses. The determination of the "principal" conduct of a business is a factual analysis that looks to the income-earning activities which occupy the time and attention of employees engaged in the conduct of the business. The source of Glenhuron's capital was thus given little weight in considering whether its business activities were conducted principally with arm's length persons.

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In addition, the FCA concluded that the TCC had erred by reading an unlegislated requirement for competition into the financial institution exception. The FCA observed that courts must be cautious before finding an unexpressed legislative intention implicit in otherwise clear provisions of the Tax Act. The FCA also clarified that the purpose of a provision, as determined in the course of ordinary statutory interpretation, should not be conflated with the policy or underlying rationale of the provision, as determined in the course of conducting a GAAR analysis. These are distinctly different exercises.

Finally, while the FCA acknowledged the Crown's concern that Glenhuron's income would not be subject to tax in Canada, it observed that such concerns do

not enable courts to give statutory provisions a broader interpretation than they can reasonably bear. Gaps in legislation, if any, are for Parliament to address.

The Crown's application for leave to appeal the FCA's decision to the SCC was granted on October 29, 2020. Osler acts for Loblaw.

Transfer pricing: *Canada v. Cameco Corporation*

In this case, the Minister reassessed the Canadian taxpayer, Cameco Corporation (Cameco Canada), to include in its taxable income all of the uranium trading profits reported by its Swiss subsidiary (Cameco Europe).

Following a corporate reorganization, Cameco Europe earned profits from market sales of uranium purchased pursuant to contracts with Cameco Canada as well as with arm's length non-residents of Canada. Cameco Canada provided Cameco Europe with a number of services pursuant to an intercompany services agreement.

At trial, the Crown's primary argument was that Cameco's transactions were a sham and, in the alternative, that the transfer pricing provisions in section 247 applied. The TCC dismissed the suggestion that there was any sham and found that neither branch of the transfer pricing provisions supported an adjustment, as the transactions were commercially rational and undertaken on arm's length terms and conditions. The Crown did not pursue its argument concerning the allegation of a sham before the FCA and only relied on transfer pricing arguments, primarily the "recharacterization" branch of the provisions.

In upholding the TCC's decision, the FCA observed that the goal of Canada's transfer pricing provisions is to ensure that transactions between related parties are priced on arm's length terms and conditions. The provisions do not allow the Minister to pierce the corporate veil and reallocate profits from a subsidiary to a parent by applying the "recharacterization" rule in the transfer pricing provisions.

The FCA also affirmed that the recharacterization rule applies in very limited circumstances and not where hypothetical arm's length persons would have entered into the relevant transactions. It rejected the Crown's subjective test, which was based on whether the taxpayer would have entered into the particular transaction with an arm's length party.

The decision confirms that transfer pricing is fundamentally a factual exercise and that the object of the rules is satisfied when transactions are priced on market terms. The FCA characterized many of the Crown's arguments as indirect attacks on the TCC's factual findings, for which no palpable and overriding error was present.

The Crown applied for leave to appeal the FCA's decision to the SCC on October 30, 2020. Osler acts for Cameco.

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Concluding observations

In response to these decisions, the Canada Revenue Agency has publicly indicated that it is considering alternative assessing positions and approaches to litigation while the government considers legislative changes. The appeal

of the *Alta Energy* and *Loblaw* decisions to the SCC means that guidance from our highest court will be forthcoming on fundamental issues of international taxation, potentially paving the way for further change.

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