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Supreme Court of Canada hears Alta Energy appeal on benefits under tax treaties

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On March 19, 2021, the Supreme Court of Canada heard the appeal in *Canada v Alta Energy Luxembourg SARL*, a case in which the Crown took the position that the taxpayer had engaged in abusive "treaty shopping." The Supreme Court reserved judgment, meaning that its decision and written reasons will be released at a future date.

Background to the appeal

This was an appeal by the Crown from the decision of the Federal Court of Appeal (the FCA), which held that Canada's general anti-avoidance rule (the GAAR) did not apply where the taxpayer, a Luxembourg-resident company, relied on the tax convention between Canada and Luxembourg (the Treaty) to exempt a capital gain from Canadian income tax.

In brief, the FCA found that the purpose of the relevant Treaty provisions was clear from its text and that the Treaty benefit (in this case, 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 Treaty. The FCA declined to read in additional requirements not grounded in the text and that could in theory preclude certain residents from obtaining Treaty benefits.

In so doing, the FCA upheld the decision of the Tax Court of Canada (the TCC). Among other conclusions, the TCC had similarly determined that the GAAR did not apply and that the taxpayer was entitled to the Treaty exemption.

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

Relevant facts and procedural history

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), 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 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 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 benefit. The Crown's appeal to the FCA related only to the GAAR.

The FCA upheld the conclusion of the TCC that the GAAR did not apply.

Arguments before the Supreme Court

On appeal to the Supreme Court, the Crown took the position that the FCA had erred in its application of the GAAR, having restricted its analysis to the text of the relevant Treaty provisions. The Crown argued that the policy or underlying rationale 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 nevertheless argued that the taxpayer had limited "economic or commercial ties" to Luxembourg and therefore had engaged in "treaty shopping," contrary to the policy of the Treaty provisions on which it relied. Finally, the Crown argued that the FCA's emphasis on the text "rendered the GAAR largely inapplicable to Canada's tax treaties."

In response, the taxpayer argued that the underlying rationale 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 the treaty partners. The taxpayer also argued that, in seeking to have the GAAR applied, the Crown was effectively adding an unexpressed condition to the test for residency under the Treaty.

Themes from the hearing

A number of broad themes can be gleaned from the questions posed by the Supreme Court during the hearing.

First, the Supreme Court sought to understand whether the Crown was arguing that the so-called "economic connection" condition is *a part of* the residence test (i.e., such that if there was insufficient economic connection, the taxpayer would not be a resident for purposes of the Treaty in its entirety), or *an additional requirement* for obtaining benefits, over and above being a resident as defined in the Treaty. The Crown clarified that it was not challenging the residence of the taxpayer for purposes of the Treaty, but that in its view the GAAR required the Supreme Court to "go beyond" the residence determination.

Second, with respect to the Crown's argument that the FCA's interpretation of the GAAR "rendered the GAAR largely inapplicable to Canada's tax treaties," the Supreme Court asked counsel for both parties how, under the FCA's interpretative approach, the GAAR might in theory apply to the provisions of a tax treaty. The Supreme Court sought to understand the circumstances in which the policy of the Treaty provisions might depart from what is expressed in the text, such that the GAAR could apply. A number of hypothetical examples were discussed.

In our view, the FCA's decision would not render the GAAR meaningless. For example, the GAAR could potentially apply to a particular transaction or series of transactions where its

application would not materially alter the conditions of a fundamental cornerstone of a tax treaty such as residence. It seems reasonable to conclude that, regardless of the outcome of this appeal, there are circumstances in which the GAAR could apply to the provisions of Canada's tax treaties.

Third, some members of the Supreme Court suggested that an examination of the policy of Treaty provisions requires an analysis of the intention of *both* treaty partners. In this case, it is difficult to accept that Luxembourg intended that the benefits of the Treaty would not be available to Luxembourg holding companies that were owned by persons who were not residents of Luxembourg. Furthermore, the Supreme Court referenced certain observations made by the Tax Court to the effect that parties to a tax treaty are presumed to know the other country's tax system when they negotiate a tax treaty and that, if Canada had wished to limit Treaty benefits in certain circumstances, it could have insisted on doing so in the Treaty itself (similar to what Canada has done in certain other tax treaties — such as Canada's tax treaty with the United States).

Finally, the Supreme Court observed that the Multilateral Instrument (the MLI), which applies to various tax treaties (including the Treaty), did not apply to the transactions in question and that its application was not retroactive. Among other items, the MLI contains a "principal purpose test" that may deny a treaty benefit to a party who engages in an arrangement or transaction for a principal purpose of obtaining such benefit, unless such benefit is in accordance with the object and purpose of the treaty provisions.

The MLI became effective for Canada's tax treaties with many countries, including Luxembourg for withholding taxes on January 1, 2020, and 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).

In referring to the MLI, the Supreme Court seemed to echo similar comments made by the FCA, which signalled the possibility of a different analysis where the transactions would be entered into following the coming into force of the MLI. It remains to be seen whether the Supreme Court will provide guidance on the potential application of the GAAR in such circumstances.

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