

Mar 1, 2021

Continued uncertainty following recent CRA position on Tax Treaty anti-avoidance rule

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The *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* [PDF] – also known as the Multilateral Instrument or MLI – entered into force for Canada on December 1, 2019. As a result, the MLI entered into effect for Canada’s tax treaties with many countries on January 1, 2020 for withholding taxes, and for other taxes (including capital gains taxes), for taxation years beginning on or after June 1, 2020 (i.e., January 1, 2021 for taxpayers with a calendar taxation year). The MLI may enter into effect at a later date for Canada’s tax treaties with countries that have not completed their domestic procedures to cause the MLI to come into effect.

The most significant treaty modification implemented through the MLI was the addition of a broad anti-avoidance rule known as the principal purpose test or PPT into Canada’s Covered Tax Agreements (which includes 84 of Canada’s 93 tax treaties, as listed [here](#) [PDF]). Under the PPT, a treaty benefit may be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain such benefit, unless it is established that granting the benefit would be in accordance with the object and purpose of the relevant treaty provision. The broad wording of the PPT, together with limited interpretive guidance to date, results in significant uncertainty as to whether treaty benefits will continue to apply in a variety of situations. In addition, the CRA indicated at the 2019 Canadian Tax Foundation (CTF) Conference that it may look to apply the PPT and Canada’s domestic general anti-avoidance rule (GAAR) as alternative assessing positions, which could substantially and unnecessarily increase uncertainty and litigation costs.

CRA PROVIDES LIST OF RELEVANT QUESTIONS IN APPLYING THE PPT

At the 2020 CTF Conference, the CRA stated that it had not yet been asked to provide any advance income tax rulings on the application of the PPT, and that the CRA has not yet audited taxation years in which the changes to tax treaties introduced by the MLI are in force and effect.

The CRA acknowledged that there is concern about the uncertainty surrounding the potential application of the PPT. The CRA stated that in determining whether any arrangement or transaction has, as one of its principal purposes the obtaining of a treaty benefit, the CRA would seek to ask a number of questions, including:

- What are the direct and indirect results of the arrangement?

- What are the terms of the arrangement and do they lead to its results?
- What actions were undertaken to carry the arrangement into effect?
- What do the circumstances surrounding the arrangement, the way in which it was implemented, as well as its terms, indicate about the arrangement and its intended results?
- Could the non-tax objectives of the arrangement be achieved some other way? If so, is the arrangement more complex, more costly (not considering the tax benefit), or contain more steps than is necessary to achieve the non-tax objectives?
- Does the arrangement entail the use of hybrid entities, flow-through arrangements, or back-to-back transactions?
- Does the arrangement involve a change of residence or applicable tax convention?
- What are the non-tax benefit purposes for establishing each of the relevant entities or actions in each relevant jurisdiction?
- Is the existence of any entity or action in the arrangement explainable only if it is principally concerned with obtaining the relevant benefit?
- Absent any tax benefit, are there quantifiable financial benefits arising from the arrangement?
- Is there a discrepancy between the substance of what the arrangement achieves and its legal form?
- Does the arrangement result in a change in nature of payments?
- Does the arrangement result in the avoidance of a specific taxing rule? For example, does it avoid the existence of a permanent establishment or to avoid a test which would otherwise limit access to a benefit?

The CRA's list of questions provides an indication of the type of facts that the CRA would consider in deciding whether to assess under the PPT, but does not provide any certainty about how the CRA would weigh these factors in applying the PPT. The CRA acknowledged that the application of the PPT is highly fact-dependent, and it is unclear whether the CRA views these questions as equally important or whether it views some questions as more important than others. Some of the questions listed by the CRA are purely mechanical – e.g., the use of hybrid entities, flow-through arrangements, back-to-back transactions, change of residence, and change in nature of payments. These facts may be present in a large number of transactions and structures that do not involve a principal purpose of obtaining treaty benefits, and may be implemented for a variety of commercial, regulatory, or other non-tax considerations. On the other hand, certain other questions posed by the CRA appear to be focused on the presence of certain non-tax objectives and benefits of the arrangement. This suggests that it would be helpful for taxpayers to clearly document any other considerations and benefits of any cross-border arrangements that result in benefits under a Covered Tax Agreement.

The CRA's list of questions is focused solely on the factual question of whether one of the principal purposes of an arrangement or transaction is to obtain a treaty benefit. However, even if such a principal purpose exists, the PPT would not apply if it is established that granting the treaty benefit in question is in accordance with the object and purpose of the relevant treaty provisions. The CRA did not address this issue in its list of questions. However, the CRA indicated that it would look to the examples included in the Commentaries to the OECD Model Tax Convention for assistance in interpreting and applying the PPT. In contrast to the guidance provided by CRA, those examples are specifically grounded in the different components of the PPT, which contains a number of terms/conditions that analytically ought to be addressed separately. In particular, a more methodical approach to interpreting the PPT (having regard to its text, context and purpose) could involve the following steps:

- **Step 1** – Identify the particular tax benefit otherwise available under a Treaty, and the relevant

- “arrangement or transaction” being considered to have given rise to it.
- **Step 2** – Determine whether the particular tax benefit resulted “directly or indirectly” from the arrangement or transaction.
 - **Step 3** – Determine any other reasons for the arrangement or transaction that resulted in the tax benefit.
 - **Step 4** – compare/weigh the various reasons from step 3 to the obtaining of the tax benefit, and determine whether it is reasonable to conclude that obtaining the tax benefit was one of the principal purposes of the arrangement or transactions. (If no, then the PPT does not apply.)
 - **Step 5** – Determine whether the granting of the tax benefit in the circumstances is in accordance with the object and purpose of the Treaty. (If yes, then the PPT does not apply.)

The examples in the OECD Commentaries address specific steps in the PPT analysis, illustrating such things as: the meaning of the types of treaty relief that count as a “benefit” in Step 1; circumstances in which such a benefit results “indirectly” from a transaction or arrangement in Step 3; the scope of the term “arrangement or transaction” in Step 1; and nuances in the “one of the principal purposes” condition in Step 4 where multiple treaties are being accessed or where the obtaining of treaty benefits co-exists with (non-treaty related) avoidance of domestic law. Moreover, a number of those examples address the issue of whether granting a treaty benefit in certain scenarios is in accordance with the object and purpose of the relevant treaty provisions. Notable among these are examples that accord due weight to commercial motivating factors, such as the following:

RCO, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.

In addition to finding that obtaining treaty benefits is not one of the principal purposes in the above circumstances (Step 4), the OECD concludes (under Step 5) that in any event “given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.”

The OECD presents a number of other examples involving the availability of a treaty benefit as a favourable consideration taken into account in entering into an arrangement or transaction, but where either obtaining the benefits is not one of the principal purposes or if it is, then granting the benefit is for specified reasons in accordance with the object and purpose of the provisions of the particular treaty. These examples show that performing the Step 5 analysis requires taking into account the commercial and operational efficiency reasons for an arrangement or transaction and giving weight to those reasons in furthering pro-trade/investment objectives of tax treaties.

It would be helpful if, in addition to providing a list of questions, the CRA in the future could provide examples that illustrate how to apply different conditions in the PPT, including the weighing exercises involved at Steps 4 and 5 (particularly since it will often not be readily apparent whether a particular consideration may be of sufficient importance to be considered a “principal purpose”).

THE PPT AND THE GAAR

The CRA referred to its prior statements at the 2019 CTF Conference, which described a plan to set up a Treaty Abuse Prevention Committee (TAP Committee) to provide recommendations to the CRA on the administration of the GAAR in a tax treaty context and “of the general anti-avoidance rule introduced by the MLI.” The CRA also stated that its list of questions (described above) may also be relevant in respect of the GAAR for taxation years currently audited. These statements by the CRA appeared to recognize a form of equivalence between the PPT and the GAAR. However, the CRA did not clearly describe its view on how the PPT and the GAAR should interact.

The analysis under the PPT is very similar to the analysis under the GAAR. Both tests require:

- identifying an arrangement, transaction, or series of transactions that resulted in a tax benefit;
- ascertaining the purpose of the relevant arrangement or transactions (i.e., whether there was an avoidance transaction under the GAAR, or whether one of the principal purposes of the transaction or arrangement was the obtaining of a tax benefit under the PPT); and
- determining whether the granting of the tax benefit is in accordance with the object, spirit and purpose of the relevant treaty or legislation (i.e., whether there was a misuse or abuse for purposes of the GAAR).

Therefore, for taxation years in which the MLI is in effect, it should generally be unnecessary for the CRA to ever assess a taxpayer under both the PPT and the GAAR (where the potential GAAR challenge is based on a misuse or abuse of a provision in a Covered Tax Agreement). If the PPT applies to an arrangement or a transaction, then there would be no benefit under the relevant tax treaty for the GAAR to apply. If the PPT does not apply – either on the basis that none of the principal purposes of the transaction was to obtain the treaty benefit, or that granting the tax benefit is in accordance with the object and purpose of the relevant treaty provision – then the GAAR also should not apply, either on the basis that there was no “avoidance transaction” or no “misuse or abuse.” Therefore, an alternate assessment under the GAAR in these circumstances will likely be of limited value and would only serve to increase uncertainty and litigation costs.

As a result, it would be helpful for the CRA to indicate that in taxation years in which the MLI is in effect, the CRA would generally not seek to apply both the PPT and the GAAR to the same treaty benefit, and would instead focus on examining the application of the PPT.

For further background on the MLI, see our Osler Updates [“Multilateral Instrument \(MLI\) will enter into force for Canada on December 1, 2019,”](#) and [“New PPT rule in the OECD’s Multilateral Instrument to displace Canadian GAAR?”](#).

For further information on the MLI, the PPT or other tax matters, please contact any member of our [National Tax Group](#).

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