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Treaty exempt gain by Luxembourg holding company upheld by Federal Court of Appeal

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In *Canada v Alta Energy Luxembourg S.A.R.L.*,[1] the Federal Court of Appeal (FCA) confirmed there was no abusive tax avoidance under Canada's general anti-avoidance rule (GAAR) 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.[2] The FCA found a clear policy in the text of the Treaty, such that it should apply to all residents of the contracting states, and refused to read in additional requirements that would preclude certain residents – such as those with weak commercial or economic ties to the residence country – from obtaining Treaty benefits.

The salient facts for the purpose of the appeal may be summarized as follows:[3]

- The taxpayer was a company incorporated and resident in Luxembourg, all the shares of which 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 in 2012.
- 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.
- In 2013, the taxpayer sold the shares of Canco, realizing a capital gain of over $380 million.

The taxpayer relied on certain Treaty provisions to exempt the gain on the Canco share sale from being taxable in Canada, the effect of which the FCA succinctly summarized as follows:

> [47] Articles 13(4) and (5) of the Luxembourg Convention provide that a person who has sold shares of a private Canadian corporation that comprise part of a substantial interest (i.e. 10% or more) of the shares of any class of that corporation will not be subject to tax in Canada on the gain realized on such disposition, if the following conditions are satisfied:

1 2020 FCA 43, aff'ing *Alta Energy Luxembourg S.A.R.L. v The Queen,* 2018 TCC 152.

2 Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital.

3 We have previously discussed the facts of the case and the decision of the Tax Court of Canada allowing the taxpayer's appeal from the Minister of National Revenue's reassessment in a 2018 publication [PDF].

(a) the person is a resident of Luxembourg; and

(b) the value of those shares is derived principally from immovable property (other than rental property) in which the business of the corporation is carried on.

In the decision under appeal, the Tax Court 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 Tax Court also concluded that GAAR did not apply to deny the applicable Treaty benefits.

The Minister of National Revenue's (the Minister) appeal to the FCA related only to GAAR, and specifically to whether one of the three conditions for GAAR's application, that is, abusive tax avoidance, was present.[4] Abusive tax avoidance requires first, identifying the "object, spirit, and purpose"—or the underlying policy—of the provisions giving rise to the tax benefit, which is discerned through a textual, contextual and purposive analysis of the provisions that have been relied upon or circumvented, as the case may be; and second, determining whether, in light of that object, spirit and purpose, the transactions resulted in an abuse of those provisions.

The FCA reduced the Minister's arguments about the Treaty provisions and their underlying policy to three main contentions. According to the Minister, the Treaty provisions were intended only to benefit:

1. Luxembourg *investors*, and not just a holding company resident in Luxembourg;

2. entities who have the *potential to realize income* in Luxembourg; and

3. entities who have *commercial or economic ties* with Luxembourg.

The FCA rejected all of these arguments for the same principal reason that there was no support for them in the text, context and purpose of the Treaty provisions. Instead, the FCA found that the rationale for the Treaty provisions was embodied in the words of the Treaty that Canada and Luxembourg had agreed upon, and specifically the definition of "resident:"

> [62] There is no basis to find that the rationale for the definition of "resident" would suggest that any criteria other than the criteria included in the definition of resident in Article 4, should be used to determine if a person is a resident of Luxembourg for the purposes of the Luxembourg Convention.

In reaching this conclusion, the FCA commented on the practical difficulties of examining the source and quantum of each resident's investment, and that it would be improper to create different classes of residents (e.g., those with strong economic ties versus those with weak ties) to distinguish who should be allowed to rely on the Treaty and who should not.

The Minister also argued that it would be improper to grant Treaty benefits to the taxpayer, given the fact that the partners of the partnership holding the shares of the taxpayer were generally resident outside Luxembourg. The FCA characterized such an approach as "pierc[ing] the corporate veil," which it declined to do based on similar reasoning that the text of the Treaty did not call for this type of inquiry.

Finally, the FCA considered the Minister's suggestion that GAAR should limit taxpayer behaviour that amounts to "treaty shopping." The FCA cited the reasoning from *MIL (Investments) SA*,[5] where the Tax Court commented that selecting one tax jurisdiction over another was relevant only to whether there was an avoidance transaction under GAAR, not whether there was abusive tax avoidance.

4 The taxpayer conceded that there was a tax benefit and an avoidance transaction, the other two criteria for GAAR to apply.
5 *MIL (Investments) SA v The Queen*, 2006 TCC 460.

In short, the FCA found that the Minister failed to identify an underlying rationale or object, spirit and purpose of the Treaty provisions in question that was abused by the taxpayer availing itself of the exemption provided under those provisions to Luxembourg Treaty residents.

Despite the comments from *MIL* and no finding that there was abusive treaty shopping in this case, the FCA signalled the possibility of a different result where transactions are entered into in today's treaty environment, i.e., after Canada has signed onto international measures to limit treaty shopping:

> [77] The Tax Court Judge also referred to the steps that the Department of Finance indicated that it would be taking to curb treaty shopping. However, there were no steps that were taken prior to the transactions in this case. Any actual steps that were taken after the transactions in this case were completed, or that may possibly be taken in the future, are not applicable in this case but may have an impact on future transactions.

Given that the taxpayer disposed of its Canco shares in 2013, the Multilateral Instrument (MLI)[6] was not in force at the relevant time. The MLI generally sits alongside and modifies tax treaties of signatory states, including by adding express reference to treaty shopping in the affected treaties' preambles,[7] as well as 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.[8]

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).

For additional discussion of the MLI, please see our Osler Update, "Multilateral Instrument (MLI) will enter into force for Canada on December 1, 2019." For a recent list of signatory jurisdictions and the status of their adoption of the MLI, please see the OECD's February 14, 2020 publication. For further information on the *Alta Energy* case, the potential application of GAAR, the MLI, the PPT or other tax matters, please contact any member of our National Tax Group.

6 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Based Erosion and Profit Shifting.
7 Article 6 of the MLI.
8 Article 7 of the MLI.