TAX EXECUTIVES INSTITUTE, INC.

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To whom it may concern:

On August 14, 2013, the Department of Finance launched a consultation on treaty shopping in Canada. A position paper, *Treaty Shopping — The Problem and Potential Solutions*, was released describing the perceived problem and outlining a range of approaches that the Canadian government might undertake to address the practice of treaty shopping. In addition, the paper highlights Canada Revenue Agency's (CRA's) efforts to curb treaty shopping under current rules. Finally, the paper sets forth a series of questions and issues on which the Government of Canada is soliciting stakeholder input. On behalf of Tax Executives Institute (TEI), I am pleased to provide the following comments on the Department's consultation on treaty shopping and how the government might address it.

Background on Tax Executives Institute

TEI is the preeminent international association of business tax executives. The Institute's 7,000 professionals manage the tax affairs of 3,000 of the leading companies in North America, Europe, and Asia. Canadians constitute nearly 15 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver. TEI members must contend daily with the planning and

compliance aspects of Canada's business tax laws, including its treaties. Many of our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities and investments in Canada. The comments set forth in this letter reflect the views of TEI as a whole, but more particularly those of our Canadian constituency.

TEI concerns itself with important issues of tax policy and administration and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit. In furtherance of this goal, TEI supports efforts to improve the tax laws and their administration at all levels of government. We believe that the diversity, professional training, and global viewpoint of our members enable us to bring a balanced and practical perspective to the issues raised by the consultation on treaty shopping.

Consultation Background

As defined in the consultation paper, "treaty shopping" refers to a situation where a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits. Canada has found treaty shopping where *all* the following circumstances exist:

- An entity ("intermediary entity"), resident in a country with which Canada has a tax treaty, claims the application of the tax treaty to obtain a reduction of Canadian tax otherwise payable on income earned in Canada;

- The intermediary entity is owned or controlled mainly by residents of another country which are not entitled to at least the same treaty benefits ("third country residents");

- The intermediary entity pays no or low taxes in its country of residence on the item of income earned in Canada (taking into account deductible amounts paid to third country residents and other relevant aspects of the tax system in the country where the intermediary is resident); and

- The intermediary entity does not carry on real and substantial business activities (other than managing investment income) in its country of residence.

Where this combination of circumstances is found, the paper avers, there is strong evidence that one of the main purposes of the intermediary entity is to receive income on behalf of third-country residents. Canada believes it would be justified in denying tax treaty benefits because the benefits are claimed by an intermediary entity lacking economic substance and a *bona fide* purpose and the ultimate beneficiaries are third-country residents not entitled to claim the benefits directly. The balance of the paper discusses whether rules to combat treaty shopping should be part of Canada's treaties or domestic laws and whether the rules should be general or specific.

General Comments

Treaty Limitation on Benefit Provisions Should be the Favoured Approach Rather Than Domestic Legislation. The threshold question posed by the consultation paper is whether treaty shopping rules should be included in Canada's domestic tax laws or whether Canada should continue to negotiate treaty-based rules. On a first principles basis, TEI believes that a treaty-based response to the perceived problem of treaty-shopping is the better approach. Treaties are agreements entered into between the countries after an extended course of detailed negotiations. Hence, the conditions that either or both countries consider *abusive* of the treaty can and should be defined through a limitation on benefits (LOB) provision in that treaty.

The consultation paper avers, and subsequent conversations with Department of Finance officials confirm, that the Department is concerned that the negotiation or re-negotiation of Canada's tax treaties may require a substantial period of time and resources or may not be possible at all without the cooperation of Canada's treaty partners. Hence, the paper implies that it may not be possible to implement a treaty-based approach on a timely basis and domestic legislation may be the preferred approach.

TEI believes that domestic anti-abuse legislation is a blunt instrument that is simultaneously over- and underinclusive in scope. As a result, while a treaty-based approach may not be as timely or as easy to implement as domestic legislation, we believe it will be the *most effective* approach and will result in fewer disputes than an anti-abuse legislative provision, thereby reducing administrative costs for taxpayers and the government alike. The United States has been in the forefront of countries negotiating LOB provisions in its treaties. While the approach has taken years to implement and there have been several iterations of the U.S. model treaty (and the LOB provision within the model treaty), the treaty-based approach has generally been effective in curtailing abuses of U.S. treaties. As important, while the U.S. model treaty sets forth a standard LOB provision, the actual LOB provision in most treaties is tailored to the legal standards, business conditions, and circumstances of the negotiating countries. Thus, we believe the better course is to define in each treaty the conditions that warrant denial of the specific treaty's benefits.

Notwithstanding our primary recommendation, the comments that follow recognize the Department may seek a rapid and expedient solution through enactment of domestic legislation. Our comments in respect of that approach, however, should not be construed as support for such a solution over the more targeted approach of LOB clauses in particular treaties.

Unilateral Approach Should Be Eschewed in Favour of a Multilateral Approach. Recommendations to address the broader issue of "treaty abuses," including treaty shopping, are part of the Base Erosion and Profit Shifting (BEPS) action plan of the Organisation for Economic Co-operation and Development (OECD). Item number 6 of the BEPS Action Plan calls for recommendations to be released by September 2014. TEI believes the OECD should be afforded an opportunity to complete its study and make recommendations for multilateral action by OECD countries before concrete, unilateral steps are taken by Canada. Otherwise, Canada's

prescriptions may be out of step with the OECD recommendations, thereby adversely affecting Canadian taxpayers and diminishing foreign direct investment in Canada. Indeed, unilateral actions by various jurisdictions to address the perceived problems identified in the OECD's BEPS paper and action plan pose great risk of engendering multiple taxation of business profits precisely because they are uncoordinated and lack consensus among the various jurisdictions. Finally, the high-profile nature of the BEPS project and the attendant international co-operation the project has engendered to combat abusive tax planning and avoidance may persuade Canada's treaty partners to move quickly in negotiating treaty LOB provisions. Hence, the consultation paper's concerns about an LOB approach producing an untimely result may be misplaced.

Evidence of the Scope and Degree of Treaty Abuse in Canada is Inconclusive. The consultation paper offers anecdotal and indirect evidence in two tables that attempt to illustrate the potential scope of treaty shopping problems in Canada. The paper, however, acknowledges that current statistical measures fail to "distinguish indirect investment through intermediaries from direct investment," and that it is "even more difficult to separately identify . . . indirect investment for [legitimate] tax planning purposes."[1] Before implementing concrete legislation that may impair foreign direct investments and conflict with the OECD's BEPS recommendations, TEI urges the Department to conduct a comprehensive study of the scope and extent of treaty shopping in Canada and, as important, *quantify* the perceived fiscal loss.[2] Implementing a legislative solution before knowing the scope of the problem may cause the remedy to be simultaneously over- and under-inclusive and thus be both wholly ineffective and impair legitimate investments.

The balance of TEI's comments address the specific questions raised in the consultation paper.

Question 1 – *The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.*

As noted in the general comments, TEI prefers a treaty-based approach that is implemented on a treaty-by-treaty basis. The consultation paper suggests that the Department is concerned that implementing a treaty-based approach would require too many resources and take longer than the Department would prefer. As a result, domestic legislation may be used as a primary countermeasure.

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[1] Our insertion of the word "legitimate" in the quotation from the consultation paper is deliberate. The paper notes that "distinguishing between acceptable uses of a tax treaty and treaty shopping can be difficult given the complexity of international transactions and the increasing sophistication of international tax planning." We agree. Hence, we assume that taxpayers may plan their international investments taking account of treaties in the same way that they take account of domestic tax laws. The principal aim of the consultation is presumably to curb abuses or unintended applications of treaty provisions through treaty shopping.

[2] Canada has concluded nearly 100 tax treaties, many with reduced withholding tax rates. The ultimate shareholders or beneficiaries of many intermediary companies may well be resident in treaty countries with comparable reduced tax rates so the fiscal loss from treaty shopping may be insignificant.

In the event a domestic law approach is used to curb treaty shopping, the legislation must be straightforward, easy to apply, narrow in scope, and produce predictable results. A broad, unfocused anti-abuse rule would create uncertainty for taxpayers and increase the degree, scope, and magnitude of controversies between taxpayers and CRA. Indeed, among global jurisdictions with a general anti-avoidance rule (GAAR), Canada has one of the broadest in section 245 of the *Income Tax Act*. The consultation paper notes that CRA's attempts to challenge treaty shopping under GAAR have been inconclusive and suggests that Canadian courts may require further legislative direction. We are not persuaded that the current GAAR provision is ineffective nor are we persuaded that another broad anti-abuse rule in the Act would make CRA more effective in curbing treaty shopping. Indeed, what the courts may require is an *explicit and narrow* definition, preferably set forth in treaties, of what constitutes *abusive* treaty shopping rather than another broad general anti-avoidance rule. As important, an overbroad law may adversely affect direct foreign investment into Canada and, ultimately, have a deleterious effect on the Canadian economy, especially in the mining and natural resource sectors.

As a preliminary step, and to reduce challenges to immaterial transactions, a *de minimis* threshold amount should be established (*e.g.*, a safe harbour) below which CRA would not raise challenges based on abuse of a treaty. For example, the commercial laws of many countries require companies to have a minimum number of shareholders, and company officers or other entities within a corporate group often serve as nominee shareholders. Dividends paid on nominal shareholdings should not be considered abusive where held by intermediary companies. Incorporating a *de minimis* rule in the anti-treaty-shopping provision would permit companies and CRA to effectively manage scarce resources.

A domestic law approach should also be based on objective factors. Thus, treaty shopping should be found to exist only where *all four* of the following factors are present:

- A claim for the application of the tax treaty to obtain a reduction of Canadian tax otherwise payable on income earned in Canada has been made in excess of a *de minimis* amount (*i.e.*, the safe harbour threshold that TEI recommends be established);

- The intermediary entity is owned or controlled by residents of another country that are not entitled to at least the same level of treaty benefits;

- The intermediary pays no or low taxes in its country of residence on the item of income earned in Canada;[3] and

[3] We note that the low- or no tax threshold must be carefully delineated. A number of countries with low tax rates, such as Hong Kong and Singapore, have concluded treaties with Canada. An intermediary company may be established in such a country for the ultimate beneficial owners resident in that country. The use of such intermediaries to obtain the treaty's benefits should *not* be considered treaty shopping because there is likely no "abuse" of the treaty. For a series of examples where Canada's current LOB provisions (or a new domestic legislative provision curbing treaty shopping) can go too far in limiting inbound investments from treaty countries in non-abusive situations *see* Wilson, Jim, and Koh, Eric, *New Limitation on Benefits Provisions in Canada's Tax*

- The intermediary does not carry on real or substantial business activities in its country of residence.

Even where all four factors are present, taxpayers, upon request, should be able to invoke an administrative review process to determine whether an abusive treaty-shopping motivation exists. Auditors for CRA should not be given unbridled authority to challenge and disallow treaty benefits. A domestic law administrative proceeding might be modeled on the Competent Authority review process that is currently available under the Canada-U.S. treaty for determining whether that treaty's LOB provision should be applied.

In addition to adopting an administrative review process, the legislation should include a relieving provision, which should apply in the following circumstances:

- The intermediary is listed on a prescribed stock exchange in the contracting countries or is a subsidiary of a listed company;

- The taxpayer can demonstrate that there is no treaty-shopping motivation or there is a clear business reason for the existence of the intermediary company;

- No tax benefit has been received or the tax benefits received are less than a *de minimis* amount (*e.g.*, a safe harbour).

- An administrative review process (with discretionary authority afforded by the legislation) concludes that there is no abusive treaty-shopping motivation.

In addition, if a domestic legislative approach is used, we recommend that all existing investments be grandfathered. CRA should not be permitted to challenge every single investment made into Canada on a retrospective basis. Taxpayers should be permitted to make their investment and structuring decisions based on the law in effect at the time the investment is made. Moreover, the implementation period should allow time for new investors to respond to the changes in domestic law. Hence, TEI recommends a delayed implementation date of at least three years.

Finally, a domestic legislative approach will require a tie-breaker rule to determine whether the domestic law or treaty applies when a transaction is covered by both an LOB and the domestic rule. Indeed, one of the primary disadvantages of a domestic law solution to curb treaty shopping is that Canada's treaty partners may view Canada as an unreliable negotiating partner if the domestic legislation overrides a specific LOB or other explicitly negotiated treaty provision. To minimize treaty overrides, we recommend that any specifically negotiated LOB provision trump a domestic anti-treaty shopping rule. Thus, the domestic legislation should

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Treaties – A Step Too Far? (July 2013), available as of December 2013 on the website of the Gowlings law firm at http://www.gowlings.com/KnowledgeCentre/article.asp?pubID=2955&lang=0.

recede in application in any instance where the transaction is subject to an LOB provision, such as that in the Canada-U.S. treaty.

Question 2 – *The Government invites stakeholders' comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping.*

As noted in our general comments, treaty abuse, including treaty shopping, is one of the targeted agenda items under review by the OECD as part of its BEPS action plan. Hence, the OECD's current guidance to Member States may well be revised as part of this initiative. Since Canada is an active participant in the BEPS workgroups, it will be able to significantly influence the recommendations ultimately adopted. We suggest that it may be premature for Canada to take action before the OECD reaches consensus and releases its recommendations for all participating countries. Indeed, Canada may undermine its position during the BEPS discussion if it moves forward with domestic legislation before a consensus on coherent international tax principles is achieved.

Question 3 – *The Government invites stakeholders' views on whether a general approach is preferred over a relatively more specific and objective approach.*

A specific and objective approach is preferred over a general approach since a general approach might be misinterpreted by CRA and thus misapplied in many circumstances that were not intended.[4] Consultations between industry groups and the Department of Finance about seemingly narrow proposed legislative provisions often demonstrate that proposed legislation is much broader and thus farther reaching in application than intended. Where a vague, general anti-abuse or "main purpose" approach is adopted, the principal result is to create uncertainty. Taxpayers, especially public corporations, prefer objective and specific laws to create a more certain environment. Moreover, if anti-treaty-abuse legislation is introduced, the Government should repeal the current rules prescribing the application of GAAR rules to treaties.[5] Having two overlapping and potentially conflicting anti-abuse regimes applicable to the same transaction or structure will create inordinate complexity and confusion for taxpayers and CRA.

Question 4 – *The Government invites stakeholders' views on whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.*

[4] Consequently, TEI's recommendation for a "specific" LOB provision would be preferred to a "general" anti-abuse rule in a treaty or domestic legislation.

[5] The 2004 Budget clarified, by way of amendments to the GAAR in subsection 245(4) of the *Income Tax Act* and the introduction of section 4.1 of the *Income Tax Conventions Interpretation Act*, the intended application of GAAR to tax treaties.

TEI believes that a main purpose test would lead to far too much uncertainty for taxpayers and dramatically increase the scope, degree, and magnitude of disputes between taxpayers and CRA. Even though sixteen of Canada's treaties have adopted a main purpose approach to limit treaty shopping for limited classes of Canadian source income (*e.g.*, dividends, interest, and royalties), we recommend revisiting that approach in favour of more objective criteria.

Question 5 – *The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration.*

TEI believes that a more specific approach coupled with relieving provisions and safe harbours would strike the best overall balance between effectiveness, certainty, predictability, simplicity, and ease of administration.

Regardless of the approach taken by the Department, there should be a provision to afford "discretionary authority to the Minister of National Revenue to grant treaty benefits in appropriate circumstances," as described in TEI's response to Question 1. CRA agents should not be permitted to deny treaty benefits without a high level of internal review, preferably in consultation with the competent authority of the treaty country that is purportedly being abused.

Question 6 – *For stakeholders who favour a more specific approach over a main purpose approach, the Government invites input on the design of the conditions and the exceptions (e.g., the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach with a view to ensuring the measure is effective and applies in a reasonably straightforward manner with predictable outcomes.*

TEI's response to Question 1 addresses this question. Briefly summarized, our points are (1) all four conditions identified in the consultation paper for treaty shopping must be present before a taxpayer should be considered to have engaged in treaty shopping; (2) even where the four conditions are present, there must be relieving provisions for non-abusive structures and exemptions, such as for public companies and their subsidiaries or where the treaty benefits afforded to the ultimate beneficiaries resident in a third country are no greater than the benefits accorded directly under the treaty between Canada and the beneficiaries' home country; and (3) an administrative proceeding should be available to provide a taxpayer with an opportunity to demonstrate that there is no misuse or abuse of a treaty.

Question 7 – *The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.*

As noted in response to Question 1, a domestic anti-abuse rule should recede where a treaty contains an LOB provision. As noted in response to Question 3, the GAAR provision in

section 245 should not apply where an alternative anti-abuse rule applies. Having overlapping anti-abuse rules apply to the same transaction is confusing and creates extraordinary complexity for taxpayers and CRA to apply.[6]

Conclusion

TEI's comments were prepared under the aegis of its Canadian Income Tax Committee, whose chair is Bonnie Dawe of Finning Corporation. Should you have any questions about TEI's comments, please feel free to contact Ms. Dawe at 604.331.4864 (or bonnie.dawe@finning.com) or Shiraz J. Nazerali, TEI's Vice President for Canadian Affairs, at 403.213.8125 (or shiraz.nazerali@dvn.com).

Respectfully submitted,

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International President

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[6] If a new domestic anti-treaty shopping domestic provision were adopted, three sets of anti-abuse rules might potentially apply simultaneously to any cross-border transaction: the new rule, the current general GAAR rule, and the main purpose rule already included in some of Canada's treaties (which may be added to future treaties).