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Tax Minimization is Every Canadian's Right: Supreme Court of Canada

By James Bowden | 19 December 2021

The Supreme Court of Canada (**SCC**) recently delivered a judgment in the *Alta Energy* case[1] which provides a timely, reasoned counterpoint to the recent attacks on legitimate tax planning. The messaging around incidents such as the Panama Papers and the Pandora Papers presents a prime example of the media attacks on legitimate tax planning, which tend to sensationalize legitimate tax minimization as illegal or immoral. Tax policy is inherently political, but tax law should not be; it should be predictable and transparent. Choosing to pay more tax than is legally required is a choice that taxpayers have; choosing to legally minimize tax is equally legitimate and should not be a source of condemnation. The SCC's majority judgment in *Alta Energy* is a strong reminder of the continued legitimacy of these choices and reaffirms that fairness and rationality will still prevail as a matter of law, even when it is not *de rigueur*.

Very briefly, the facts of the *Alta Energy* case were as follows: US parties established a Canadian subsidiary (**CanCo**) for the purpose of acquiring and developing certain shale oil properties in Canada. A tax optimizing structure was then created whereby a Luxembourg entity was established (**LuxCo**), and ownership of the Canadian company was transferred to LuxCo. LuxCo had no other purpose than to hold the shares in CanCo. The structure was created in order to take advantage of the tax treaty between Canada and Luxembourg (the **Treaty**) when the shares of CanCo would ultimately be sold to a third party (a Chevron entity). When that sale took place, LuxCo realized a capital gain on the shares of CanCo of around CAD 380 million. Under the terms of the Treaty, that amount was taxable only in Luxembourg, not in Canada. The Minister of National Revenue (the **Minister**) disputed this outcome, arguing that the use of the Treaty in this manner was an abusive avoidance of Canadian tax, and it challenged the outcome under the *Income Tax Act*'s general anti-avoidance rule (**GAAR**)[2].

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James is an experienced transactional and corporate and commercial practitioner, having trained in both Ontario and with Afridi & Angell in Dubai for many years. He has developed significant expertise in a number of specialisations, most notably commercial advisory and transactional work, onshore and offshore trusts structures, asset protection, and tax and estate planning. James spearheaded the firm's initiative to establish its Toronto office (Afridi & Angell Professional Corporation), which he now heads, taking advantage of the firm's many Canadian ties and bringing the Afridi & Angell service standard to Canadian clientele. James is a member of the Ontario bar and received his L.L.B., from Queens University, Canada, in 2004.

[1] *Canada v. Alta Energy Luxembourg S.A.R.L, 2021 SCC 49.*
[2] Section 245 of the Income Tax Act.

The Minister was essentially arguing that treaty shopping is abusive tax avoidance rather than legitimate tax planning. The majority of the SCC disagreed and found in favour of the taxpayer.

In the majority reasoning, the SCC went out of its way to provide commentary, which could be perceived as a gentle chastisement of the Minister, regarding some of the fundamental principles on which Canada's taxation system is based.[3] Setting the tone for the judgment, the first sentence in the majority decision reads: "The principles of *predictability, certainty, and fairness* and respect for the *right of taxpayers to legitimate tax minimization* are the bedrock of tax law." (emphasis added).

The following are some further quotations from the majority judgment (some new, some from prior cases but cited with approval):

- Regarding treaty shopping generally: "There is nothing inherently proper or improper with selecting one foreign regime over another", and "the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive". (para. 26)
- A reminder of the well-accepted *Duke of Westminster* principle that has been cited with approval in Canadian courts many times for many years, that "taxpayers are entitled to arrange their affairs to minimize the amount of tax payable". (para. 29)
- "Tax avoidance should not be conflated with abuse.", …. "Even if a transaction was designed for a tax avoidance purpose and not for a *bona fide* non-tax purpose, such as an economic or commercial purpose, it does not mean that it is necessarily abusive…" (para. 47)
- "Taxpayers are allowed to minimize their tax liability to the full extent of the law and to engage in "creative" tax avoidance planning, insofar as it is not abusive within the meaning of GAAR" (para. 48)
- "…courts should not infuse the abuse analysis with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do" (para. 48)

For taxpayers seeking certainty in their planning, and for professionals involved in tax planning, these statements from the SCC are invaluable as they unambiguously reinforce the right of every taxpayer to engage in lawful tax avoidance and even "creative" tax avoidance. This judgment comes at a time when media and political messaging around tax planning has been particularly aggressive, and the distinction between tax avoidance and tax evasion is being lost, at least in public dialogue.

A central issue in *Alta Energy* focussed on the interpretation of the Treaty, and whether or not LuxCo should be entitled to benefit from the Treaty provisions even though it had no significant ties to Luxembourg other than having been incorporated there. LuxCo had no economic substance or active business; it was a holding company established for the sole purpose of taking advantage of the Treaty. That is, this was a straight-forward case of treaty shopping. After detailed reasoning, the majority of the SCC found that treaty shopping is not abusive and that it can be part of legitimate planning. The fact that there was no other economic purpose for LuxCo aside from accessing the Treaty benefits did not make the structure abusive.

While the *Alta Energy* judgment is a victory for the taxpayer and for the rule of law, the practical application of the SCC's judgment is, unfortunately, somewhat limited. The SCC's reinforcement of every taxpayer's right to engage in legal tax avoidance, even "creative" tax avoidance, can be relied upon by Canadians unless and until the SCC or the legislature expressly decides otherwise. That much remains positive and helpful. However, the particular application of the judgment to treaty shopping is much less clear thanks to a new multi-lateral treaty signed by Canada in 2017, and by many other

[3] Notably, the tone of chastisement was also directed toward the minority decision, in which 3 of the 9 Supreme Court justices did find that the treaty shopping in the *Alta Energy* case was abusive, and set out their reasons at length.

countries since then[4]. This is the OECD-backed Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the **MLI**), which has one primary effect: to amend existing tax treaties to deny the application of benefits under the treaties in cases of treaty shopping. The key article of the MLI is article 7(1), which reads as follows (emphasis added):

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was *one of the principal purposes* of any arrangement or transaction that resulted directly or indirectly in that benefit, *unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement*.

Article 7(1) of the MLI sets out what is known as the "principal purpose test". It is an anti-avoidance rule which can be applied to deny treaty benefits if "one of the principal purposes" of using an entity in a treaty country was to obtain a benefit under the treaty, unless granting the treaty benefits would be "in accordance with the object and purpose of the relevant provisions of" the treaty. This language has raised significant questions among professional advisors as it could be applied to deny treaty benefits in almost any conceivable scenario, and it is not yet clear how this article will be applied in practice. In short, it has introduced uncertainty into planning that involves tax treaties. It may also be difficult to square the *Alta Energy* judgment with the "object and purpose" language in the MLI. The SCC did in fact address the object and purpose of the relevant provisions of the Treaty in detail in its judgment, and concluded that the taxpayer's use of LuxCo solely to access a tax benefit under the Treaty was itself consistent with the object and purpose of the Treaty provisions. Given that finding by the SCC, it would appear that the language of article 7(1) of the MLI is potentially self-defeating insofar as the Treaty is concerned, and potentially many other treaties. This introduces even greater uncertainty, at least in the near term until the issue is tested before Canadian (and foreign) courts[5].

The MLI is only one product of many that fall under the OECD's much larger "base erosion and profit shifting" (**BEPS**) framework which has introduced some uncertainty to international tax planning. Another BEPS initiative includes the introduction of "economic substance" rules which require companies in low/no tax jurisdictions to demonstrate real economic ties to those jurisdictions (i.e.: local employees, local revenues, physical offices, physical presence of directors, etc.), failing which they incur very substantial penalties and may be de-licensed. Such economic substance rules have been adopted and are being strictly enforced in many jurisdictions. Had they been in place earlier, namely during the material time in *Alta Energy (pre 2012)*, they may have forestalled the Minister's arguments which centred on the fact that LuxCo did not have "real" economic ties to Luxembourg and was merely a holding entity. We now have both the MLI and the economic substance rules to consider, but since neither refers to the other, some further ambiguity is created. For example, if an entity established in the UAE (a zero income tax jurisdiction) complies with the UAE's OECD-compliant economic substance rules, can it be certain that it will be entitled to the benefits under the Canada-UAE tax treaty as amended by the MLI? The answer should be yes, but the language of the MLI leaves the interpretation uncertain as it does not affirm the status of entities that comply with OECD-compliant economic substance rules. This is unfortunate and is likely an unintended consequence of too many initiatives being adopted too quickly under BEPS, and what we are left with is a dramatic departure from tax certainty, despite the helpful language of this recent SCC decision.

To end on a positive note, even if treaty-based planning has become uncertain at least in the near term, professional advisors and taxpayers have every reason to welcome the SCC's affirmation of the fundamental right of Canadians to minimize their tax burden using all legal means available.■

[4] The current list of signatories to the MLI and their status can be found here: https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf
[5] This issue was not considered by the court in *Alta Energy* because the facts of the case occurred in and prior to 2012, well before the MLI was introduced.

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