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Treaty Shopping and the GAAR: Where From Here?

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On March 19, 2021, the Supreme Court of Canada heard the appeal in *Canada v. Alta Energy Luxembourg S.A.R.L.*, a case in which the Crown took the position that the taxpayer had engaged in abusive "treaty shopping". The appeal was from the decision of the Federal Court of Appeal (FCA), which held that Canada's general anti-avoidance rule (GAAR) did not apply where the taxpayer, a Luxembourg-resident company, relied on the tax convention between Canada and Luxembourg (the Can-Lux Treaty) to exempt a capital gain from Canadian income tax.

In this case, 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, it realized a capital gain of over $380 million and took the position that this gain was exempt from tax in Canada.

Article 13(4)(a) of the Can-Lux 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 (TCC) 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 benefits. The Crown's appeal to the FCA related only to the GAAR.

On appeal, the FCA held that the object and purpose of the relevant provisions, including Article 13(4) of the Can-Lux Treaty, were fully reflected in the plain language of these provisions. The FCA also rejected the Crown's position that Article 13(4) effectively requires the taxpayer to have strong economic or commercial ties to Luxembourg, since the sole criterion to be eligible for the exemption is residence in Luxembourg, which turns on liability to tax. Also, as the FCA observed, measures subsequently taken by the Department of Finance to curtail treaty shopping were not applicable to its decision and could affect future transactions.

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 provisions. The Crown argued that the policy or underlying rationale of the 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 Can-Lux 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 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 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 Can-Lux Treaty.

As the Supreme Court reserved judgment, guidance from our highest court will be forthcoming on a fundamental issue of international taxation. It remains to be seen whether the Court will agree with the Crown that the taxpayer engaged in abusive tax avoidance or whether it concludes that the GAAR cannot be used to curtail treaty shopping.