Alta Energy Luxembourg - Tax Court (Again) Affirms Taxpayer's Right to Access Treaty Benefits

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- The Tax Court of Canada has decided in *Alta Energy Luxembourg S.A.R.L. v. Her Majesty the Queen* that a Luxembourg resident corporation may avail itself of the benefits of the Canada-Luxembourg Income Tax Convention without being subject, for that reason alone, to the general anti-avoidance rule ("GAAR") under Canada's *Income Tax Act* ("ITA").
- In its August 22, 2018 decision, the Court confirmed that a GAAR analysis should not be about labels such as (so-called) "treaty shopping", but rather must be grounded in the text of the applicable statute or treaty.
- The case also contains an interesting analysis of how the immovable property exception in the Canada-Luxembourg convention functions in the context of the resource sector.
- While the result was favourable for the taxpayer, the fact that the Crown chose (again) to challenge on the basis of GAAR (in the treaty context) is both noteworthy and troubling.

Background

The following are some of the key facts in the case:

- Alta Energy Partners Canada Ltd. ("Alta Canada") was a wholly-owned subsidiary of Alta Energy Partners, LLC of Delaware.
- Alta Canada's shares constituted "taxable Canadian property" for ITA purposes because the company was in the business of acquiring and developing Canadian resource properties.
- In a 2012 restructuring, the shares of Alta Canada were transferred to a related newly-formed Luxembourg company (the "Appellant").
- In 2013, the Appellant sold its shares of Alta Canada to an arm's length third party for approximately $680 million.
- At the time of the sale, Alta Canada owned licenses to explore, drill and extract hydrocarbons over 62,000 acres in Alberta's Duvernay Formation ("Working Interest"). It had also drilled six wells and participated in two other wells as a non-operator.

Taxpayer's Filing and Minister's Reassessment

The Appellant filed its Canadian tax returns on the basis that the approximately $380 million capital gain it had realized on the share sale was exempt from tax under the *Canada-Luxembourg Income Tax Convention 1999* (the "Treaty"). While Articles 13(4) and (5) of the Treaty establish that Canada retains the right to tax a capital gain arising from the disposition of shares that derive their value principally from immovable property located in Canada, there is an exception (the "Immovable Property Exception") for immovable property in which the company carries on business. Note that there is no comparable exception in the Canada-US tax treaty.

The Minister of National Revenue (the "Minister") reassessed the Appellant's return, denying its claim that the share sale was exempt from Canadian tax. The Minister advanced two arguments for its conclusion that the Immovable Property Exception did not apply to the Working Interest:

- Alta Canada drilled in and extracted hydrocarbons from only a small number of sections in the property which it controlled ("sections" being the term for areas within a property with respect to which licenses are issued); and
- The application of the Immovable Property Exception in this case is subject to the GAAR on the basis that the Appellant's use of the Treaty amounts to abusive "treaty shopping".

Issues on Appeal

On this appeal of the Minister's decision, the Tax Court was asked to decide on the following points:

- Is the capital gain realized by the Appellant as a result of the Alta Canada share sale exempt from tax under Articles 13(4) and (5) of the Treaty?
- If so, does the GAAR override the Treaty on the basis of so-called abusive "treaty shopping"?

Decision: Treaty Exemption Applies but GAAR Doesn't

The Immovable Property Exception in the natural resource context

While it is not our focus in this post, the decision includes valuable analysis of how the Immovable Property Exception applies in the context of the resource sector. In this case, not all of the lands were under active exploitation at the time of the sale. The Crown's position was that the exception should apply strictly on a license-by-license basis and that only the lands covered by a license on which there was active drilling or extraction should be covered.

Rejecting this approach, Justice Hogan of the Tax Court noted that the Crown's position did not reflect the commercial realities of how the resource industry operates. In the case of the oil industry, it ignored the fact that oil extracted through a vertical well on one section will in many cases come from a pool that underlies many sections. While this case dealt with the oil and gas sector, Justice Hogan extended his analysis to forestry operations, in which best environmental practices require that some sections of a timber property remain untouched. In Justice Hogan's view, to limit the Immovable Property Exception to sections of a timber property that are currently being exploited would incentivize clear-cutting at the expense of sustainable development.

Accordingly, after reviewing the purposes of Article 13 and the Immovable Property Exception, Justice Hogan concluded that the Treaty drafters would have intended for a resource company to qualify for the Immovable Property Exception when such property is developed in accordance with the industry's best practices, as was the case here.

Application of GAAR

In the alternative, the Crown advanced the argument that the GAAR should apply to override the Treaty result. In many respects, this argument was a reprise of the 2007 Federal Court of Appeal decision in *Canada v. MIL (Investments) S.A.*, which is surprising given that, as discussed below, *MIL* and a number of cases that followed it are generally believed to have cemented the proposition that a vague general policy against "treaty shopping" cannot support a GAAR-based finding of abuse of the Treaty.

Case law on treaty shopping

MIL involved a taxpayer changing its domicile from the Cayman Islands to Luxembourg prior to selling shares in a Canadian company, apparently for the purpose of taking advantage of the capital gains exemption set out in the Treaty. In rejecting the Crown's position that "treaty shopping", as such, represented an abuse of the provisions of the Treaty that exempted the capital gain from tax in Canada, Pelletier J.A. wrote:

> [W]e are unable to see in the specific provisions of the [ITA] and the Tax Treaty to which we were referred, interpreted purposively and contextually, any support for the argument that the tax benefit obtained by the respondent was an abuse or misuse of the object and purpose of any of those dispositions.

MIL clearly stands for the proposition that in isolation so-called treaty shopping is not abusive under GAAR. Similar statements were made in *Garron Family Trust (Trustee of) v. The Queen.* and *Antle v. The Queen*, each of which involved the shifting of a capital gain to a Barbados trust followed by the claim of a treaty exemption under the Canada-Barbados treaty. For example, Sharlow J.A. for the Federal Court of Appeal in *Garron* stated:

> The fact that the Trusts would also be entitled to a treaty exemption flows from the fact that in the Barbados Tax Treaty, Canada has agreed not to tax certain capital gains realized by a person who is a resident of Barbados. If the residence of the Trusts is Barbados for treaty purposes, the Trusts cannot misuse or abuse the Barbados Tax Treaty by claiming the exemption.

These decisions strongly support the position that the use of a treaty is not abusive simply because there is no tax in Canada or elsewhere.

In response to the above case law, Canada's Department of Finance ("Finance") announced a treaty shopping consultation process in the 2013 federal budget, which was followed by a consultation paper. In this consultation paper, Finance recognized the judicial precedent related to treaty shopping stating:

> As discussed in more detail below, Canadian courts have generally accepted that treaty shopping occurred in the cases before them, but did not find a clear tax treaty policy or legislative intent to deny the application of a tax treaty benefit to any particular treaty shopping arrangement.
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> …
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> Collectively, these three cases indicate in relatively strong terms that the courts in Canada are not currently inclined to find against taxpayers in treaty shopping cases. *In other words, the courts in Canada require clearer legislative direction to the effect that treaty shopping is an improper use of Canada's tax treaties.* [emphasis added]

Finance ultimately decided not to proceed with a proposed domestic treaty shopping rule, which was the outcome of the consultation paper. However, it did later become a signatory to the OECD's *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("MLI"). Once effective, the MLI will introduce a new anti-treaty shopping rule into many of Canada's tax treaties and will likely be the mechanism by which the Government challenges treaty shopping arrangements that it doesn't like.

The contrast between the Minister's GAAR argument in this case and the earlier statements by Finance was recognized by Justice Hogan:

> It is apparent to me that the [Crown] seeks to achieve the same result in the instant case under the GAAR as that intended under the above captioned proposed rule. In my opinion, the [Crown] is seeking to apply the GAAR in order to deal with what Finance now believes is unintended gap in the Treaty.

Given all of this, Justice Hogan did not appear to have any difficulty in finding that the vague proposition of “treaty shopping” could not constitute abuse under the Treaty, in the absence of identifying abuse of specific articles in the Treaty. As further support, Justice Hogan noted that the OECD Model Treaty does not contain an Immovable Property Exception and that it must be presumed that Canada had a valid reason to allow Luxembourg to retain the right to tax capital gains in those specific circumstances. As he concluded, “It is certainly not the role of the court to disturb their bargain in this regard.”

Conclusion

The Minister of National Revenue clearly did not like the tax result that was achieved as a consequence of the Appellant’s reorganization. However, this alone is not sufficient to support the application of the GAAR. As the Supreme Court of Canada has stated, a GAAR analysis “should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do”. Given the existing case law on the topic, the apparent contradiction with Finance’s own statements and the impact of the MLI going forward, the position taken by the Minister in this case might best be described as “puzzling”.