



Court decisions dealing with GAAR

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(Session 2)

Capacity Building Unit
Financing for Development Office
Department of Economic and Social Affairs

<http://www.un.org/esa/ffd/>

1. SURPLUS STRIPPING

- *RMM Canadian Enterprises v. The Queen*
[1998] 1 CTC 2300 (TCC)

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Facts

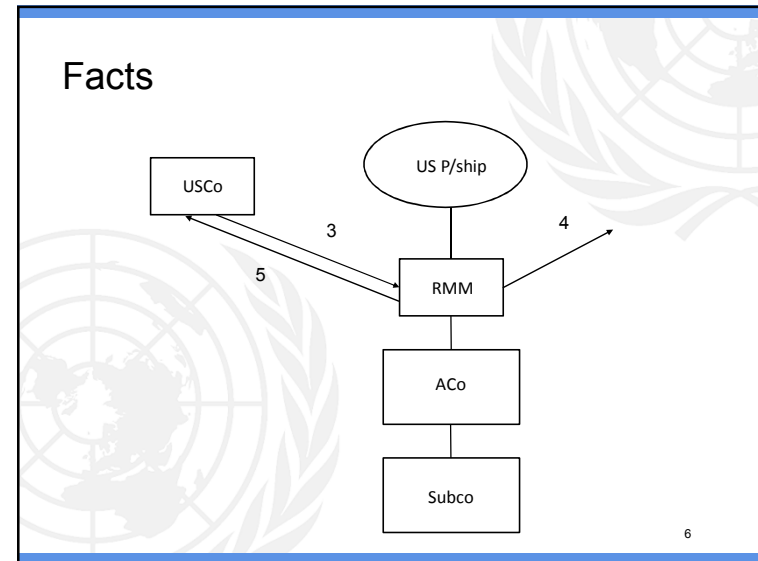
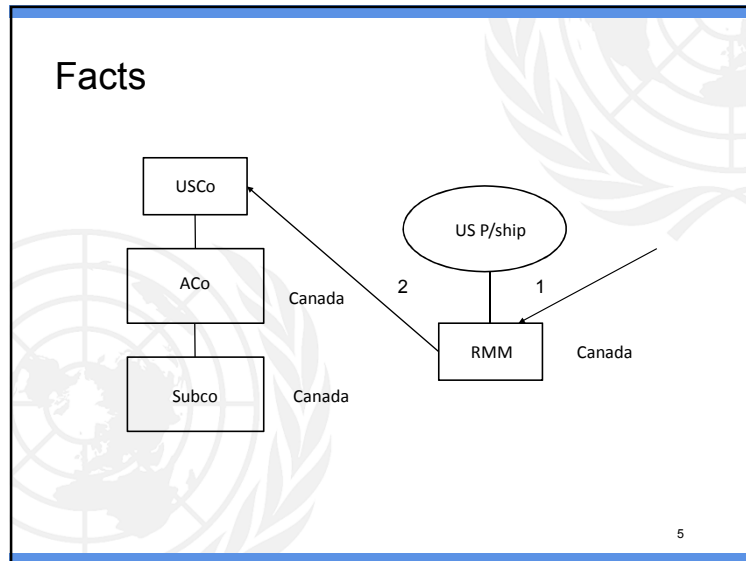
- US corporation owns Country A subsidiary (ACo), which owns another Country A corporation (SubCo)
- ACo and SubCo cease to carry on equipment leasing business
- Assets of ACo and SubCo consist of cash and near-cash

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Facts

- Shares of ACo sold to RMM, a Country A corporation owned by friends of executives of US corporation
- RMM borrows from the bank to pay USCo
- Purchase price equals cash and near cash of ACo and SubCo
- US corporation guarantees amount of lease receivables and pays RMM's legal fees
- RMM repays bank
- ACo wound up and SubCo amalgamated with RMM
- Lease payments made by RMM to USCo

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- ### Issues
- Do specific anti-avoidance rules in Country A's domestic law apply?
 - Does Country A's GAAR apply?
 - Does Country A-US treaty prevent the application of the provisions of Country A's domestic law including the GAAR?

- ### Domestic Law
- Country A has provisions of domestic law that deem amounts paid on the winding up or discontinuance of corporation to be a dividend and that deem certain gains on the disposal of shares of Country A companies to non-arm's length nonresidents to be deemed dividends
 - Alternatively, GAAR can apply to recharacterize a gain as a dividend
 - Dividend subject to withholding tax

Relevant Treaty Provisions

- Article 13: only residence country can tax gains from disposal of shares unless the shares derive their value principally from immovable property in the source country
- Article 10: country in which the company paying dividends can tax at rate up to 5% or 15%
- LOB applies only for US
- No anti-abuse rule in treaty

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Article 13(4)

Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

- Aco and Subco did not own immovable property in Country A
- Therefore, gain is covered by Article 13(4)

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Article 10(2) and (3)

- Dividends paid by company resident in Country A to a company resident in US owning at least 10% of the shares may be taxed by Country A at a rate of 10%
- Dividends means “income from shares or other rights, not being debt-claims, participating in profits, as well as income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident.”

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Treaty Issues

- Does Article 13(4) of the treaty prevent the application of Country A's deemed dividend rules?
- Does Article 13(4) of the treaty override the recharacterization of the gain as a dividend under the GAAR?
- If the specific anti-avoidance rules and the GAAR do not apply, does the treaty contain an inherent anti-abuse concept?

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Treaty Issues

- Under Article 13(4), gains on shares are taxable only by residence country
- Meaning of “gains”? Does “gains” mean gains under domestic law or does it have a treaty meaning?
- Article 10 deals with dividends
- Meaning of “dividends”? Defined in Article 10(3) to include amounts treated as dividends under domestic law (I.e., deemed dividends)

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Arguments

- Taxpayer argues recharacterization of sale as dividend under GAAR is contrary to the treaty
- Problem: no gain was subject to tax under Country A’s law (i.e., gain was nil); therefore, no violation of the treaty
- Government’s argument: gain is deemed dividend under domestic law
- Should taxpayer get the benefit of the reduced rate on dividends under Article 10?

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Treaty Issues

- Article 3(2): undefined terms have their meaning under domestic law at the time that the treaty is applied
- Assume Country A’s GAAR was introduced after treaty with US was entered into
- Is recharacterization under GAAR equivalent to a deeming provision for purposes of Article 10?

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Treaty Issues

- Taxpayer argues that the GAAR is a unilateral amendment of the treaty
- Article 3(2): undefined terms have their domestic meaning unless the context otherwise requires
- Taxpayer argues that here the context requires that the nature of the gain cannot be altered by the application of the GAAR

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Decision

- “It would be a surprising conclusion that Canada, or indeed any of the other countries with which it has tax treaties, including the US, had intentionally or inadvertently bargained away its right to deal with tax avoidance or tax evasion by residents of treaty countries in its own laws. It would be equally surprising if tax avoidance schemes that are susceptible to attack under either general anti-avoidance provisions or specific anti-avoidance rules, if carried out by Canadian residents, could be perpetrated with impunity by non-residents under the protection of a treaty. That is not what treaties are for.”

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Decision

- This is not an ordinary sale
- “alienation” in Article 13(4) “connotes a genuine alienation, and not one that is made to an accommodation party as an integral part of a distribution of surplus.”
- Definition of “dividends” in Article 10(3) is broad enough to cover the payments

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Decision

- Subsequent 1995 Protocol and US Technical Explanation indicates that the right of the states to apply their own anti-abuse provisions is inherent in the treaty
- Treaty cannot be construed to prohibit the application of domestic anti-abuse rules applied in the context of domestic law alone or in conjunction with the treaty

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Interpretive or Factual Approach

- Under the Commentary on Article 1
- Do anti-avoidance rules establish facts or are they interpretive principles?

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Interpretive or Factual Approach

- Under interpretive approach statute does not apply to transactions without economic substance or business purpose
- If treaties interpreted in same way, no conflict between treaties and domestic law
- In some countries interpretive approach applies only under the GAAR

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2. HYBRID MISMATCH

Mills v. Commissioner of Taxation [2012] HCA 51

- Unanimous decision from Australia's High Court (five judges) reversing the decision of the Full Federal Court
- Deals the application of a general anti-avoidance rule
- Domestic case (but Articles 10 and 11 of the Australia-New Zealand treaty are relevant to that case)

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Facts

- PERLS V (Perpetual Exchangeable Resaleable Listed Securities V) publicly issued by the Commonwealth Bank of Australia
- These stapled securities include a preference share and a subordinated unsecured note issued by the New Zealand branch ("stapled" because conditions of issue generally prevent the shares and the notes from being traded separately)

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Facts

- PERLS V are "Non-innovative Residual Tier 1 capital" for the bank, i.e. counts as capital providing "a permanent and unrestricted commitment of funds, be freely available to absorb losses, not impose any unavoidable servicing charge against earnings and rank behind the claims of depositors and other creditors in the event of winding up"

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Facts

- Holder entitled to quarterly distributions, including interest on the notes at a distribution rate to be calculated each quarter, non-cumulative and at the discretion of the Bank (but if not paid a “dividend stopper” restricting the Bank from paying dividends, interest or distributions or returning capital on ordinary shares and certain other securities would arise)

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Facts

- PERLS V issued in 2009, after bank management determined that bank “would face a substantial capital requirement over the ensuing year due to business growth, potential acquisitions and foreign exchange movements”
- Decision to issue \$600 million; due to strong demand, Board agreed to increase the maximum size of the issue of PERLS V to \$2.25 billion

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Facts

- Tax ruling was sought in Australia but was expected to be adverse; agreed that would be settled by courts
- Tax ruling was obtained in New Zealand on deductibility of interest

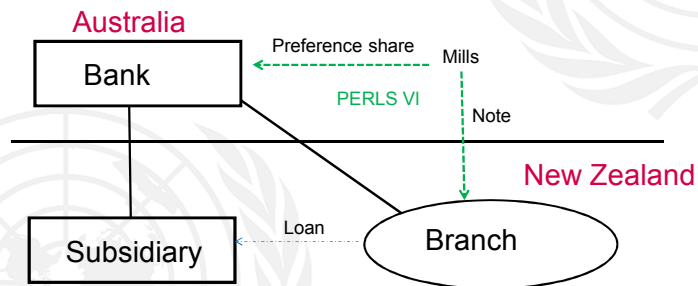
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Facts

- Mills acquires PERLS V
- Claims an “imputation credit” (dividend tax credit) for the return on PERLS V (Australia has an imputation system under which corporate tax is credited in the hands of shareholders who receive dividends)
- Note issued by the branch in New Zealand (mostly used for loan to a bank subsidiary)
- Australia exempts foreign PE income

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Facts



Debt-equity distinction in Australia

- Under Australian law, the debt-equity distinction is more a matter of substance than of form
 - “equity interest can include not only an interest in a company as a member but also an interest that carries a right to a variable or fixed return from the company where the right itself or the amount of the return is either in substance or in effect contingent on the economic performance of the company **or at the discretion of the company**”

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Part IVC of *Tax Assessment Act*

- General anti-abuse rule applies if “... having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme **did so for a purpose (whether or not the dominant purpose but not including an incidental purpose)** of enabling the relevant taxpayer to obtain an imputation benefit.”

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Question

- Whether, having regard to the “relevant circumstances” of the arrangements for the issue of PERLS V, it would be concluded from the perspective of a reasonable person that the Bank entered into and carried out those arrangements “for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling holders of PERLS V to obtain an imputation benefit”

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Decision

- Taxpayer wins
- “It would be concluded from the perspective of a reasonable person that the Bank entered into and carried out the arrangements for the issue of PERLS V for a purpose of enabling taxpayers who became holders of PERLS V to obtain franking credits.”
- “It would also be concluded that the purpose was incidental to the Bank's purpose of raising Tier 1 capital.”

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Decision

- Quotes the Explanatory Memorandum on the GAAR that “a purpose is an incidental purpose when it occurs fortuitously or in subordinate conjunction with another purpose, or merely follows another purpose as its natural incident”
- “Incidental purpose” best read in the sense suggested by the majority in the Full Federal Court as that of “supplying with the requisite means or opportunities to [that] end”

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Decision

BUT High Court disagreed with Full Federal Court on a fundamental issue:

“...a purpose can be incidental even where it is central to the design of a scheme if that design is directed to the achievement of another purpose. Indeed, the centrality of a purpose to the design of a scheme directed to the achievement of another purpose may be the very thing that gives it a quality of subsidiarity and therefore incidentality. That is not impermissibly to confine the scope of s177EA(3)(e) to a dominant purpose: **the categories of “dominant” and “incidental” are not exhaustive.**”

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The cross-border aspects

- Hybrid mismatch arrangement
- BEPS concerns
 - Deduction in New Zealand
 - No taxation and dividend tax credit in Australia
 - Domestic law issue
- Treaty aspects
 - Article 7 and deduction of interest
 - Withholding tax aspects

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Australia-New Zealand Treaty

- Article 11 (Interest)

2. That interest may be taxed in the Contracting State in which it arises, and according to the law of that State, but the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

3. The term "interest" in this Article includes ... as well as all other income assimilated to income from money lent by the law, relating to tax, of the Contracting State in which the income arises, but does not include any income which is treated as a dividend under Article 10.

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Australia-New Zealand Treaty

- Article 10 (Dividends)

3. The term "dividends" in this Article means income from shares and other income assimilated to income from shares by the law, relating to tax, of the Contracting State of which the company making the payment is a resident for the purposes of its tax.

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Thank you

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