



Case study 1: GAAR and Treaty Abuse

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

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

CASE STUDY: TREATY SHOPPING

Based on *MIL Investments v. The Queen* (Tax Court of Canada 2006; affirmed Canadian Federal Court of Appeal, *The Queen v. MIL Investments* 2007 FCA 236)

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FACTS

- Mr. B, a resident of Belize/Monaco, acquired 29.4% of shares of DFR, a public company engaged in mining exploration and resident in Country A
- In 1993 Mr. B transferred shares to MIL, a Cayman Islands company
- Mr. B owns all the shares of MIL
- DFR made a major nickel discovery in Country A
- DFR transferred property to VBNC, a company resident in Country A

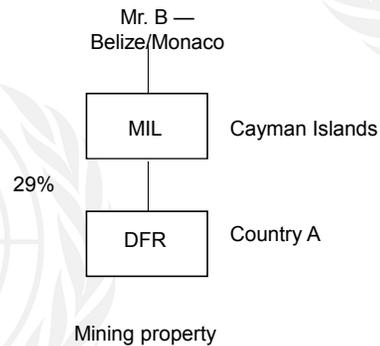
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FACTS

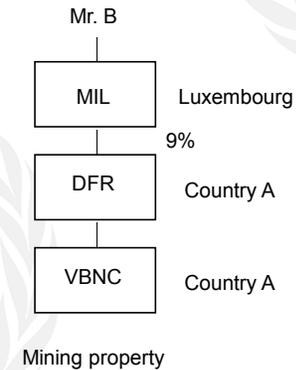
- Inco, a public company resident in Country A, bought 25% of VBNC
- MIL exchanged DFR shares for Inco shares on rollover basis
- As a result of the exchange, MIL's percentage of the shares of DFR was reduced to less than 10%
- MIL continued from Cayman Islands to Luxembourg
- One year later, MIL sold shares of DFR to Inco and realized a capital gain of \$425 million

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FACTS



FACTS



ISSUES

- Is capital gain taxable under domestic law of Country A?
- Is capital gain exempt from domestic tax under Article 13(4) of Country A-Luxembourg treaty?
- Does Country A's GAAR apply?
- Is there an anti-abuse rule in the treaty?

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DECISION

Tax Court of Canada held:

- Capital gain is exempt under Article 13(4) of treaty
- GAAR does not apply
 - No avoidance transaction on the evidence (continuation to Luxembourg was primarily to manage African mining operations)
 - No abuse of Article 13(4) "selection of a treaty to minimize tax on its own cannot be viewed as being abusive"

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Article 13(4), Canada-Luxembourg Treaty

- 4) Gains derived by a resident of a Contracting State from the alienation of:
- a) shares . . . forming part of a substantial interest in the capital stock of a company the value of which is derived principally from immovable property situated in that other State . . .
may be taxed in that other State. . . . a substantial interest exists when the resident and persons related thereto own 10 percent or more of the shares of any class of the capital stock of a company.

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Article 13(5), Canada-Luxembourg Treaty

Gains from the alienation of any property, other than that referred to in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator is a resident.

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Decision

- Expert evidence as to anti-abuse rule in treaty
- Both countries must consider their domestic anti-abuse rules to apply
- Subsequent 2003 Commentary to Article 1 cannot be considered
- No anti-abuse rule inherent in treaty without explicit provision

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APPEAL DECISION

- Federal Court of Appeal held:
- Government's appeal from the decision of the Tax Court dismissed summarily
- Treaty shopping is not inherently abusive

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ANALYSIS: Domestic Law

- Is capital gain taxable under Country A's domestic law?
 - Does Country A impose tax on gains from the disposal of immovable property situated in Country A?
 - Does Country A impose tax on disposal of shares in companies that derive their value from immovable property situated in Country A?
- If capital gain is not taxable under domestic law, the treaty is irrelevant

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ANALYSIS: Domestic Law

- If sales of shares of companies that derive their value from immovable property are not subject to tax under Country A's domestic law, does Country A's GAAR apply?
- Country A's GAAR applies to "avoidance transaction or series of transactions that result in a tax benefit if the primary purpose of the transaction is to obtain a tax benefit unless the transaction or series does not misuse provisions of the Act or constitute an abuse of the provisions of the Act as a whole"

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ANALYSIS: Domestic Law

- Is there a transaction or series of transactions?
- Does the transaction or series result in a tax benefit?
- What is the primary purpose of the transaction or series?
- Does the transaction or series result in a misuse or abuse of the Act?
- If the GAAR applies, what are the tax consequences?

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ANALYSIS: Treaty

- Is the capital gain exempt from tax under Article 13(4) of the treaty?
 - Assuming that the gain is taxable under Country A's domestic law
 - Assuming Country A's GAAR applies, does the treaty prevent the application of the GAAR?
- Is there an anti-abuse doctrine inherent in the treaty that would apply to deny the exemption under Article 13(4)?

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Taxpayer's Arguments

- Taxpayer relies on Articles 13(4) and (5)
- What is the object and purpose of Articles 13(4) and (5)?
- Does the transaction frustrate or defeat the purpose of Article 13(4)?

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Taxpayer's Arguments

- MIL was resident of Luxembourg under Luxembourg law and under Article 4 of the treaty
- Treaty does not contain any limitation on benefits provision or general anti-abuse rule
- Treaty does not contain any inherent anti-abuse concept; such a concept is only possible if both states agree

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Taxpayer's Arguments

- Purpose of Articles 13(4) and (5) is to allow source country to tax gains from the disposal of substantial interests in companies, and substantial interest is 10% or more
- Only residence country can tax the gain under Article 13(5)
- Series of transactions is in accordance with the purpose of Article 13(4) and (5)

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Taxpayer's Arguments

- Treaty prevails over Country A's domestic GAAR – *pacta sunt servanda*
- Guiding principle in paragraph 9.5 does not apply because treaty was entered into before 2003
- Prior Commentary indicated state wishing to apply anti-avoidance rule had the onus of putting provision in the treaty

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Government's Arguments

- Taxpayer acquired Luxembourg residence just to get treaty benefits
- Residence was acquired artificially shortly before disposal
- Therefore, taxpayer was not a real legitimate resident of Luxembourg and is not entitled to the benefits of the treaty

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Government's Arguments

- Article 13(4) and (5) do not contemplate or include artificial transactions to reduce a taxpayer's interest to less than 10%
- Transaction was arm's length but Inco was tax-indifferent party
- Therefore, GAAR applies to deny treaty benefits

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Government's Arguments

- No conflict between Country A's GAAR and the treaty
- Based on explicit statement in the 2003 Commentary on Article 1
- 2003 Commentary applies to the interpretation of treaties entered into before 2003

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Government's Arguments

- If the GAAR does not apply, can treaty be interpreted to deny treaty benefits?
- Paragraph 9.5:
 - is one of the purposes of the transaction to get treaty benefits? and
 - would granting benefits frustrate provisions of treaty?
- Issues are very similar to GAAR issues
- Treaty has inherent anti-abuse concept: states must perform treaty obligations in good faith and taxpayers acquire their rights from their states

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Treaty Override

- Some countries explicitly provide in their domestic law that the GAAR prevails over the provisions of tax treaties in order to prevent courts from giving treaty relief
- Some countries cannot use domestic law to override tax treaties

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Thank you

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