TAX TREATY ABUSE:
IS CANADA RESPONDING EFFECTIVELY?

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WP 09/05

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(October 2008, revised March 2009)

1 INTRODUCTION

1.1 The Form and Flexibility of the International Tax Treaty System

It hardly needs repeating that the existing income tax treaty system, designed to allocate countries' taxing rights over profits from bilateral trade and investment, struggles under the weight of global economic integration. The evolution of the mode of transnational trade and investment – from single-state enterprises carrying on foreign business via branch operations to highly integrated multinational enterprises ('MNEs') – has disturbed the foundations upon which the current system of double taxation conventions ('DTCs' or 'tax treaties') are based.[1] The transnational integration of business also creates opportunities for the unintended use or 'abuse' of tax treaties, particularly from the perspective of host states.

There is a tendency to think of the problems related to international taxation, and particularly international corporate taxation, as being recent. However, they have troubled policy-makers since at least the late 19th century. The period between the World Wars in particular saw an unprecedented expansion of international business and a corresponding crisis in international taxation, to which the initial model DTCs were a response.[2] In 1992, several years before electronic commerce became a worldwide norm, Picciotto described the state of the then-current international tax regime as an 'increasing crisis' which was in need of a 'new approach'.[3] As he observed at the time, much of this crisis has to do with the creation and manipulation of offshore statehood by internationally integrated firms; the well-advised MNE is able to exploit the loosely coordinated tax treaty system, often through the use of tax haven intermediaries, in

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[1] Two of the best critiques are: K Vogel, 'Worldwide vs Source Taxation of Income – A Review and Re-Evaluation of Arguments (Parts I–III)' (1988) 8–9 Intertax 216, (1988) 10 Intertax 310, (1988) 11 Intertax 393; and MJ Graetz, 'The David R Tillinghast Lecture – Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54 Tax Law Rev 261.

[2] ERA Seligman, *Essays in Taxation* (10th edn, MacMillan, New York 1925) ch 4; H Wurzel, 'Foreign Investment and Extraterritorial Taxation' (1938) 38 Columbia Law Rev 809.

[3] S Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Weidenfeld & Nicolson, London 1992) 67–68.

order to minimize its worldwide tax burden.[4] While issues related to tax havens and treaty manipulation are not new, it is only recently that governments have come to appreciate the socio-political ramifications of such issues, rather than treating them as technical matters within the exclusive purview of tax professionals.[5]

Evidently verbs such as ‘exploit’, ‘manipulate’ and ‘abuse’ when applied to tax treaties express value judgements – they are words of conclusion rather than analysis. Among other commentators, Rosenbloom has stated that ‘abuse’ is a heavily loaded term:

> Not only is it derogatory; it implies that the proper use of tax treaties can be identified. Yet differences over precisely that point lie at the heart of the current discussion. Because the term suggests what is being discussed is a point of common understanding and agreement, when plainly it is not, the usefulness of the term is questionable.[6]

Problems of terminology plague any theoretical analysis of tax avoidance behaviour, whether in the domestic tax law context or treaty context. The debate is muddled by the differing assumptions that underlie terms such as ‘unacceptable tax avoidance’, ‘aggressive tax avoidance’ or ‘tax abuse’ in contrast to ‘acceptable tax avoidance’, ‘tax mitigation’ or ‘tax planning’.[7] Nevertheless, there seems to be a widely held view that there exist some international tax minimization activities – even if it is difficult to delineate them – that are so inconsistent with the object and spirit of a treaty that they may reasonably be labelled ‘abuse’.

This paper explores the means by which tax authorities have sought to strengthen their tax treaties, through safeguards of varying nature and scope, in order to identify and prevent what they consider to be abuse of such treaties. Canadian and, to a lesser extent, British perspectives on treaty abuse are compared to international recommendations and the approaches of other states. In recent years Canada has moved beyond making exhortations to litigating cases where the Canada Revenue Agency (‘CRA’) believes that some abuse of a Canadian tax treaty has occurred. There is good reason to suspect that Her Majesty’s Revenue and Customs (‘HMRC’) have closely monitored the Canadian approach and would proceed similarly in a case of perceived abuse of a UK tax treaty. It will be seen that, while elements of the Canadian response

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[4] ibid 134–41. For a more recent exposition see S Picciotto, ‘Tackling Tax Havens and “Offshore” Finance’, Seminar on Money Laundering, Tax Evasion and Financial Regulation (Transnational Institute, Amsterdam 2007), available at <www.tni.org/crime-docs/picciotto.pdf> (accessed 25 February 2009).

[5] Picciotto 2007 (fn 4) 1–2. The Oxfam report *Tax Havens: Releasing the Hidden Billions for Poverty Eradication* (Oxfam Policy Paper, Oxford 2000) has helped raise the visibility of these issues in the United Kingdom.

[6] HD Rosenbloom, ‘Tax Treaty Abuse: Policies and Issues’ (1983) 15 Law & Policy in Int’l Business 763, 766.

[7] For further discussion see J Freedman, ‘Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament’ (2007) 123 LQR 53.

have merit, to date it has been ineffective in curtailing tax treaty abuse. In the author's view this failure is primarily due to the lack of critical inquiry into the essence of such abuse, in particular the lack of attempt to segregate the objective and subjective components of alleged abuse.

1.2 Outline of Paper

This working paper draws on more substantial research that comprises the author's doctoral thesis ('Thesis'),[8] currently in progress. The paper briefly reviews the nature and purposes of bilateral tax treaties, which in broad terms serve to allocate fiscal jurisdiction so as to reduce the burden of double taxation. It is explained that the Organisation for Economic Co-operation and Development ('OECD'), the United Nations ('UN') and various states have identified 'treaty shopping' as a concern mainly because it violates reciprocity between treaty states. The typical but not exclusive pattern is where an entity established in a treaty state is used as a 'conduit' to route payments from the treaty partner to a third state. The paper examines the means by which various tax administrations worldwide seek to challenge conduit arrangements and other arrangements that they view as abusive, with particular focus on Canada and the UK. These means of challenge may be grouped under two headings. The first involves purposive approaches to treaty interpretation, particularly with respect to the terms 'person', 'resident' and 'beneficial ownership'. The second comprises broader responses to unacceptable tax avoidance, specifically reliance on treaty anti-abuse principles and domestic anti-avoidance rules. The Canadian response is evinced by two recent cases in which the government unsuccessfully challenged 'treaty shopping' arrangements, *MIL (Investments) SA v Canada*[9] and *Prévost Car Inc v Canada*.[10] It is argued that the position advanced by the CRA in these cases was inadequate, largely because it conflated multiple approaches and failed to address directly a key concern: the presence or lack of genuine economic establishment in the treaty state. The paper concludes by suggesting that a more coherent response to this form of treaty 'abuse' is to identify by statute and treaty those circumstances in which a purported intermediary lacks genuine economic establishment – that is, residence – in the treaty state.

[8] The Thesis analyzes the rationales for taxation of corporations on the basis of residence, the policy responses in the United Kingdom ('UK') and Canada to manipulation of offshore residence, and the tenuous connection between the rationales and responses. The goals of the Thesis are: (a) to demonstrate that a variety of policy responses to international tax avoidance often represent confused attempts to attack the reality of a corporation's establishment in a state; and (b) to argue that a more coherent and intellectually honest response is to amend domestic laws and treaty provisions such that they are based on a substantive formulation of corporate residence.

[9] 2006 TCC 460, affirmed 2007 FCA 236.

[10] 2008 TCC 231, affirmed 2009 FCA 57.

2 THE USE AND ABUSE OF TAX TREATIES

2.1 Background: The Nature of Tax Treaties

As discussed in Chapter 2 of the Thesis, the primary concern in international income taxation is the resolution of competing jurisdictional claims between states of 'source' and 'residence', thus mitigating the burden of double taxation that would arise in the absence of international agreement.[11] It is generally accepted that double taxation is undesirable and it is commonly presumed that alleviation of double taxation, whether unilaterally or through tax treaties, enhances transnational investment and global welfare.[12] Most states, whether developed or developing, therefore seek to negotiate treaties with other states in order to divide and share tax jurisdiction on some mutually agreed basis.

The ideal would be to allocate income tax jurisdiction via some multilateral treaty based on universally accepted terms and concepts, particularly with respect to MNEs which by definition earn income across multiple states. Yet pleas for a multilateral agreement continue to seem utopian in the face of very real concerns over national sovereignty. Allocations of tax competence have in fact been achieved through a combination of unilateral statutory measures, bilateral tax agreements and nascent customary norms, producing an international tax consensus which Avi-Yonah aptly describes as a 'flawed miracle'.[13] It is estimated that there are over 2500 bilateral tax treaties now in existence,[14] many of which exhibit a remarkable similarity in both structure and principle. This is not surprising given that most are based on the model conventions developed by the OECD[15] and the UN,[16] models which were themselves derived from earlier draft conventions produced by the League of Nations.[17] Canada

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[11] Thesis ch 2 pp 18–21.

[12] These views are not universal. For alternative perspectives see: T Dagan, 'The Tax Treaties Myth' (2000) 32 NYU J of Int'l Law and Politics 939; RB Davies, 'Tax Treaties and Foreign Direct Investment: Potential versus Performance' (2004) 11 Int'l Tax and Public Finance 775.

[13] RS Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 Texas Law Rev 1301, 1303.

[14] BJ Arnold, J Sasseville and EM Zolt, 'Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century' (2002) 56 Bulletin for Int'l Fiscal Doc 233; A Schindel and A Atchabahian, 'General Report' in *Cahiers de Droit Fiscal International* vol 90a 'Source and Residence: New Configuration of Their Principles' (Int'l Fiscal Association, Rotterdam 2005) 26.

[15] OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (OECD, Paris 2008) ('OECD Model'). The OECD Model is accompanied by detailed Commentary ('OECD Commentary'), which includes reservations expressed by various states.

[16] United Nations, *Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN, Geneva 2001) ('UN Model'). The UN Model is accompanied by detailed Commentary ('UN Commentary'), building upon and sometimes differing from the OECD Commentary.

[17] The history of the model treaties is discussed in Thesis ch 2 pp 15–27.

has entered over 80 DTCs with both developed and developing nations,[18] usually in the format of the OECD Model or the UN Model. This extensive network of tax treaties, among other factors, makes Canada one of the most globalized nations in the world.[19]

There are two principal purposes of tax treaties. The first is the aforementioned reduction or elimination of double taxation on transnational trade and investment; the second is the prevention of tax evasion through an open exchange of information between the Contracting States.[20] Tax treaties have other subsidiary goals, including ensuring that residents are not subject to discriminatory tax treatment in foreign jurisdictions, establishing mechanisms for settling jurisdictional conflicts and other disputes, and providing certainty to residents regarding their potential tax liabilities abroad. For present purposes we will focus on the widely accepted primary goal of DTCs – reducing or eliminating double taxation.

This aim is achieved by a pragmatic but imperfect division of taxing rights between countries, premised on achieving some degree of national and transnational equity.[21] In very broad terms, the international tax treaty system has evolved such that the primary right to tax income from foreign direct investment is given to the 'source' state while the right to tax income from foreign portfolio investment is awarded to the 'residence' state. The incentive to engage in treaty shopping stems from the fact that the residence/home jurisdiction typically enjoys the dominant right to tax derivative or passive income, notably dividends, interest, royalties and most capital gains.[22] This is a dominant but not exclusive right. Many countries do retain jurisdiction to tax dividends and interest (and occasionally royalties) at source by way of withholding taxes.

[18] Canada has concluded comprehensive DTCs with 89 countries, excluding the former USSR; 87 of these are currently in force. Several treaties are under renegotiation or have been recently amended, including the *Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital* (1980) ('Canada–US tax treaty'), which was amended by the Fifth Protocol to the Canada–US tax treaty ('Fifth Protocol') in September 2007. A complete list of Canada's tax treaties is maintained by the Department of Finance at <www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp> (accessed 25 February 2009).

[19] A number of indices published by quasi-independent organizations support this observation, although one must be wary of political biases that may motivate such organizations. For example, the Kearney *Globalization Index* (AT Kearney/Foreign Policy, Chicago 2005–2007) has ranked Canada in the top 10 for three years in a row, taking into account various factors including international treaties.

[20] P Baker, *Double Taxation Conventions* (loose-leaf, Sweet & Maxwell, London 2007) [B.06]–[B.12]; OECD Commentary (fn 15) Art 1 para 7; UN Commentary (fn 16) para 2.

[21] See generally: NH Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 Law & Policy in Int'l Business 145; RS Avi-Yonah, 'International Tax as International Law' (2004) 57 Tax Law Rev 483; K Brooks, 'Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Value' in R Krever and JG Head (eds), *Tax Reform in the 21st Century* (Kluwer Law Int'l, forthcoming), available at <http://ssrn.com/abstract=1292370>.

[22] OECD Model (fn 15) Arts 10(1), 11(1), 12(1) and 13(5); UN Model (fn 16) Arts 10(1), 11(1), 12(1) and 13(6).

Canadian income tax legislation imposes a 25 percent withholding tax[23] on various amounts paid or credited to a non-resident person, including dividends, some forms of interest and most royalties.[24] This tax is reduced to a nominal level where the recipient is a resident of a state with which Canada has concluded a tax treaty.[25] The reduced withholding tax rate is often 5 percent for dividends paid to corporate shareholders with a substantial interest in the paying company, 15 percent for dividends paid to other shareholders, and 10 percent for interest and royalties. The dividends and interest articles in the Canada–UK tax treaty are representative:

> **Article 10 – Dividends**
>
> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State the tax so charged shall not exceed:
>
> (a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which controls, directly or indirectly, at least 10 per cent of the voting power in the company paying the dividends;
>
> (b) 15 per cent of the gross amount of the dividends in all other cases.
>
> …
>
> **Article 11 – Interest**
>
> 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such interest may be taxed in the Contracting State in which it arises, and according to the law of that State; but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. …

The Canada–UK tax treaty is, of course, based on the OECD Model. Many other Canadian tax treaties feature aspects of the UN Model, with the exception of the

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[23] *Income Tax Act*, RSC 1985 c 1 (5th Supp), as amended ('Income Tax Act') s 212. Following an announcement made in the 2007 Budget, section 212 was amended to eliminate withholding tax on interest payments made to arm's length foreign lenders.

[24] The UK is more generous to inward investment in that withholding tax does not apply to dividends and is imposed on interest and royalties only in limited circumstances. UK taxation is further restricted by the Interest and Royalties Directive (2003), which provides for the elimination of host state taxation on interest and royalty payments between associated companies in different EU Member States.

[25] OECD Model (fn 15) Arts 10(2) and 11(2); UN Model (fn 16) Arts 10(2), 11(2) and 12(2).

Canada–United States tax treaty, which is based in part on the model convention developed independently by the United States ('US').[26] The structure of the current US Model is substantially similar to that of the OECD Model but there are significant differences,[27] notably the inclusion of the 'limitation on benefits' provision, discussed in section 4.2.1 below. Each model reflects different policy decisions on the allocation of jurisdiction between the home and host states. Thus the UN Model permits source taxation with respect to dividends, interest and royalties,[28] while the US Model contemplates source taxation only for dividends – there is no provision for withholding tax on interest or royalties.[29] These different allocations of taxing rights reflect the fact that the UN Model and the US Model are slightly more favourable to capital importing nations and capital exporting nations respectively. In any event, all model conventions and all tax treaties based upon them cede jurisdiction over some types of income to the residence state, thus making treaty state residence attractive.

2.2 What is 'Treaty Shopping' and Why is it Considered a Problem?

2.2.1 Treaty Shopping Described

As with other international treaties, a tax treaty reflects a balance of advantages that is agreed to by the Contracting States when the treaty is negotiated. Treaty abuse, and in particular 'treaty shopping',[30] is considered to occur where this balance is undermined by persons who are not resident in either Contracting State seeking treaty advantages that would not ordinarily be available to them. In 1987 the OECD published an influential report ('OECD Conduit Report') which addressed the use of tax treaties by a person 'acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person'.[31] The

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[26] US Department of the Treasury, *United States Model Income Tax Convention of November 15, 2006* ('US Model'). The US Model has its own Technical Explanation: US Department of the Treasury, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* ('US Commentary'). The US Model and US Commentary are both available at <www.ustreas.gov/offices/tax-policy/treaties.shtml> (accessed 3 March 2009).

[27] For analysis and comparison see RS Avi-Yonah and MB Tittle, 'The New United States Model Income Tax Convention' (2007) 61 Bulletin for Int'l Taxation 224. For analysis of earlier versions of the US Model see RL Doernberg and K van Raad, *The 1996 United States Model Income Tax Convention: Analysis, Commentary and Comparison* (Kluwer, The Hague 1997).

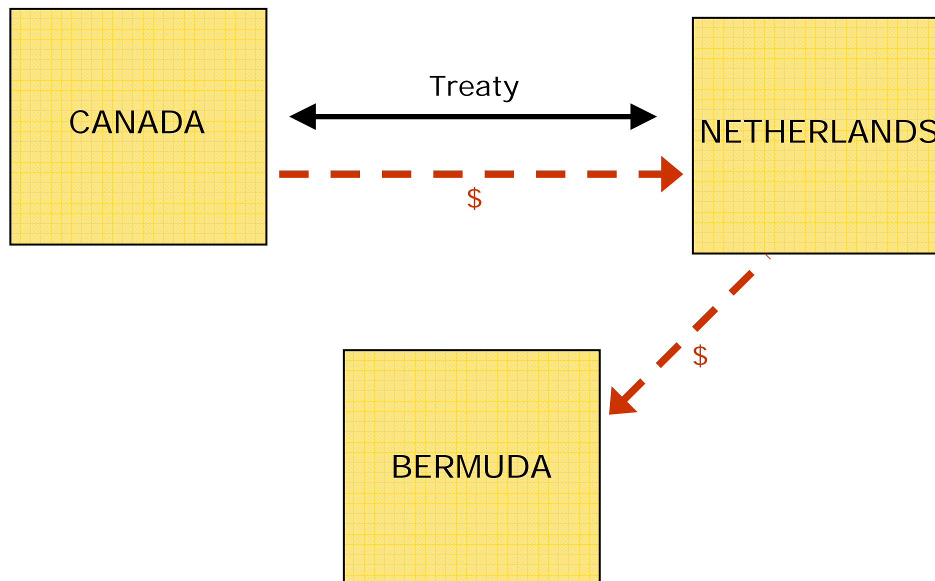
[28] UN Model (fn 16) Arts 10, 11 and 12.

[29] US Model (fn 26) Arts 10, 11 and 12. One of the most significant provisions in the Fifth Protocol to the Canada–US tax treaty is the elimination of withholding taxes on interest payments between residents of Canada and the US. Effective 2010 this exemption will apply whether or not the parties deal at arm's length; thus it is more generous than the recent amendment to the Income Tax Act (see fn 23).

[30] There are other forms of treaty abuse, such as 'rule shopping', that need not involve establishment of corporate intermediaries. For further discussion see S van Weeghel, *The Improper Use of Tax Treaties: with Particular Reference to the Netherlands and the United States* (Kluwer, London 1998) 124–58.

[31] OECD Committee on Fiscal Affairs, 'Double Taxation Conventions and the Use of Conduit Companies' in *International Tax Avoidance and Evasion: Four Related Studies* (OECD, Paris 1987) 88. The key points from this report are reiterated in the current OECD Commentary (fn 15), especially at Art 1 paras 11–21.

UN in 1988 published its own report on treaty shopping ('UN Treaty Shopping Report'), where it gave a substantially similar description of treaty shopping but, as we will see below, reached different conclusions about its acceptability.[32] It is useful to illustrate the phenomenon via the following diagram:



In this example an enterprise resident in Bermuda wishes to make some investment in Canada, perhaps by acquiring shares or debentures of a Canadian company. Assume that the Bermudian enterprise will not deal at arm's length with the Canadian company because they will be part of the same corporate group. There is no tax treaty between Canada and Bermuda, so if the Bermudian enterprise invested directly it would face the prospect of (a) Canadian capital gains tax on a subsequent disposition of the investment, and (b) Canadian withholding taxes on any dividends or interest payments it received. Instead the Bermudian enterprise makes use of a wholly-owned entity in a convenient jurisdiction, here the Netherlands, to invest indirectly in the Canadian company. In the terminology of the OECD Conduit Report, the entity based in the Netherlands acts as 'a conduit for channelling income' from Canada to the ultimate recipient in Bermuda.[33] The conduit entity is usually a corporation, but could be a partnership, trust or other entity having taxable status under the domestic law of the relevant state. The OECD Conduit Report observed that such an arrangement usually acts to the detriment of the source/host state because through the treaty it has ceded tax jurisdiction to the conduit's purported state of residence. In this example the Canada–Netherlands tax treaty ensures that Canadian capital gains tax on a disposition of the Canadian shares is avoided (unless the value of the shares derives principally

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[32] UN, Department of International Economic and Social Affairs, *Contributions to International Co-operation in Tax Matters: Treaty Shopping, Thin Capitalization, Co-operation between Tax Authorities, Resolving International Tax Disputes* (UN, New York 1988).

[33] OECD Conduit Report (fn 31) 88.

from real property in Canada) and that Canadian withholding taxes on any dividends or interest are reduced,[34] ignoring for the moment any anti-avoidance responses. Although these are the *intended* benefits of the treaty, they are effectively extended to persons to whom the treaty was *not intended* to apply.

Often the effectiveness of such a structure stems from the fact that the treaty benefits outweigh the corresponding taxes in the conduit's purported state of residence, perhaps because the residence state has a preferential regime for certain businesses or imposes low rates of corporate tax. Some Canadian treaty partners which currently bestow tax preferences of this nature are Ireland, Luxembourg, the Netherlands, Switzerland and – an enduring favourite of Canadian tax planners – Barbados.[35] In our example dividends or interest payments would flow from Canada to the Netherlands entity, which would in turn pay an equivalent or slightly lower amount to Bermuda. Assuming that the additional tax burden imposed by the Netherlands is sufficiently low, this arrangement will be more tax-efficient for the Bermudian enterprise than would a direct investment. The OECD Conduit Report categorized variations of this arrangement as 'direct conduit strategies' and 'stepping stone strategies'. More complex arrangements involving multiple countries are also possible. Indeed, the deployment of a combination of intermediary entities through multiple treaty networks can reduce or eliminate taxation both at source and in each entity's purported state of residence, while insulating the ultimate beneficiary from tax liability.[36]

2.2.2 The Discontent with Treaty Shopping

It might be argued based on the above example that Canada's treaty with the Netherlands becomes a 'treaty with the world'. This is precisely the view that was taken by the US Treasury in the early 1980s with respect to its tax treaty with the Netherlands, which the US believed was being exploited by non-residents worldwide to avoid US withholding taxes.[37] Since that time the US has been at the forefront internationally in guarding its treaty network from abuse, as discussed in section 4.2.1 below. Before a country is to implement a response to treaty 'abuse', however, it must ask itself why and how the arrangement described above is abusive. More specifically,

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[34] Canada–Netherlands tax treaty Arts 10(2), 11(2) and 13(7).

[35] The Canada–Barbados tax treaty, concluded in 1980, is attractive for a variety of reasons related to the treaty text, the domestic tax laws of Barbados, and provisions of the Income Tax Act dealing with foreign affiliates (Income Tax Act ss 90–95 and associated regulations). It is regularly relied upon for structuring investments into and out of Canada. The treaty is currently under renegotiation.

[36] Picciotto 1992 (fn 3) 135–41.

[37] It was common for non-residents to invest in the US through corporations set up in the Netherlands Antilles, an overseas possession of the Netherlands. At the time a protocol to the US–Netherlands tax treaty applied to the Antilles. A 1981 report by the US Treasury, *Tax Havens and their Use by United States Taxpayers – An Overview* (the 'Gordon Report'), suggested that the US should consider terminating this treaty and other 'tax-haven treaties' in order to eliminate the potential for abuse. For further detail see: Rosenbloom (fn 6); van Weeghel (fn 30).

it must ask which variations of the above arrangement might be acceptable uses of the tax treaty and which variations might constitute abuse.

In the UN Treaty Shopping Report the term 'abuse of tax treaties' was defined loosely as 'the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them'.[38] The authors admit that this definition begs a number of questions, notably: Can we identify the persons whom a tax treaty is designed to benefit? This report differs from the OECD Conduit Report in that it recognizes there may be public benefits in allowing enterprises to structure their affairs so as to take advantage of tax treaties. For example, countries that are keen to attract inward investment may actively desire that dividends or interest paid to a recipient in a treaty jurisdiction be subject to low or no withholding tax, even if the recipient is a holding company for shareholders based elsewhere. The authors go on to say that, if one of the general objectives of tax treaties is to promote enhanced flows of international trade and investment, it is arguable that 'it does not matter if the desirable result is achieved by the direct use of tax treaties or by their indirect use'.[39] Other commentators start from the view that all taxes are distortionary and thus should be neutralized where possible within the legal limits of the international tax regime; they suggest that a distinction be drawn between 'treaty routing' – meaning legitimate reliance on a particular tax treaty – and the derogatory term 'treaty shopping'.[40]

Little progress has been made since 1988 in expounding that nature of treaty abuse. The current OECD Commentary, which was substantially revised in 2003 to clarify (among other things) the organization's views on this issue, states that it should not be 'lightly assumed' that a taxpayer has entered an abusive transaction.[41] The Commentary sets out the 'guiding principle' that treaty benefits should be denied only where 'a main purpose' for an arrangement was to secure a more favourable tax position and where obtaining that favourable treatment 'would be contrary to the object and purpose of the relevant provisions'.[42] These elements will be described herein as the 'subjective component' and 'objective component' of treaty abuse, respectively. These two elements of treaty abuse have been expressed in slightly different terms by tax scholars,[43] correspond to the international law doctrine of abuse of rights, and are

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[38] UN Treaty Shopping Report (fn 32) 2.

[39] ibid 6–7.

[40] eg LB Terr, 'Treaty Routing vs Treaty Shopping: Planning for Multicountry Investment Flows under Modern Limitation of Benefits Articles' (1989) 12 Intertax 524; MJ Langer, *Practical International Tax Planning* (3rd edn, Practising Law Institute, New York 1988) ch 1; P Tadros, 'Caribbean Tax Treaties Create Unique Opportunities for Foreign Investment' (2004) 36 Tax Notes Int'l 873.

[41] OECD Commentary (fn 15) Art 1 para 9.5.

[42] ibid.

[43] van Weeghel (fn 30) 117, 258; K Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd edn, Kluwer, The Hague 1997) 117.

usually embodied in the domestic anti-avoidance rules or principles of various states.[44] This expression of the elements of abuse seems reasonable enough, yet it is nebulous and requires further explanation, particularly with respect to the objective component. It is unclear whether the UN agrees that this should be the guiding principle for identifying treaty abuse.[45] Moreover, various states and taxpayers are likely to have differing perspectives regarding which uses of a tax treaty are 'contrary to the object and purpose' of the relevant treaty provisions.

2.2.3 Three Potential Problems

Despite the possible advantages that some developing countries and many MNEs may recognize in the indirect expansion of treaty benefits, both the OECD and the UN have identified various reasons why treaty shopping (or 'routing') might be problematic.

The primary concern put forward in the OECD Conduit Report is that treaty shopping breaches the 'principle of reciprocity'.[46] In the typical conduit arrangement treaty benefits negotiated between two Contracting States are extended to third-country residents without that country having to make any concessions of its own. Taking Canada as the home country, its tax treaties are intended to provide benefits to residents of Canada and residents of the particular treaty partner on a reciprocal basis. The concern is that, if third-country residents are able to exploit Canada's tax treaties to secure reductions in Canadian source taxation, the benefits would flow in only one direction: third-country residents would enjoy Canadian tax reductions for their Canadian investments, but Canadian residents would not enjoy reciprocal tax relief for their investments in that country. The OECD Commentary reiterates that treaty shopping fails to accord with the balance of advantages negotiated in the particular treaty.[47] The UN characterizes this problem slightly differently, referring instead to distortions in the level and balance of income and capital flows between the treaty partners.

The second problem identified by the OECD is that treaty shopping arrangements may result in transnational income being exempted from taxation altogether or being subject to 'inadequate taxation'.[48] The OECD view is that Contracting States agree to sacrifice aspects of their tax jurisdiction with the

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[44] J Sasseville, 'A Tax Treaty Perspective: Special Issues' in G Maisto (ed), *Tax Treaties and Domestic Law* (Int'l Bureau of Fiscal Documentation, Amsterdam 2006) ch 3 pp 57–58.

[45] The current UN Commentary merely quotes passages from the 1997 OECD Commentary, which reflects certain observations made in the OECD Conduit Report but lacks the analysis of the 2003 and 2008 OECD Commentaries. The UN Commentary may soon be updated to incorporate recommendations of the Committee of Experts on International Cooperation in Tax Matters, which met in 2005 and 2006 to discuss a variety of issues including possible wording for treaty anti-abuse provisions.

[46] OECD Conduit Report (fn 31) 90.

[47] OECD Commentary (fn 15) Art 1 paras 8, 9, 11.

[48] OECD Conduit Report (fn 31) 90.

expectation that the other Contracting State will impose a reasonably comparable level of taxation. If a conduit entity is able to take advantage of deductions such that it brings its taxable income to zero in its state of residence, or is able to make onward payments to the ultimate investor with little or no additional taxation, then the treaty relief upon which it relies may extinguish all taxation. Put simply, the OECD view is that tax treaties are designed to prevent double taxation, not to create double non-taxation, a view which is reflected throughout the current OECD Commentary. This is a contentious proposition, however. Various commentators have argued that existing treaties based on the OECD Model and the UN Model cannot easily be seen as serving the objective of preventing double non-taxation.[49] The UN Treaty Shopping Report suggested that, for developing countries, double non-taxation could very well be a goal of its tax treaties:[50] developing countries that grant reliefs on inward investment may regard it as desirable that equal relief be granted in the other Contracting States in order to avoid frustration of their own reliefs. While this may be true, in the author's view it does not mean that developing countries wish the tax advantages they provide to be exploited by persons who have no real economic connection with the developing country's treaty partners. India in particular has been aggressive in challenging structures involving investments routed through its treaty partner Mauritius, in part because Mauritius imposes minimal taxation on foreign-owned investment entities.[51] Perhaps the most tenable position is that double non-taxation can potentially, but not automatically, be regarded as a basis for objection.

The final disadvantage of treaty shopping identified by both the OECD and UN is more convincing. This is the argument that treaty shopping destroys the incentive for countries to negotiate and conclude new treaties. In the typical conduit arrangement described above, the state where the ultimate investor is resident (Bermuda) has little incentive to enter treaties of its own when its residents can simply take advantage of other state's treaty networks.[52] Thus the practice is inconsistent with the laudable goals of enhanced global tax harmonization and inter-nation equity. In particular, tax haven states will continue to dwell outside treaty networks, depriving both developed and

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[49] M Lang, 'General Report' in *Cahiers de Droit Fiscal International* vol 89a 'Double Non-Taxation' (Int'l Fiscal Association, Rotterdam 2004) 73; BJ Arnold and S van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-Abuse Measures' in G Maisto (ed), *Tax Treaties and Domestic Law* (Int'l Bureau of Fiscal Documentation, Amsterdam 2006) ch 5 pp 90–91. In *MIL Investments*, discussed below, the Federal Court of Appeal gave short shrift to the Crown's argument that the tax treaty between Canada and Luxembourg should be interpreted so as to prevent double non-taxation: *MIL Investments* (FCA) (fn 9) para 8.

[50] UN Treaty Shopping Report (fn 32) 7.

[51] To date the Indian courts have not been sympathetic: *Azadi Bachao Andolan v Union of India* (2003) 6 ITLR 233 (Supreme Court of India). The current Indian experience is analyzed in greater detail in GT Loomer, 'The Vodafone Essar Dispute: Inadequate Tax Principles Create Difficult Choices for India' (2009) Nat'l Law School of India Rev [*forthcoming*].

[52] OECD Conduit Report (fn 31) 90; UN Treaty Shopping Report (fn 32) 7. The validity of this concern is demonstrated by the fact that several successful financial centres have few if any tax treaties, although some have entered Tax Information Exchange Agreements with the US: eg Bermuda, Cayman Islands and Liechtenstein.

developing nations of public funding that would otherwise be generated through taxation.[53]

2.2.4 Relating the Alleged Problems to the Concept of Abuse

Upon reviewing the problems said to be created by treaty shopping, it becomes apparent that each makes an implicit assumption that the entity established in the treaty state is somehow translucent, irrelevant or non-existent. It does not make sense to talk about a lack of reciprocity, the spectre of double non-taxation, or disincentives to future treaty negotiation if the entity's independent existence and connection to the treaty state are recognized and if the income it receives is recognized as its own income. As between the source/host state where the investee entity is established and the treaty state where the direct investor is established, there *is* reciprocity, there *is* potential double taxation relieved by treaty, and there *is* fulfilment of the treaty objects. To conclude otherwise one must assume that the important relationship is the relationship between the source/host state where the investee entity is established and the third state where the indirect investor is resident, conceptually disregarding the direct investor. Pointing to the problems cited above does not greatly assist us in determining in what circumstances we should or should not make that conceptual leap.

The three highlighted problems suggest that, at least in the OECD's view, a key factor is the intermediate entity's *lack of substance* in the treaty state. Presumably this would be encapsulated in the objective component of the OECD's guiding principle, in that these problems seem to constitute the very indicia of an arrangement being 'contrary to the object and purpose' of the applicable treaty. One might query whether that is not sufficient for a finding of abuse. It is questionable whether the main purpose or purposes of a particular arrangement are of any relevance to the identified problems of lack of reciprocity, double non-taxation and disincentives to treaty negotiation. Rosenbloom correctly states that, while a focus on tax motivations may have its place in tax treaty policy, 'important policy issues regarding the availability of treaty benefits can arise even when that state of mind is lacking'.[54] Nevertheless, the OECD and those states that take a fervent stance against treaty shopping continue to focus on both the objective and subjective components, indicating that a tax avoidance purpose is considered critical.

2.2.5 Canadian Perspective

The CRA has stated on multiple occasions that it will challenge aggressive tax avoidance arrangements involving offshore entities, including 'treaty shopping'

[53] Oxfam (fn 5); RS Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 Harvard Law Rev 1573, 1632–48.

[54] Rosenbloom (fn 6) 767.

arrangements.[55] The Advisory Panel on Canada's System of International Taxation ('Advisory Panel') has echoed the CRA view that 'treaty shopping' should be policed appropriately, although it made no specific recommendations on how to achieve this.[56] Unfortunately neither the CRA nor the Advisory Panel have clarified what they consider to be the characteristics of treaty shopping, other than to say that such arrangements seek to avoid tax on the disposition of Canadian property or to reduce withholding tax on outflows of dividends, interest or royalties. The difficulty with this description is that there are many legitimate investments made by non-residents which, by virtue of a tax treaty between Canada and the non-resident's home country, will be immune to Canadian capital gains taxes or will face reduced Canadian withholding taxes – that is precisely what the treaty is intended to achieve. The CRA seems to emphasise the subjective component of treaty abuse, referring to a taxpayer establishing residence in a treaty state 'in order to avail itself' of treaty provisions 'for tax avoidance purposes'. The difficulty of articulating the distinction between acceptable and abusive structures is probably what led the Advisory Panel to make no recommendations to government in this area.[57]

The point at which the legitimate use of tax treaties is considered to become abuse of tax treaties is perhaps best illustrated by examining the two challenges recently mounted by the CRA and Department of Justice.

MIL Investments[58] involved a challenge to a tax planning strategy that relied on the Canada–Luxembourg tax treaty. An individual resident in Monaco owned all of the shares of MIL, originally established in the Cayman Islands, which in turn owned shares in a Canadian mining company (DFR). The DFR shares had significantly appreciated in value between 1993 and 1995. In order to avoid Canadian capital gains tax on a potential sale by MIL of the DFR shares, MIL was continued into Luxembourg in July 1995. Summarizing and eliminating many of the technical aspects of the arrangement, the DFR shares were subsequently sold to another Canadian mining group. MIL claimed an exemption from Canadian tax on the $425m capital gain by virtue of Article 13 of the Canada–Luxembourg tax treaty. It also paid no tax in Luxembourg by virtue of satisfying all requirements under the Luxembourg substantial shareholdings exemption. It is important to note that all shareholders of DFR, not just

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[55] CRA, *Income Tax Technical News No 30* (21 May 2004) (a summary of issues discussed at the 2003 Canadian Tax Foundation conference); CRA, *Income Tax Technical News No 34* (27 April 2006) (a summary of issues discussed at the 2005 Canadian Tax Foundation conference). Both are available at <www.cra-arc.gc.ca/tx/tchncl/ncmtx/tnws3-eng.html> (accessed 3 March 2009).

[56] Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Department of Finance, Ottawa 2008) ('Advisory Panel Report') paras 5.61–5.68, available at <www.apcsit-gcrcfi.ca/index-eng.html> (accessed 3 March 2009). The Advisory Panel was established in 2007 to make recommendations to government for improving Canada's system of international taxation.

[57] The Advisory Panel merely concluded that the federal government 'should continue to monitor developments in this area': ibid para 5.68.

[58] (fn 9).

MIL, sold their shares and that there were sound commercial reasons to do so. The Revenue nevertheless felt that the use of this structure for holding and disposing of the shares was a flagrant abuse of the Canada–Luxembourg tax treaty.

A more recent and internationally important decision is *Prévost Car*,[59] which involved a direct conduit strategy very similar to those addressed in the OECD Conduit Report. Two companies, one based in Sweden and the other in the UK, had established a holding company in the Netherlands (PHBV) in order to hold shares in a Quebec-based bus manufacturing company, Prévost Car Inc (Prévost). PHBV had no physical office or employees in the Netherlands or elsewhere and was managed by a Dutch advisory firm. Dividends paid by Prévost to PHBV were subject to the reduced 5 percent rate of withholding tax under Article 10(2) of the Canada–Netherlands tax treaty. Substantially equivalent amounts were paid pro rata to the Swedish and UK shareholders, in accordance with a shareholders' agreement, although PHBV was not contractually obliged to pay those dividends. There was no additional taxation in the Netherlands on the dividends paid to the ultimate shareholders. If PHBV had not been established and the dividends had been paid directly from Prévost to the Swedish and UK investors, the withholding rates would have been 15 percent and 10 percent respectively.[60] According to the taxpayers, a Dutch holding company had been chosen for both tax and commercial reasons, including that the Swedish and UK investors each wanted to operate via a joint enterprise based in a 'neutral' country. The Revenue felt that the arrangement was abusive and sought to impose the higher rates of withholding tax under the Canada–Sweden tax treaty and Canada–UK tax treaty.

The specific legal responses of the Canadian government to these arrangements are discussed below in the context of other international responses to treaty abuse. None of the challenges were accepted by the Tax Court or the Federal Court of Appeal, who vindicated the arrangements, not because the arrangements were considered ethical or desirable from a tax policy perspective, but because Canada's domestic laws and tax treaties dictated that result. It is likely that HMRC have closely monitored the Canadian approach, particularly in *Prévost Car*. The author has little doubt that the same result would be reached under UK tax law, although HMRC may insist otherwise. It may therefore be necessary for tax treaties negotiated by Canada and the UK to be more precise in the way they delimit those persons who are and who are not intended to benefit. The crucial question is how to achieve this objective without penalizing taxpayers whose reliance on a tax treaty is commercially legitimate and, more generally, without actively discouraging inward investment.

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[59] (fn 10).

[60] Canada–Sweden tax treaty Art 10(2); Canada–UK tax treaty Art 10(2).

3 CURRENT INTERNATIONAL RESPONSES TO TREATY ABUSE – INTERPRETIVE APPROACHES

3.1 General Approach to Interpretation of Treaty Terms

Tax treaties, like other treaties, have a dual nature. They are international agreements according to which sovereign governments agree to divide and share jurisdiction but they also become part of the domestic law of each Contracting State.[61] This means that a tax treaty is simultaneously subject to the rules of interpretation in public international law and domestic tax law. There is a vast literature on the interpretation of tax treaties.[62] As various scholars have implored in recent work, the rules of international law governing the interpretation and application of treaties, arising from the Vienna Convention on the Law of Treaties ('Vienna Convention')[63] and other sources of international law, are as much applicable to tax treaties as they are to any other type of treaty.[64] It is sufficient for present purposes to observe that Canadian courts, along with courts in most other countries, accept that DTCs should be interpreted accordingly.

The leading domestic authority is the decision of the Supreme Court of Canada in *Crown Forest Industries Limited v Canada*.[65] In that case Justice Iacobucci, speaking for the Court, observed that treaty terms should be given a liberal interpretation that best implements the true intentions of the Contracting States. This requires that due consideration be given to relevant model treaties, model commentaries,[66] and the principles expressed in Articles 31 and 32 of the Vienna Convention. Of particular note is paragraph 1 of Article 31 of the Vienna Convention, which provides:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

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[61] The incorporation of a treaty into domestic law happens either upon ratification or upon enactment of separate legislation, depending on the constitutional tradition of the specific country: Baker (fn 20) [F.01]; Vogel (fn 43) 24–25. In Canada and the UK separate legislation is required.

[62] eg Baker (fn 20) [E.01]–[E.35]; Vogel (fn 43) 32–51; DA Ward, 'Principles to be Applied in Interpreting Tax Treaties' (1977) 25 Can Tax J 263 (revised and reprinted in (1980) 34 Bulletin for Int'l Fiscal Doc 545); JF Avery Jones, 'Interpretation of Tax Treaties' (1986) 40 Bulletin for Int'l Fiscal Doc 75; JS Hausman, 'Interpreting Tax Treaties – A Canadian Perspective' (2001) 55 Bulletin for Int'l Fiscal Doc 93; F Engelen, *Interpretation of Tax Treaties under International Law* (Int'l Bureau of Fiscal Documentation, Amsterdam 2004). In Canada it is also necessary to consider the *Income Tax Conventions Interpretation Act*, RSC 1985 c I-4, as amended.

[63] [1980] Can TS No 37, available at <http://untreaty.un.org/ilc/texts/texts.htm>.

[64] Avi-Yonah 2004 (fn 21); Engelen (fn 62) ch 10.

[65] [1995] 2 SCR 802. See also *Cudd Pressure Control Inc v Canada* [1998] DTC 6630 (FCA).

[66] The Commentaries to the OECD Model are a widely-accepted guide to the interpretation of treaties based on that model, yet there is some uncertainty regarding the legal status of the Commentaries: Vogel (fn 43) 43–47; Engelen (fn 62) 439–73.

Clearly this approach does not entail disregarding the text of the treaty. As Engelen observes, the basic assumption underlying Articles 31 and 32 of the Vienna Convention is that the treaty text is presumed to be the authentic expression of the intention of the Contracting States: 'the starting point of interpretation is the elucidation of the meaning of the text, not an investigation *ab initio* into the subjective intentions of the parties'.[67] Some terms used in a tax treaty will be clearly defined in the treaty itself, while others will be defined by reference to the domestic laws of the Contracting States. Article 3(2) of the OECD Model directs that any term not defined in the treaty shall, unless the context otherwise requires, have the meaning that it has under the domestic law of the State applying the treaty. All of Canada's tax treaties have a provision of this nature. It is important to note that the proviso 'unless the context otherwise requires' does not operate as some freestanding substance over form rule. Generally, the most appropriate domestic meaning of a term for the purposes of Article 3(2) will be ascertained by reference to the context and purpose of the relevant domestic law, which may be insufficient to meet policy objectives that are peculiar to the treaty.[68]

3.2 Interpreting Which 'Persons' are Entitled to Treaty Benefits

3.2.1 Relevance of the Terms 'Person' and 'Resident'

Article 1 of the OECD Model provides that the treaty in question 'shall apply to persons who are residents of one or both of the Contracting States'. This is of vital importance because only those who are 'persons' and 'residents' of either Contracting State can establish that they are entitled to treaty benefits. Article 3(1) confirms that the term person includes a company. Article 4(1) provides that a resident of a Contracting State is 'any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature …'. The relevant articles of the UN Model and the US Model are substantially similar in these respects. All of Canada's tax treaties are restricted in their application to persons who are residents of the relevant Contracting States, although the precise definition of resident varies from treaty to treaty. In virtually all of Canada's treaties[69] the determination of a person's status as someone liable to tax by reason of residence or other factors will be made under domestic law.

The first implication of these provisions is that treaty benefits will be unavailable where an intermediate entity in a conduit arrangement is not a 'person'.

[67] Englen (fn 62) 541.

[68] For further discussion see: JF Avery Jones, 'Article 3(2) of the OECD Model Convention and the Commentary to It' (1993) 33 European Taxation 252; Vogel (fn 43) 206–16; Engelen (fn 62) 473–77; MN Kandev, 'Tax Treaty Interpretation: Determining Domestic Meaning under Article 3(2) of the OECD Model' (2007) 55 Can Tax J 31.

[69] A notable exception is the Canada–United Arab Emirates tax treaty, Article 4(1)(b) of which sets more rigorous conditions for an individual or company to qualify as a resident of the United Arab Emirates.

The OECD Conduit Report observed that an entity which is not a juridical person liable to tax in is own right, such as a partnership or other fiscally transparent entity, could be excluded from treaty benefits.[70] In its more recent work on partnerships, the OECD has observed that even if a partnership is taxed as if it were a person under domestic law it cannot qualify as a 'resident' for treaty purposes.[71] This view is reflected in the current OECD Commentary, is consistent with Canadian law, and is accepted by most other states.[72]

Further, Article 4(1) of the OECD Model excludes from the class of residents any person who is who is liable to tax in the Contracting State 'in respect only of income from sources in that State…'. This provision ensures, among other aims, that branch operations of foreign enterprises cannot qualify as residents in their own right. In *Crown Forest Industries*, the critical issue was whether a Bahamas shipping corporation could claim the benefit of the Canada–US tax treaty as a 'resident of the United States' simply because the corporation had a place of management in the US. The Bahamas corporation filed income tax returns in the US but paid no tax there because it qualified as a foreign corporation exempt from US tax. The Court decided that the treaty was inapplicable, holding that a person must be liable to tax in a Contracting State on its worldwide income to be considered a resident under the treaty. More specifically, it was held that the criteria for determining residence in Article 4(1) 'entail being subject to as comprehensive a tax liability as is imposed by a state'.[73]

3.2.2 The Shortcomings of this Approach

Canada could rely upon these basic provisions to deny the application of one of its tax treaties where a third state resident purported to obtain treaty benefits via a partnership, branch or other fiscally transparent entity 'located' in the treaty partner state. The argument would be that the conduit was not actually established in the state and thus was not a resident entitled to treaty benefits. The difficulty is that any well-advised MNE seeking to exploit a state's treaty network will take the steps necessary to ensure that it achieves residence status in that state. It will typically make use of an affiliated corporation, establishing formal residence in accordance with the corporate residence rules in the state's domestic laws.

This practice is, of course, not difficult. The OECD Commentary observes that tax treaties generally do not concern themselves with the domestic laws of the Contracting States under which a person is to be treated as fiscally resident and, consequently, subject to comprehensive tax liability in that State. Nor do treaties set out

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[70] OECD Conduit Report (fn 31) 92.

[71] OECD Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships* (OECD, Paris 1999).

[72] OECD Commentary (fn 15) Art 1 paras 2–6.7.

[73] *Crown Forest Industries* (fn 65) para 40.

minimum standards which the provisions of domestic laws on residence have to meet. 'In this respect the States take their stand entirely on the domestic laws'.[74] The UN Treaty Shopping Report observed that, while Article 1 of the UN Model delimits the range of persons that a tax treaty is designed to benefit, this limitation does not mean that the indirect advantages of a treaty will never extend beyond territorial boundaries, particularly to non-resident shareholders.[75] Thus, while a tax treaty must be interpreted in good faith and in accordance with its text, context and purpose, such interpretation does not amount to a substance-over-form approach that a court could employ to disregard the separate legal personality and residence of a corporation under the relevant domestic law.[76]

As discussed in Chapter 4 of the Thesis, the domestic laws of the UK, Canada and most other Commonwealth jurisdictions determine corporate residence based on the formalistic tests of incorporation and 'central management and control'. It is worth reiterating that, quite regrettably, neither standard denotes any substantial economic interest in the home state.[77] The only circumstance in which a treaty-specific concept of residence becomes relevant is when a person is considered to be resident in *both* treaty states under their respective domestic laws. In such circumstance Article 4 of the applicable treaty generally sets out preference criteria (tiebreaker rules) for awarding residence to one Contracting State. In the case of corporations the preference criterion is usually 'place of effective management',[78] a concept which may be more substantive than domestic formulations of corporate residence. Nevertheless, only a poorly-advised MNE is likely to engage in activities that would result in a conduit corporation being resident in both the intended residence state and the source state. In the normal course the fiscal residence of the conduit corporation would be determined solely by the domestic laws of the intended residence state.

3.2.3 Canadian Perspective

The view of the CRA regarding which persons are entitled to the benefits of Canada's tax treaties is consistent with *Crown Forest Industries* and the OECD Commentary. According to the CRA, a person is considered liable to tax on the basis of residence if the person is subject to the most comprehensive form of taxation as exists in the relevant state.[79] The CRA has conceded that it does not necessarily follow from this

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[74] OECD Commentary (fn 15) Art 4 para 4.

[75] UN Treaty Shopping Report (fn 32) 3.

[76] The potential application of treaty anti-abuse principles and domestic anti-avoidance rules is discussed in sections 4.2 and 4.3, below.

[77] Thesis ch 4 pp 30–47, particularly the discussion of *Wood v Holden* [2006] STC 443 (CA).

[78] OECD Model (fn 15) Art 4(3); UN Model (fn 16) Art 4(3). The Canada–US tax treaty is exceptional in that the preference criterion is place of incorporation. If a corporation subsists under the laws of both Canada and the US, dual residence is resolved by mutual agreement of the states' Competent Authorities.

[79] *Technical News 34* (fn 55); CRA, *Income Tax Technical News No 35* (26 February 2007).

requirement that a person actually pays tax to a particular jurisdiction. For example, it may be that an entity is fully subject to the tax jurisdiction of a Contracting State but the domestic law of that state imposes low or nil rates of tax on such entities (such as pension funds) or on some forms of income (often capital gains). The CRA has expressed the following opinion:

> In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive (e.g. treaty shopping where the person is in fact only a "resident of convenience"). Such could be the case, for example, where a person is placed within the taxing jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any material economic nexus to that State.[80]

This comment suggests that the CRA divines a distinction between residence and residence of convenience, with the distinction being made on the basis of the motives for establishment in the foreign state ('in order to gain treaty benefits') or the extent of the establishment in that state ('material economic nexus'). While the overall tenor of this policy view is understandable, it tends to confound the objective and subjective components of treaty abuse. The author's own view is that an appropriate method of addressing treaty abuse is to interrogate the economic reality of an entity's nexus with a state, consistent with the second element of the CRA's opinion above. Yet this will not be possible without significant changes in the definition and understanding of corporate residence. The fact remains that corporate residence will be determined according to the provisions of the domestic laws of the Contracting States, provisions which currently tend to be formalistic and not amenable to substance-over-form analysis. It is therefore not surprising that in *MIL Investments* and *Prévost Car* the Department of Justice did not seek to challenge the residence status of the respective holding companies.

3.3 Interpreting 'Beneficial Ownership'

3.3.1 Relevance of the Term

It was noted above that the passive income articles in the OECD Model and the UN Model allocate tax jurisdiction to both the residence/home state and the source/host state, with limits set on source taxation where the 'beneficial owner' of the income is a resident of the other state. Thus, where a Canadian company pays dividends, interest or royalties to a non-resident investor, reduced withholding taxes will apply only if the recipient is the *beneficial owner* of the payment. This is a critical feature of tax treaties that may be relied upon by governments to prevent treaty advantages being accessed through some of the more blatant conduit arrangements.

[80] *Technical News 35* (fn 79).

3.3.2 History of the Term in Tax Treaties

The concept of 'beneficial ownership' is employed in the OECD Model, other model conventions, and numerous tax treaties worldwide. The terms 'beneficial owner', 'beneficially owned by' or 'beneficially entitled' appear in every one of Canada's tax treaties.[81] Yet prior to the *Prévost Car* decision there was no Canadian jurisprudence interpreting the beneficial ownership requirement in the treaty context.

Tax scholars have established that the first reference to this concept appeared in the 1966 protocol to the UK–US tax treaty, replacing an earlier requirement in the dividends, interest and royalties articles that the recipient be 'subject to tax' on the income in its state of residence.[82] The term was also used in the Canada–UK tax treaty of 1966. The concept was adopted in the 1977 OECD Model and from there found its way into various countries' tax treaties. Prior to the widespread inclusion of this term, it was possible for states to reach the same result by interpreting the terms 'paid' and 'received' such that they referred only to the ultimate recipient of an amount.[83] Thus, the US Tax Court in *Aiken Industries v CIR* held that interest payments made from a US corporation to a related Honduras corporation, where an equivalent amount of interest was paid onward to a related Bahamas corporation, were not actually 'paid' to the Honduran entity.[84] The court considered that the Honduran entity did not have 'complete dominion and control' over the funds. Thus the tax treaty exemption from US withholding tax did not apply. This decision, however, was influenced by anti-avoidance doctrines that are peculiar to the US. The Canadian case *MacMillan Bloedel Ltd v MNR* demonstrates a very different approach.[85] There the Revenue argued that interest paid on Canadian debentures to two nominees, a US firm of stockbrokers and a US bank, were not 'received' by the nominees but were in substance received by the beneficial owners of the interest. The Tax Review Board was not willing to read a 'beneficial ownership' requirement into the (former) interest article of the Canada–US tax treaty. Instead it applied the treaty literally and allowed the reduced withholding tax rate on the interest payments. Under Canada's current treaties, the express restriction of withholding tax relief to the beneficial owner of dividends, interest or royalties ensures a more satisfactory result.

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[81] Of Canada's 87 tax treaties currently in force, 74 refer to beneficial ownership in the Articles for dividends, interest and royalties, while 13 refer to it only with respect to dividends (each of these was negotiated or last amended before 1985). The treaty with New Zealand is the only one that offers any explanation of the term, stating that 'dividends, interest or royalties in respect of which a trustee is subject to tax in that Contracting State shall be treated as being beneficially owned by that trustee'.

[82] JF Avery Jones and others, 'The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States' [2006] BTR 695, 753–54.

[83] See van Weeghel (fn 30) 59–64.

[84] (1971) 56 TC 925 (USTC).

[85] (1979) 79 DTC 297 (TRB).

3.3.3 Conflicting Meanings

The difficulty that has arisen with the interpretation of beneficial ownership in tax treaties is that there is no universally accepted meaning for the term. In particular, there is a tension between the common law meaning and what has been described as the 'international fiscal meaning'.

The OECD Conduit Report made reference to the original commentary to the 1977 OECD Model, which explained that an agent or nominee would not qualify as a beneficial owner. The OECD Conduit Report added 'conduit company' to the list of potentially excluded persons, asserting that:

> … a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).[86]

The UN Treaty Shopping Report similarly stated that a person would not be considered a beneficial owner if the person was 'a mere nominee or agent' or 'a conduit company' whose powers over assets were so narrow as to render it 'a mere fiduciary or administrator'.[87] These statements are not contentious insofar as a nominee, agent, fiduciary or administrator is by definition a nominal owner only – none would qualify as a beneficial owner under any understanding of that term. What is debatable is whether a 'mere fiduciary or an administrator acting on account of the interested parties' should encompass an intermediate corporation in a corporate group, despite having independent legal personality and exercising independent powers. Put another way, is a company that is substantially or wholly owned by another, and is therefore likely (but not obliged) to pay to its parent company any amounts received by way of dividends or interest, the beneficial owner of amounts it receives? Each state's answer to that question will depend on how the term beneficial ownership is understood in its domestic law and on how its domestic approach to tax avoidance moderates that understanding in particular cases.

Given that its origins lie in the UK–US tax treaty and Canada–UK tax treaty, beneficial ownership is clearly a common law concept derived from the distinction between legal and equitable ownership.[88] Lawyers working in common law systems might illustrate the distinction by pointing to the different rights and obligations of a trustee and beneficiary under a trust. A beneficial owner is distinguished from a mere legal owner by the fact that he, she or it can ultimately exercise the rights of ownership

[86] OECD Conduit Report (fn 31) 93.

[87] UN Treaty Shopping Report (fn 32) 8.

[88] Avery Jones (fn 82) 747–54.

in the property.[89] Yet the word 'ultimately' must be read with caution. A parent company is not the 'beneficial owner' of the assets of its subsidiary because a shareholder has no proprietary interest in the assets of a company. The concept is well-established in common law legal systems and appears throughout UK and Canadian tax legislation. The OECD Commentary, however, endorses a different view. Drawing on the statements from the OECD Conduit Report quoted above, it states that the term beneficial owner is not used 'in a narrow technical sense'.[90] The Commentary suggests that the term should be accorded what Baker describes as an 'international fiscal meaning', not derived from the domestic laws of Contracting States.[91] Part of the reason that the OECD takes this view is that most civil law jurisdictions do not recognize the duality of legal and equitable ownership. They are thus inclined to interpret beneficial ownership as 'substantive' or 'effective' ownership.[92] Even among continental European states there is no general agreement as to the meaning of the term.[93] Thus the OECD prefers an autonomous treaty meaning, independent of any domestic law.

The alleged international fiscal meaning of beneficial ownership was relied upon in *Indofood International Finance Ltd v JP Morgan Chase Bank*,[94] a decision of the English Court of Appeal that has prompted a wave of negative commentary from international tax practitioners. The Indofood group, which is a large food production and distribution enterprise based in Indonesia, had borrowed money for use in its business. Rather than the Indonesian parent company issuing notes directly to investors and having them face a 20 percent withholding tax on the interest payments (for which Indofood was contractually liable), it had incorporated a special purpose company in Mauritius, which had issued the notes and on-lent the loan proceeds to the parent company. This structure resulted in the interest payments from Indonesia being subject to 10 percent withholding tax under the Indonesia–Mauritius tax treaty, with no additional tax on the interest payments from Mauritius to investors. All went well until Indonesia terminated its treaty with Mauritius because of perceived widespread abuse. The essential issue was whether the Indofood group could interpose a new company in the Netherlands to act as intermediary between the parent company and the Mauritius company. The intention was for interest payments to be made from Indonesia to the

[89] *Ayerst (Inspector of Taxes) v C & K (Construction) Ltd* [1976] AC 167 (HL) 177; *Jodrey Estate v Nova Scotia*, sub nom *Covert v Nova Scotia (Minister of Finance)*, [1980] 2 SCR 774, 784. For a detailed analysis see C Brown, 'Beneficial Ownership and the Income Tax Act' (2003) 51 Can Tax J 402.

[90] OECD Commentary (fn 15) Art 10 para 12, Art 11 para 9, Art 12 para 4.

[91] Baker (fn 20) [10B]–[14].

[92] See for example the decision of the French Supreme Administrative Court in *Bank of Scotland v Ministre de l'Economie, des Finances et de l'Industrie*, discussed at text to fn 138.

[93] C du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (Int'l Bureau of Fiscal Documentation, Amsterdam 1999); JDB Oliver and others, 'Beneficial Ownership and the OECD Model' [2001] BTR 27.

[94] [2006] STC 1195 (Eng CA).

Netherlands, thence to Mauritius, and thence to the ultimate investors abroad. The case was before the English courts because the notes were governed by English law.

The success of this structure depended on the proposition that the Dutch financing company would be the 'beneficial owner' of the interest it would receive from the parent within the meaning of Article 11(2) of the Indonesia–Netherlands tax treaty. The Court of Appeal held unanimously that the Dutch company would not be the beneficial owner of the interest and thus the treaty relief would not apply. It reached this conclusion by considering how beneficial ownership would be understood *by an Indonesian court*, having regard to a circular published by the Indonesian Director General of Taxes on this issue, the Indonesian principle of substance over form in tax matters, Article 31 of the Vienna Convention, and the interpretation of beneficial ownership suggested by the 2003 OECD Commentary. The Court refused to adopt a 'technical and legal' approach, focusing instead on the commercial and practical reality of the arrangement.[95] On that basis it decided that neither the Dutch company nor the Mauritian company would beneficially own the interest payments they received because neither would have the 'full privilege to directly benefit from the income'.[96]

The *Indofood* decision caused concern among tax practitioners, who were quick to point out that the case is of no precedential value in the UK or Commonwealth.[97] This is because the case related to Indonesian law and, in any event, the relevant UK tax jurisprudence with respect to beneficial ownership was not put before the Court. In contrast, HMRC claim that the *Indofood* decision reflects an implicit anti-avoidance rule and that such an approach is consistent with the UK's 'existing policy' against treaty shopping.[98] It would appear that the CRA, at least until recently, agreed with this view.

3.3.4 Canadian Perspective

We noted above that in *Prévost Car* the government felt that the Swedish and UK investors had abused the Canada–Netherlands tax treaty by routing dividend payments through the Dutch holding company PHBV. Specifically, the CRA assessed on the

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[95] ibid para 44.

[96] ibid paras 42–44. The Chancellor also observed that the Dutch company would not be a resident entitled to the benefit of the Indonesia–Netherlands tax treaty because it would be 'effectively managed' from Indonesia, not the Netherlands. The other justices were skeptical about this opinion and preferred to decide the case solely on the beneficial ownership issue.

[97] eg R Fraser and JDB Oliver, 'Treaty Shopping and Beneficial Ownership' [2006] BTR 422; M McGowan, '*Indofood* Court Expands Interpretation of Beneficial Ownership' (2006) Tax Notes Int'l 1091.

[98] The HMRC International Manual was amended in October 2007 to state that the *Indofood* decision regarding beneficial ownership in the treaty context is 'now part of UK law': HMRC International Manual [332050], available at <www.hmrc.gov.uk/manuals/intmanual/index.htm> (accessed 3 March 2009). This view is criticized in R Fraser and JDB Oliver, 'Beneficial Ownership: HMRC's Draft Guidance on Interpretation of the *Indofood* Decision' [2007] BTR 39.

basis that the 'beneficial owners' of the dividends paid by Prévost were the corporate shareholders of PHBV in Sweden and the UK, rather than PHBV itself. The Department of Justice, when arguing the case, did not deny that PHBV existed or that it qualified as a resident of the Netherlands. They argued instead that PHBV was a mere conduit company which exercised no real control over the funds it received from Prévost. In support of this they pointed to the shareholders' agreement under which substantially all of the Prévost dividends were paid onward to the 'ultimate' corporate shareholders, as well as the fact that PHBV lacked any meaningful presence in the Netherlands. They submitted that the term 'beneficial owner' had no settled meaning in Canadian tax law and should be given an international fiscal meaning, an argument no doubt inspired by the decision in *Indofood*.

In some ways this argument was dead before it even began. First is the obvious fact that Canada, being a jurisdiction in the Anglo-Commonwealth legal tradition, has ample experience with the distinction between legal and beneficial ownership in domestic law. Moreover, Canada has publicly acknowledged in the context of the Canada–US tax treaty that the term 'beneficial owner' should be determined under the domestic law of the relevant Contracting State.[99] Finally there is Article 3(2) of the Canada–Netherlands tax treaty which, consistent with the OECD Model, directs that undefined treaty terms shall have the meaning taken from the domestic law of the relevant State 'unless the context otherwise requires'. The only way to escape the domestic law meaning of beneficial ownership would be to argue that the context otherwise requires, with 'context' interpreted broadly so as to incorporate other sources mentioned in Articles 31 and 32 of the Vienna Convention. Yet even if one took this approach it is not obvious how one would arrive at an 'international fiscal meaning' that serves an anti-avoidance purpose. It is therefore unsurprising that this argument found no favour in the Tax Court or Federal Court of Appeal.

The Tax Court in *Prévost Car* adopted the purposive approach to interpretation enunciated in *Crown Forest Industries*, having regard to the OECD Conduit Report, the 2003 OECD Commentary, and Article 31 of the Vienna Convention, but failed to see how any of this could amplify the Canadian (or Dutch) meaning of beneficial ownership. Having considered extensive submissions and expert evidence on the matter, Justice Rip observed that one is the beneficial owner of income under Canadian

[99] The US Treasury's Technical Explanation of the Fifth Protocol to the Canada–US tax treaty (fn 18), available at <www.ustreas.gov/offices/tax-policy/treaties.shtml#canada>, states that the term 'beneficial owner' should be determined under the internal law of the host country in question. It implies that only nominees, agents and conduits would not be regarded as beneficial owners under the domestic laws of Canada and the US (pp 9–10). It goes on to say that prevention of treaty shopping is achieved not through an expansive interpretation of beneficial ownership but through express anti-abuse rules in the treaty or in domestic law (pp 51–61). Canada has acknowledged that it agrees with the Technical Explanation: Minister of Finance, News Release 2008-052 (10 July 2008), available at <www.fin.gc.ca/news08/08-052e.html>. Equivalent views are expressed in the US Treasury's Technical Explanation to the UK–US tax treaty, available at <www.ustreas.gov/offices/tax-policy/treaties.shtml#uk>.

or Dutch law unless one is *legally obliged* to release the income to someone else. He concluded as follows:

> In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. … In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. When the Supreme Court in *Jodrey* stated that the "beneficial owner" is one who can "ultimately" exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word "ultimately", to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation.[100]

Justice Rip reiterated that PHBV was a duly constituted legal entity carrying on corporate activity in accordance with Dutch law and that there was no 'predetermined or automatic flow of funds' from PHBV to its shareholders.[101] Accordingly PHBV was held to be the beneficial owner of the dividends paid to it by Prévost and the 5 percent withholding tax rate was maintained.

The Federal Court of Appeal, in a brief judgment, dismissed the Crown's appeal with costs. It could discern no error in the Tax Court's factual findings or legal conclusions. Justice Décary observed that the broad interpretation of beneficial ownership advanced by the Crown 'opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve'.[102] He further stated that the Crown seemed to be urging the Court 'to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian government' have adopted.[103]

It appears that, following the decision in *Prévost Car*, there has been some consideration given to establishing a more substantive definition of beneficial ownership for Canadian tax treaty purposes. Whether this would be achieved through blanket legislation or via renegotiation of individual treaties is unclear. The Advisory Panel reported in 2008 that submissions made to them indicated 'that it might be best to wait for a globally agreed definition before taking unilateral action in this regard'.[104]

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[100] *Prévost Car* (TCC) (fn 10) para 100.

[101] ibid paras 102–103.

[102] *Prévost Car* (FCA) (fn 10) para 15.

[103] ibid.

[104] Advisory Panel Report (fn 56) para 5.66.

4 CURRENT INTERNATIONAL RESPONSES TO TREATY ABUSE – APPLYING ANTI-AVOIDANCE PRINCIPLES AND RULES

4.1 Overview of Anti-Avoidance Approaches

The limited efficacy of the interpretive approaches reviewed above suggests that, if a state wishes to exercise greater control over who may use its tax treaties, it should endeavour to include express statements to that effect within its treaties. Existing treaty provisions of this nature fit into two categories: those that look at objective factors relating to the qualities of the person seeking treaty benefits; and those that consider the subjective intentions of the person seeking treaty benefits. Such provisions are often referred to as 'limitation on benefits' or 'limitation of benefits' articles.[105] Alternatively, a state may advance the view that a principle prohibiting treaty abuse is inherent in all of its tax treaties, without requiring expression in the text. Each of these avenues may be characterized as the invocation or implication of a treaty anti-abuse principle. A quite distinct approach is for a state to have recourse to its domestic anti-avoidance laws to counter tax treaty abuse. In practice, several states including Canada have sought to rely on a combination of such approaches, with varying degrees of success.

4.2 Invoking or Implying Treaty Anti-Abuse Principles

4.2.1 Express Limitation on Benefits Articles

The UN Treaty Shopping Report concluded that it was not possible to say as a general rule that provisions prohibiting treaty abuse should be a standard feature of tax treaties. The UN view is that it is for each state to consider the probability and extent of any abuse and to weigh that against the economic benefits of the treaty left unguarded.[106] This view is reflected in both the OECD Model and the UN Model, neither of which includes express anti-abuse provisions. It remains the case that a few of the largest developed nations, notably the US, the UK and Germany, have independently made policy decisions to incorporate express limitation on benefits articles in their tax treaties.

The US has been vigilant in guarding its treaty network from abuse since the introduction of its own model convention 30 years ago. The US holds strongly to the view that its tax treaties should include express provisions preventing unintended access by residents of third countries.[107] This is achieved by the very detailed limitation

[105] FA Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* (Eucotax Series on European Taxation, Kluwer, The Hague 2006).

[106] UN Treaty Shopping Report (fn 32) 19.

[107] US Commentary (fn 26) Art 22; Doernberg and van Raad (fn 27) 172–73.

on benefits rules in Article 22 of the US Model.[108] In general, the provision does not rely on an analysis of subjective motives but instead sets forth a series of objective tests to determine whether a person has a sufficient economic nexus with a Contracting State to warrant treaty benefits. The Article delineates who is a 'qualified person', which includes resident individuals, certain publicly traded companies and certain other companies for which at least half of the voting shares are owned by qualifying persons. Qualification according to any of these criteria entitles the person to treaty benefits. A resident who is not a 'qualified person' may nevertheless be entitled to treaty benefits with respect to an item of income derived from the source state if the resident 'is engaged in the active conduct of a trade or business' in the residence state (other than certain investment businesses) and the income is derived in connection with that trade or business. The US view is that 'Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes'.[109] Wheeler confirms that limitation on benefit provisions are an 'entity test: they test the strength of the connection between the person claiming benefits and the residence state in which he does so'.[110] In effect, the US limitation on benefits article introduces more substantive restrictions on fiscal residence than exist under most states' domestic laws.

Other states that employ limitations on benefits have done so less rigorously. Of particular interest are the treaties negotiated by Germany and the UK. In the case of Germany, Article 29(6) of its tax treaty with Canada provides as follows:

> Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.[111]

A very similar provision appears as Article 29A(7) of the Canada–US tax treaty, supplementing the express limitation on benefits rules. Thus treaty benefits can be denied under these two treaties where allowing the benefits would constitute an 'abuse' of the treaty provisions. This approach would arguably take account of both objective and subjective elements. The UK prefers to include rules denying particular treaty benefits where a person involved in an arrangement has a dominant tax avoidance purpose. The dividends article of the Canada–UK tax treaty contains the following representative exclusion:

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[108] In the Canada–US tax treaty this appears as Article 29A. The provision was added to the treaty in 1995, but at the time applied unilaterally in favour of the US. It was not until the Fifth Protocol in 2007 that the provision was made reciprocal, thus permitting Canada to deny treaty benefits to US conduit entities.

[109] US Commentary (fn 26) Art 22 para 1.

[110] J Wheeler, 'General Report' in *Cahiers de Droit Fiscal International* vol 92b 'Conflicts in the Attribution of Income to a Person' (Int'l Fiscal Association, Rotterdam 2007) 40.

[111] Canada–Germany tax treaty Art 29(6).

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.[112]

There are similar exclusions for dividends, interest, royalties and other income in many newer UK tax treaties.[113] This is now a common UK treaty provision and has gained wider acceptance in the OECD Commentary.[114] One reason that the UK and other European Union member states may prefer to rely on purpose-based limitations, rather than entity-based limitations as employed by the US, could be a concern not to breach freedom of establishment under the EC Treaty.[115]

The difficulty with applying a 'main purposes' test or other subjective test for abuse is that, as noted in the UN Treaty Shopping Report, it is 'a notoriously difficult business' to show that arrangements have been entered into for the main purpose of benefiting from a treaty.[116] The UN therefore encouraged the use of objective tests instead. Canada, in contrast, appears to favour the type of 'main purposes' test employed by the UK: it has negotiated equivalent provisions in a handful of Canadian tax treaties recently concluded with smaller countries, including those with Mexico, Oman and Peru. In any event, there are as yet no judicial decisions on disqualification from Canadian tax treaty benefits under an express limitation on benefits article, whether objective or subjective.[117] It is likely that the structures used in *MIL Investments* (discussed in section 4.2.3 below) and *Prévost Car* would have collapsed under a US-style limitation on benefits provision because, among other things, the

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[112] Canada–UK tax treaty Art 10(7).

[113] eg the UK's tax treaties with Australia, Denmark, Korea, New Zealand, Oman and Saudi Arabia. The tax treaties concluded with France and the Netherlands in 2008 (not yet in force) contain provisions of this nature, replacing the current language: '…mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons'. Article 10(3) of the new treaty with the Netherlands is particularly interesting:

> No relief shall be available under this Article if it was the main purpose or one of the main purposes of any person concerned with an assignment of the dividends, or with the creation or assignment of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the company that is the beneficial owner of the dividends and the conduct of its operations, to take advantage of this Article. In any case where a Contracting State intends to apply this paragraph, its competent authority shall in advance consult with the competent authority of the other Contracting State.

The treaty contains equivalent rules for interest, royalties and other income.

[114] OECD Commentary (fn 15) Art 1 para 21.4.

[115] This is an enormous topic in its own right. For further discussion see Vega Borrego (fn 105) ch 4; CH Panayi, *Double Taxation, Tax Treaties, Treaty-Shopping and the European Community* (Eucotax Series on European Taxation, Kluwer, The Hague 2007) ch 5. An analysis of purpose-based limitations on the use of controlled foreign companies is contained in Thesis ch 5.

[116] UN Treaty Shopping Report (fn 32) 8, 17–18.

[117] The issue did not arise in *Crown Forest Industries* because the then-current version of the Canada–US tax treaty did not contain a limitation on benefits article.

controlling shareholders of the treaty entities were not residents of the relevant treaty state. One can only speculate whether these decisions would have been different had the respective tax treaties contained purpose-based anti-treaty shopping provisions, although the observations made in *MIL Investments* suggest that the outcomes would have been the same.

4.2.2 Implied Anti-Abuse Principles

Some jurisdictions take the view that a principle prohibiting treaty abuse is inherent in all of their tax treaties, obviating the need to express such a principle through a limitation on benefits provision. This argument derives from public international law, particularly Article 31 of the Vienna Convention, which provides that a treaty 'shall be interpreted in good faith', and Article 26 thereof, which provides that every treaty 'is binding upon the parties to it and must be performed by them in good faith' (*pacta sunt servanda*).[118] It is said that the obligation to interpret and perform a treaty in good faith creates an autonomous 'abuse of law' principle with respect to tax treaties, similar to the domestic doctrines applied by some states.[119] The OECD Commentary entreats Contracting States to interpret and apply tax treaties in accordance with the 'guiding principle' mentioned previously, suggesting this is sufficient to disregard abusive transactions without recourse to express restrictions or domestic anti-avoidance rules.[120] The OECD recognizes, however, that not all states share this view. There is a reasonable argument that the principle of good faith in the interpretation and application of tax treaties relates solely to the good faith of the Contracting States, not of taxpayers who seek to rely on the treaty.[121]

A notable example of this approach is the decision of the Swiss *Bundesgericht* (Federal Supreme Court) in *A Holding ApS v Federal Tax Administration*.[122] As in *Prévost Car*, the case involved an international flow of dividends through special purpose companies. An individual resident in Bermuda was the sole shareholder of a Bermuda company, which in turn owned a Guernsey company, which in turn owned a Danish holding company, which in turn owned 100 percent of the shares of a Swiss operating company. It was claimed that dividends distributed by the Swiss company to the Danish entity were exempt from Swiss source taxation by virtue of the Switzerland–Denmark tax treaty. The Danish holding company had no assets or employees and its only activity was to receive and pay dividends. It was accepted that

[118] van Weeghel (fn 30) ch 7; Engelen (fn 62) ch 6; N Goyette, 'Tax Treaty Abuse: A Second Look' (2003) 51 Can Tax J 764, 765–75.

[119] See section 4.3 below.

[120] OECD Commentary (fn 15) Art 1 paras 9.3–9.5, addressed at text to fn 41–42.

[121] Engelen (fn 62) 124–28, citing B Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (Cambridge Univ Press, Cambridge 1953, reprinted 1987) 106–36.

[122] (2005) 8 ITLR 536; Case 2A.239/2005; available at <www.bger.ch/>. For commentary in English see: S Oesterhelt and M Winzap, 'Swiss Supreme Court Decision on Treaty Abuse' (2006) 46 European Taxation 461.

the holding company was a resident of Denmark for purposes of Danish law and that it took beneficial ownership (albeit briefly) of the Swiss dividends. The issue was whether these dividends could be denied the treaty exemption from Swiss withholding tax on some other basis. The Switzerland–Denmark tax treaty did not have an express anti-abuse principle, unlike some Swiss tax treaties, and the Swiss domestic tax avoidance legislation did not apply to this situation. The Supreme Court nonetheless decided that, by virtue of international law, all Swiss tax treaty provisions must be interpreted so as to prevent abuses of the treaty. It considered this arrangement to be abusive and therefore denied the treaty relief claimed.

4.2.3 Canadian Perspective

The few Canadian tax treaties that contain express anti-abuse principles appear to have been designed that way at the insistence of the other Contracting State, notably the US and Germany. The Canadian tax treaties that are most often exploited in treaty shopping arrangements, such as those with Barbados, Luxembourg and the Netherlands, have no such rules. The question becomes whether those treaties should be read as containing an implied anti-abuse principle, similar to the approach of the Swiss Supreme Court in *A Holding ApS*. In 2003 the CRA expressed the view that, where it identified cases of treaty abuse, it would seek to deny benefits through two related approaches:[123] it would rely on an inherent principle against the abuse of treaties and would also challenge the arrangement under Canada's general anti-avoidance rule ('GAAR').[124] Both of these approaches were advanced in *MIL Investments*.

As explained previously, *MIL Investments* involved a complex series of transactions that resulted in no taxation in Canada (or Luxembourg) on a significant capital gain realized on the disposition of shares in the Canadian company DFR. One of the arguments made by the Crown was that the exemption under Article 13 of the Canada–Luxembourg tax treaty could be denied on the basis of an anti-abuse rule inherent in the treaty. Justice Bell analyzed the relevant provisions of the Vienna Convention, the OECD Commentary applicable at the time the treaty was concluded, and the context and purpose of the relevant treaty provisions. None of this persuaded him that the 'carefully negotiated treaty' should be read as including an implied anti-abuse rule.[125] In any event, he considered that 'the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive'.[126] Thus it seems unlikely that, had the treaty contained an *express* provision against abuse similar to Article 29(6)

[123] *Technical News 30* (fn 55). The Advisory Panel appears to accept the validity of these dual approaches: Advisory Panel Report (fn 56) paras 5.67–5.68.

[124] The GAAR is set out in section 245 of the Income Tax Act. The application of the GAAR is discussed in section 4.3.3 below.

[125] *MIL Investments* (TCC) (fn 9) para 87.

[126] Ibid para 72.

of the Canada–Germany tax treaty, it would have been applied by the Court in this case.

One might complain that Justice Bell's analysis was very traditionalist and out of step with current international tax thinking. Among other things, he refused to consider revisions to the OECD Commentary published later than the conclusion of the Canada–Luxembourg tax treaty and seemed to insist that there be an 'ambiguity' in the treaty before looking to its broader context and purpose.[127] Nevertheless, the government's appeal with respect to the GAAR (discussed below) was dismissed and there is no reason to believe that the Federal Court of Appeal would have disturbed the Tax Court's conclusion with respect to the alleged treaty anti-abuse principle drawn from international law. It is therefore unremarkable that the Department of Justice did not seek to imply a treaty anti-abuse principle when it argued *Prévost Car* the following year.

4.3 Invoking Domestic Anti-Avoidance Rules

4.3.1 Consistency with Treaty Obligations

Perhaps the most common approach to countering treaty shopping, aside from pursuing arguments about a lack of beneficial ownership, is to rely on a state's internal laws prohibiting abusive tax avoidance. A threshold issue is whether the application of domestic anti-avoidance rules to international treaties is permitted under international law. As this issue is now largely academic in Canada it will be addressed only briefly here.

There are various domestic approaches to abusive tax avoidance. The US employs judicial doctrines known as 'economic substance', 'step transaction' and 'substance-over-form' to disregard transactions motivated predominantly by tax considerations.[128] The legal systems of several European states, including France, Germany, Switzerland and the Netherlands, incorporate doctrines regarding abuse of law and abuse of rights, both of which are deeply rooted in civil law traditions; these doctrines are known variously as *abus de droit*, *fraude à la loi*, *Rechtsmissbrauch* and *fraus legis*.[129] In some of these jurisdictions general principles preventing abuse of law are buttressed by express provisions in domestic tax legislation. The UK prefers to deal with aggressive tax avoidance through ordinary statutory interpretation.[130] The tradition in developed Commonwealth countries, including Canada, Australia, New Zealand and

[127] The better view is expressed in *Prévost Car* (FCA) (fn 10) paras 9–12.

[128] AC Infanti, 'United States' in Maisto (fn 49) ch 13.

[129] For an international comparison of such approaches see Z Prebble and J Prebble, 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law' (2008) 62 Bulletin for Int'l Taxation 151.

[130] Freedman 2007 (fn 7). Any approach which the UK might take to countering treaty abuse would, arguably, be comprised in the 'interpretive approaches' discussed in section 3 above.

South Africa, is to rely on a statutory GAAR. While GAARs differ in their wording and scope, the common theme of such provisions is to deny a tax advantage where: (a) the main or primary purpose of a transaction or series of transactions is to obtain such tax advantage; and (b) the relevant tax provisions relied upon to achieve that advantage have been abused, having regard to their context and purpose.[131] Evidently this formulation is similar to the guiding principle that the OECD suggests be used for identifying treaty abuse.

The OECD Commentary favours the view that domestic anti-avoidance rules do not have to be expressly incorporated in tax treaties in order to condition the application of treaties. The Commentary on this issue was substantially expanded in 2003 and 2008 but unfortunately the analysis is somewhat meandering, perhaps because it attempts to fuse a wide variety of national perspectives. In essence, the OECD argues that taxes are imposed by domestic law and are merely relieved by treaties, thus an abuse of the provisions of a tax treaty would also be an abuse of the provisions of domestic law under which the tax is levied.[132] The OECD concludes that there is no conflict between domestic anti-avoidance rules and tax treaties.

Some commentators have argued that the views expressed in the OECD Commentary are unsound. They believe that a state which adopted the OECD position would be engaging in a unilateral treaty override, possibly amounting to a breach of international law.[133] The UN Treaty Shopping Report queried whether the denial of treaty benefits by virtue of domestic anti-avoidance laws 'is compatible with the denying State's obligations under the treaty'. They observed that, if in any particular case it was decided that the treaty permitted the abusive relief to be given, the treaty partners would then have to consider renegotiating the treaty so as to deny similar relief in the future.[134] The opposing view is that a state's domestic tax laws and a state's international tax treaties must be interpreted concordantly; this will of necessity involve application of anti-avoidance rules in addition to other domestic tax provisions.[135]

4.3.2 Approaches of Other Jurisdictions

In any event, for many states it appears to be a matter of international custom (if not international law) to agree reciprocally that their respective anti-avoidance regimes

[131] D Pickup, 'In Relation to General Anti-Avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect Their Tax Revenues' in J Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford Univ Centre for Business Taxation, Oxford 2008) 9.

[132] OECD Commentary (fn 15) Art 1 paras 9.1–9.2, 22–22.2.

[133] eg Baker (fn 20) [F08]–[F10]; Doernberg and van Raad (fn 27) 173; Arnold and van Weeghel (fn 49) 92–98.

[134] UN Treaty Shopping Report (fn 32) 10. This was the conclusion reached by the Indian Supreme Court with respect to the India–Mauritius tax treaty in *Azadi Bachao Andolan* (fn 51).

[135] Goyette (fn 118) 778–805.

may be invoked to counter tax treaty abuse. For example, the Canada–Germany tax treaty expressly incorporates the domestic anti-abuse provisions of the respective states.[136] The US Commentary takes it as given that US limitation on benefits provisions work in conjunction with domestic anti-avoidance rules.[137] This position is supported by the tax jurisprudence of other states as well.

As already noted, the English Court of Appeal opined in *Indofood* that the Indonesian principle of substance over form, drawn from its domestic tax law, could be relied upon to amplify the interpretation of 'beneficial ownership' in the Indonesia–Netherlands tax treaty. A similar conclusion was reached by the French *Conseil d' Etat* (Supreme Administrative Court) in the *Bank of Scotland* case.[138] There an American company had entered a usufruct agreement with a UK bank, under which the bank acquired dividend coupons relating to the shares of a French subsidiary of the US parent. The Court concluded that treaty benefits were not available to the UK bank under the France–UK tax treaty because 'le bénéficiaire effectif' (the effective beneficial owner) of the dividends was the US parent company. The Court appears to have been influenced by the French doctrine of *abus de droit*. Thirdly, the *Del Commercial Properties* case[139] is an application of US economic substance principles to a tax treaty. The US Court of Appeals, affirming the decision of the Tax Court, held that certain loan repayments purportedly made from a US corporation to a Dutch intermediary were in substance made to the ultimate Canadian lender and were structured to avoid US withholding taxes. The Courts applied the American step-transaction doctrine under which a series of formally separated steps may be collapsed and treated as a single transaction.

4.3.3 Canadian Perspective

Canadian tax treaties other than those with Germany and the US do not expressly incorporate Canadian anti-avoidance rules. The absence of such provision in Canada's other tax treaties is no longer of concern, however. A retroactive amendment to the GAAR enacted in 2005 ensures that the GAAR applies not only to an abuse of the Income Tax Act, but to an abuse of the Income Tax Regulations, the Income Tax Application Rules and each of Canada's tax treaties.[140] While the retroactive scope of

[136] (fn 111).

[137] US Commentary (fn 26) Art 22 para 1.

[138] *Bank of Scotland v Ministre de l'Economie, des Finances et de l'Industrie*, Case 283314 (29 December 2006), available at <www.legifrance.gouv.fr/>. For commentary in English see: B Gibert and Y Ouamrane, 'Beneficial Ownership – A French Perspective' (2008) 48 European Taxation 2.

[139] *Del Commercial Properties Inc v Commissioner of Internal Revenue*, 251 F.3d 210 (DC Cir 2001). For commentary see Infanti (fn 128) 380–83.

[140] *Budget Implementation Act 2004* (No 2), SC 2005 c 19 ss 52 and 60.

the amendment may be deplored,[141] Canadian courts have accepted that the amendment is effective to make the GAAR, at least in principle, applicable to tax treaty abuse.[142]

The GAAR was introduced in 1987 in response to what the government viewed as the excessive formalism of Canadian courts with respect to tax avoidance. There is a large literature with respect to the GAAR which cannot be discussed in any detail here.[143] It is sufficient to review the key features of the GAAR and the prevailing judicial attitude towards its interpretation and application.

In broad terms, the GAAR may be relied upon to deny a tax benefit that would be obtained through an 'avoidance transaction' or through a series of transactions that includes an 'avoidance transaction'. An avoidance transaction is a transaction that, but for the GAAR, would result in a tax benefit, unless it 'may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes'.[144] Even if these conditions are satisfied, the tax benefit will be denied only if the transaction would result in a 'misuse' or 'abuse' of provisions of the Income Tax Act, a tax treaty or certain other instruments not relevant here.[145] There have been approximately 30 decisions that have considered the GAAR. The determinative issues have in most cases been the presence or absence of bona fide motivations for a transaction and the identification of a transaction as legitimate or abusive in the context of specific provisions of the Income Tax Act.

The Supreme Court of Canada had opportunity to elucidate the meaning of the GAAR in two recent cases, *Canada Trustco Mortgage Co v Canada*[146] and *Mathew v Canada*.[147] In each case the Court, having dealt briefly with the concepts of 'tax benefit' and 'avoidance transaction', adopted the following two-stage framework to determine if an avoidance transaction results in an abuse of the Income Tax Act. A court must first interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose, employing an approach that is at once textual, contextual and purposive. It must then determine whether the impugned avoidance transaction

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[141] See GT Loomer, 'Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation' [2006] BTR 64; B Alarie, 'Retroactivity and the General Anti-Avoidance Rule' in DG Duff and H Erlichman (eds), *Tax Avoidance in Canada* (Irwin Law, Toronto 2007) 197, available at <http://ssrn.com/abstract=1107489>.

[142] *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 2005 SCC 54, para 7; *MIL Investments* (TCC) (fn 9) paras 28–31.

[143] For detailed analysis see: B Arnold 'The Long, Slow, Steady Demise of the General Anti-Avoidance Rule' (2004) 52 Can Tax J 488; B Arnold, 'Confusion Worse Confounded: The Supreme Court's GAAR Decisions' (2006) 54 Can Tax J 167; DG Duff, 'The Supreme Court of Canada and the General Anti-Avoidance Rule: *Canada Trustco* and *Mathew*' (2006) 60 Bulletin for Int'l Taxation 54; Duff and Erlichman (fn 141).

[144] Income Tax Act s 245(3).

[145] Income Tax Act s 245(4).

[146] (fn 142).

[147] [2005] 2 SCR 643, 2005 SCC 55.

frustrates that object, spirit or purpose. Importantly, the Supreme Court insisted that the GAAR is not an overriding 'economic substance' test – it requires a rigorous analysis of the individual transactions in the context of the specific provisions relied upon. The Court opined that abusive tax avoidance exists:

> … where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.[148]

In the author's view this formulation sets an inordinately high threshold for a finding of abuse, depriving the GAAR of any substantial impact beyond that which could be achieved through ordinary statutory interpretation. The potential deficiency in this formulation of the GAAR is apparent when the provision is applied to the exploitation of a tax treaty.[149]

The Crown in *MIL Investments* argued that the taxpayer had abused the capital gains exemption under Article 13 of the Canada–Luxembourg tax treaty, with the result that the tax benefit should be denied pursuant to the GAAR. There is no doubt that there were valid commercial reasons for the individual shareholder to cause MIL to sell the DFR shares; the question was whether the method chosen to implement that sale comprised at least one avoidance transaction that frustrated the purpose of the treaty. Justice Bell considered the framework from *Canada Trustco* and referred to various Canadian decisions recognizing the legitimacy of tax planning in the course of commercial arrangements. His primary conclusion was that none of the impugned transactions (including the continuance from Cayman to Luxembourg) was an avoidance transaction. While accepting that one of the 'driving forces' of the transactions was to ensure the sale of the DFR shares in a tax effective manner, he concluded that the overall commercial purpose was sufficient to exculpate the transactions.[150] He nevertheless went on to consider whether, had one or more of the transactions been an avoidance transaction, it would have constituted an abuse of the tax treaty. Given the high threshold established in *Canada Trustco*, it is unsurprising that Justice Bell came to the conclusion that there was no abuse. Indeed, his view was that 'the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive'.[151] He held that a court must examine 'the *use* of the selected treaty' rather than its *selection*. From there he turned to the text of the specific treaty provisions relied upon. He could discern no reason why those provisions should not apply to a Luxembourg holding company owned by a foreign shareholder.

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[148] *Canada Trustco* (fn 142) para 60.

[149] The application of the GAAR to international arrangements not involving treaty shopping is addressed in Thesis ch 7.

[150] *MIL Investments* (TCC) (fn 9) paras 53–54.

[151] *MIL Investments* (TCC) (fn 9) para 72.

The Federal Court of Appeal agreed, saying it was clear that: (a) the Canada–Luxembourg tax treaty intends to exempt Luxembourg residents from taxation on gains from the disposition of certain Canadian property; and (b) under the terms of the tax treaty, the shares of DFR held by MIL were such exempt property. The Court held that, if the exempting provision was intended to be limited to portfolio investments, or to non-controlling interests in immoveable property, then 'it would have been easy enough to say so' in the tax treaty.[152]

The CRA and Department of Justice may fear that this interpretation of the GAAR amounts to its annihilation so far as treaty shopping is concerned. This may be why the GAAR was not invoked in *Prévost Car* as an alternative to the beneficial ownership contention. The analysis in section 2.2 above demonstrated that, while it may be difficult to delimit which uses of a treaty will be considered legitimate or abusive, it is the very selection of a particular treaty by unintended beneficiaries in which the abuse subsists. Yet the analysis in *MIL Investments* indicates that one must focus on the particular mechanics by which the treaty provisions operate, rather than on the selection of that treaty by particular beneficiaries. The analysis in *MIL Investments* seems to ensure that any avoidance strategy involving a Canadian tax treaty, no matter how blatant, will be immune to the GAAR provided the intermediate entity is formally established in the particular state and meets the technical requirements of the particular treaty provisions relied upon.

5 CONCLUSION – TOWARDS AN EFFECTIVE CANADIAN RESPONSE

5.1 The Canadian Response in Context

Numerous states around the world, both developed and developing, have encountered the problem of unintended beneficiaries exploiting their tax treaty networks. Different states have responded to treaty shopping in different ways, based on their individual perceptions of the scope and severity of the problem and based on their individual legal traditions. Canada has targeted aggressive international tax planning, including treaty shopping, but to date has been unsuccessful before the courts. These results might be welcomed by some MNEs, high net worth individuals and their international tax advisors, on the view that the arrangements in *MIL Investments* and *Prévost Car* (and indeed *Indofood*) were legitimate and deserved to be vindicated. Yet if the Canadian government believes that arrangements of this nature are antithetical to Canadian tax treaty policy, it must query how it can effectively forestall such arrangements without discouraging bona fide investment.

One should first consider why the arguments advanced by the CRA and the Department of Justice have failed. In *Prévost Car*, the challenge hinged upon the court accepting an interpretation of beneficial ownership borrowed from international fiscal

[152] *MIL Investments* (FCA) (fn 9) para 7.

law and scholarship. Aside from the obvious problem that this approach ignored the domestic legal meaning of the term, it was tantamount to using 'beneficial ownership' as a surrogate anti-avoidance rule. Moreover, the position advanced in *Prévost Car* attempted to relate beneficial ownership to the holding company's degree of presence in its jurisdiction of residence, thereby conflating distinct issues. Such an approach is not likely to succeed in any Anglo-Commonwealth legal system, where beneficial ownership has an established meaning and where tax avoidance rules are carefully circumscribed. Even jurisdictions that have an anti-avoidance ethos which is more favourable to the domestic tax authorities, such as Switzerland and the US, have countered dividend conduit arrangements not by extending the concept of beneficial ownership but by invoking treaty anti-abuse principles or domestic anti-avoidance rules.[153] The arguments advanced in *MIL Investments* were more tenable than those in *Prévost Car*. However, the Canadian courts are not yet willing to accept that the decision to establish an affiliate in a particular state is in itself abusive, whether under an implied treaty principle or the GAAR. It seems inevitable that, in a legal system characterized by liberalism, the overall commercial purpose of investing abroad will generally be considered sufficient to justify the particular structure employed.

Given these constraints it appears that there are three possibilities open to the Canadian government. The first option would be to terminate specific tax treaties considered most susceptible to abuse, which would be a radical and possibly counter-productive action. A preferable avenue would be to renegotiate specific tax treaties so as to include express anti-abuse rules, limiting treaty benefits to an intended class of beneficiaries. A related and more fundamental response would be for Canada and other interested states to reconsider their formulations of corporate residence.

5.2 Including Express Anti-Abuse Principles in Canadian Treaties

One viable option is to include express anti-abuse principles in Canadian tax treaties, preferably using objective rather than subjective assessments. Provisions that seek to deny benefits where there is 'abuse' (as in the Canada–Germany tax treaty) or where the beneficiary has a tax avoidance 'main purpose' (as in the Canada–UK tax treaty) are vague and are unlikely to be fruitful given the decision in *MIL Investments*. It would be more effective to incorporate objective rules in the form of US-style limitation on benefits provisions, in conjunction with current or enhanced beneficial ownership requirements.

It was not until 2007 that the US limitation on benefits provision was made reciprocal, thus permitting Canada to deny treaty benefits to US conduit entities.[154] Canada would do well to renegotiate its other tax treaties to include provisions of this nature, as they ensure that only residents with a substantial economic nexus in the

[153] *A Holding ApS* (fn 122); *Del Commercial Properties* (fn 139).

[154] Fifth Protocol to the Canada–US tax treaty (see fns 18 and 108).

treaty partner state can enjoy the benefits of the treaty. The 'substance' of that economic nexus could be determined based on objective factors, such as the proportion of shares ultimately held by residents of the treaty partner state or the degree of business activity carried on in the treaty partner state. The factors chosen would determine whether the tax structures used in *MIL Investments*, *Prévost Car* or other variations would or would not be barred from treaty entitlements. For example, requiring a majority of ultimate individual shareholders to be resident in the treaty partner state would completely undermine the avoidance arrangements employed in both Canadian cases and most other conduit structures envisaged by the OECD and UN. If Canada believes that it is appropriate to add a subjective element they could do so. Which factors to adopt is a policy decision – the important point is that control over the use of Canada's international agreements would be restored to Canada and its treaty partners, rather than being in the domain of MNEs and their international tax advisors.

5.3 Reconfiguring Corporate Residence

A more fundamental response, which in the author's view is a corollary to express limitation on benefits provisions, is to seek to reconfigure the law of corporate residence through legislative amendment. In attacking treaty shopping arrangements, what tax authorities are essentially challenging is the perceived abuse that arises from a person's lack of connection with the Contracting State through which it seeks to obtain treaty benefits. This is stated plainly in the US Commentary,[155] is implicit in the OECD Conduit Report and OECD Commentary,[156] and is evident from the arguments made in various treaty shopping cases, including *Prévost Car*, *Indofood* and *A Holding ApS*. Each case involved a letter box company (or companies) having no physical offices, staff or productive business. Tax authorities generally do not waste effort challenging the residence of conduit entities because there is little chance of success under most domestic laws. In Canada and many other jurisdictions the determination of residence is made based on place of incorporation or place of central management and control. The author has argued previously that both concepts fail as measures of a substantial economic nexus.[157] Implementing a US-style limitation on benefits provision in a tax treaty represents a partial recognition of this failure. More comprehensive recognition is possible. Redefining what Canada considers to be 'residence' and 'non-residence' – in its domestic law and its tax treaties – would be a rational, effective and transparent way of addressing international tax treaty abuse, without hindering foreign direct investment into Canada.

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[155] Text to fn 109–110.

[156] Text to fn 46–47 and text following fn 53.

[157] Thesis ch 4.

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