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The New Era of Taxation Conference

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Principal purpose, anti-abuse rules and tax relief – new ways for allocating assets and income?

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Overview

In the wake of the PPT of the MLI and the ECJ Danish cases, did the ’beneficial ownership’ concept get a new twist?

How are anti-abuse rules applied worldwide?

The anti-abuse rules and the CJEU’s rulings in the Danish beneficial owner cases are likely to have a significant impact not only on multinational group structures, but also on transactions among unrelated parties.

- **Denmark** Update on the ECJ Danish cases
- **Poland** Main anti-abuse measures | Danish cases
- **Ireland** Beneficial Ownership – Irish Experience | PPT for Non-CIV Funds
- **Italy** GAAR | Beneficial Ownership | Position re. Danish cases
- **Germany** German Anti-Treaty Shopping Rule | GAAR and Beneficial Ownership
- **Canada** Treaty Shopping and GAAR | PPT and GAAR | Beneficial Ownership
- **USA** PPT Disfavored in the US | US Domestic Anti-Abuse Doctrines | Codification of Economic Substance Doctrine

IBA New Era of Taxation Conference, 2 December 2021, Dublin

"The Danish cases" on beneficial ownership and alleged abuse of law

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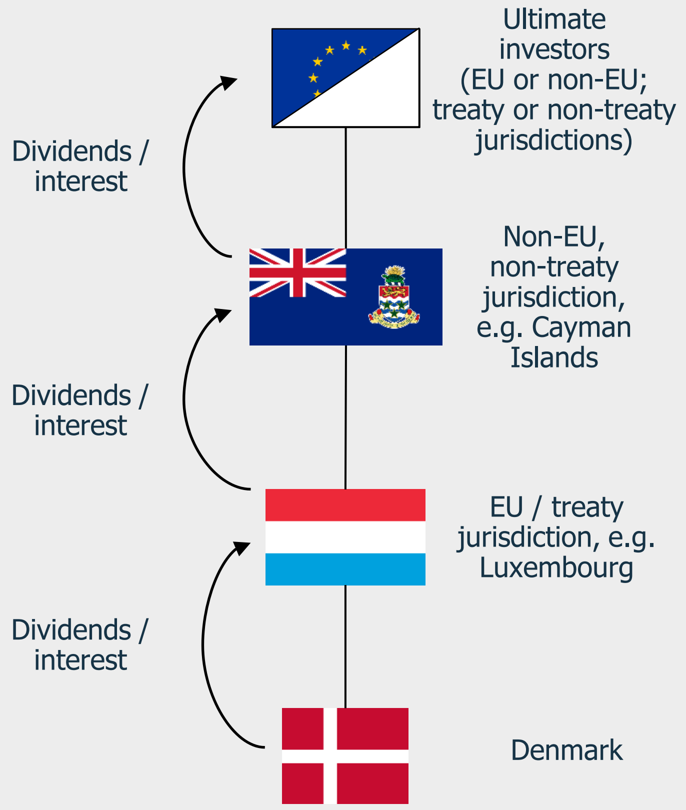
A quick introduction to "The Danish Cases" (1)

- **Six cases decided by the ECJ on February 26, 2019**
  - 4 interest WHT cases: Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg I et al*
  - 2 dividend WHT cases: Cases C-116/16 and C-117/17, *T Danmark et al*

- **"Landmark rulings"**
  - Many different questions referred by the Danish high courts to the ECJ
    - A general (unwritten) EU anti-abuse principle
    - Beneficial ownership under the interest-royalty directive
    - EU fundamental freedom questions
  - Decided by the ECJ Grand Chamber (13 judges)
  - The ECJ deviated from previous ECJ case law, from the EU Commission's understanding and from AG Kokott's opinions
  - The ECJ's decisions arguably left several questions unaddressed
  - Leading tax scholars have called the decisions "surprising"

Example: Intermediate holdco structure



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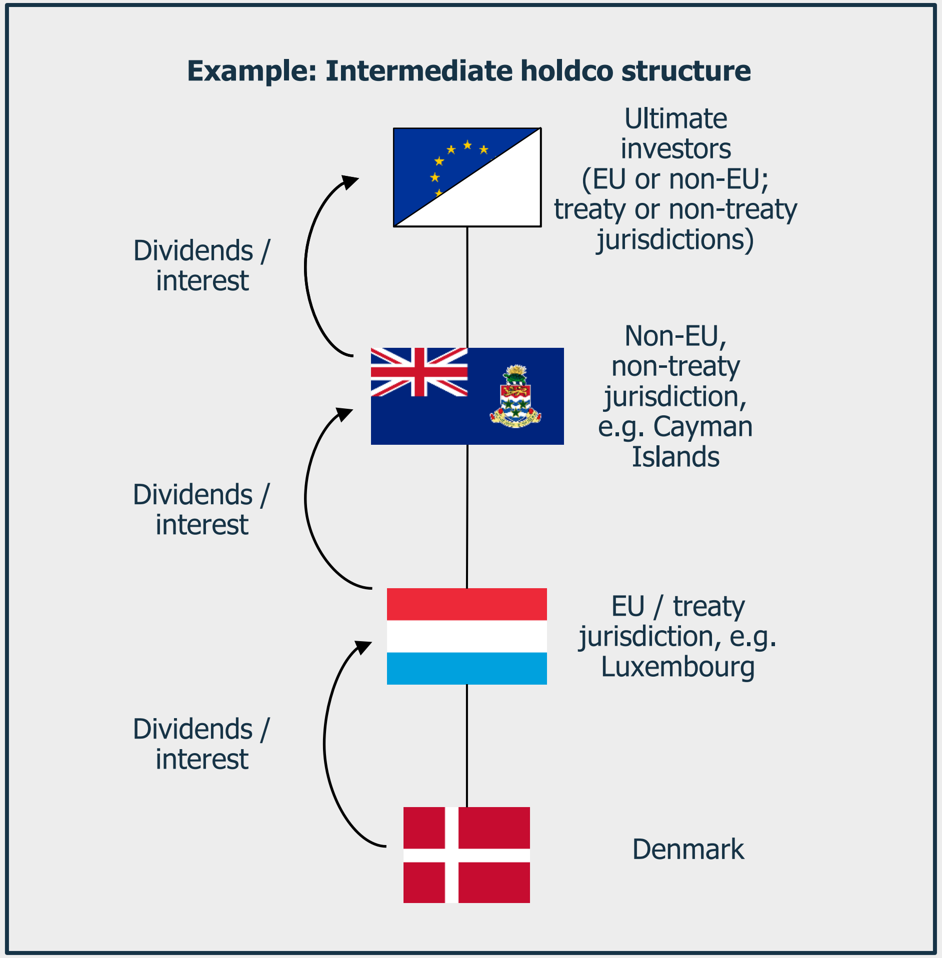
A quick introduction to "The Danish Cases" (2)

- Until recently, Denmark had **no GAAR, PPT og LOB**. Denmark has no domestic rules on beneficial ownership. (Lots of SAARs, though).
- In **1998**, Denmark abolished all WHT to become an EU holdco jurisdiction.
- In **2001/2004**, Denmark re-introduced WHT on dividends/interest, unless paid to a **beneficial owner in an EU or treaty jurisdiction**.
- In connection with the re-introduction, the minister of taxation publicly stated that **intermediate EU holdcos** would be considered the beneficial owners.
- Starting in **2008**, the DTA initiated mass audits and issued ~150 assessments, claiming billions of DKK in revenue, claiming negligence and abuse of law.
- The assessments took MNEs and advisors by **surprise**. The taxpayers claim that domestic Danish **administrative law** prohibits the DTA from changing its mind retroactively *(see* the article "The great hypocrisy" on Plesner.com*)*.
- The taxpayers also claim WHT exemption under the **EU Parent-Subsidiary and Interest-Royalties directives** and under **tax treaties**.

- Was the interposition of EU holdcos an **abuse of EU/treaty law?**



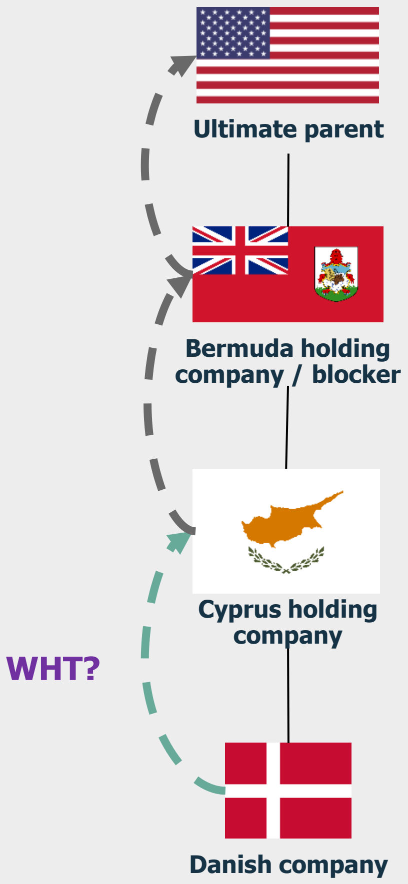
The ECJ's judgments

- There is a **general unwritten EU principle of anti-abuse**
  - Abuse = objective criteria + a subjective motive
    - Tax is one of the structure's principal motives
    - Immediate flow-through of funds to non-EU entities
    - Conduit companies with very little activity
    - Conduit companies with restriction on their use of the funds
    - Structures made in reaction to changes in tax law

- Beneficial ownership is an **autonomous EU term** (that follows OECD guidance)
  - The tax authority does not have to point out who is the beneficial owner
  - It is sufficient if the tax authority can prove that the EU recipient is a conduit company

- Remaining **open questions** include
  - What if the taxpayer proves that **direct payments** to the ultimate investor would have been exempt?
  - How long can/must a company possess/control the funds before it is no longer the beneficial owner?

Example
based on Case
C-117/16, *Y Denmark*



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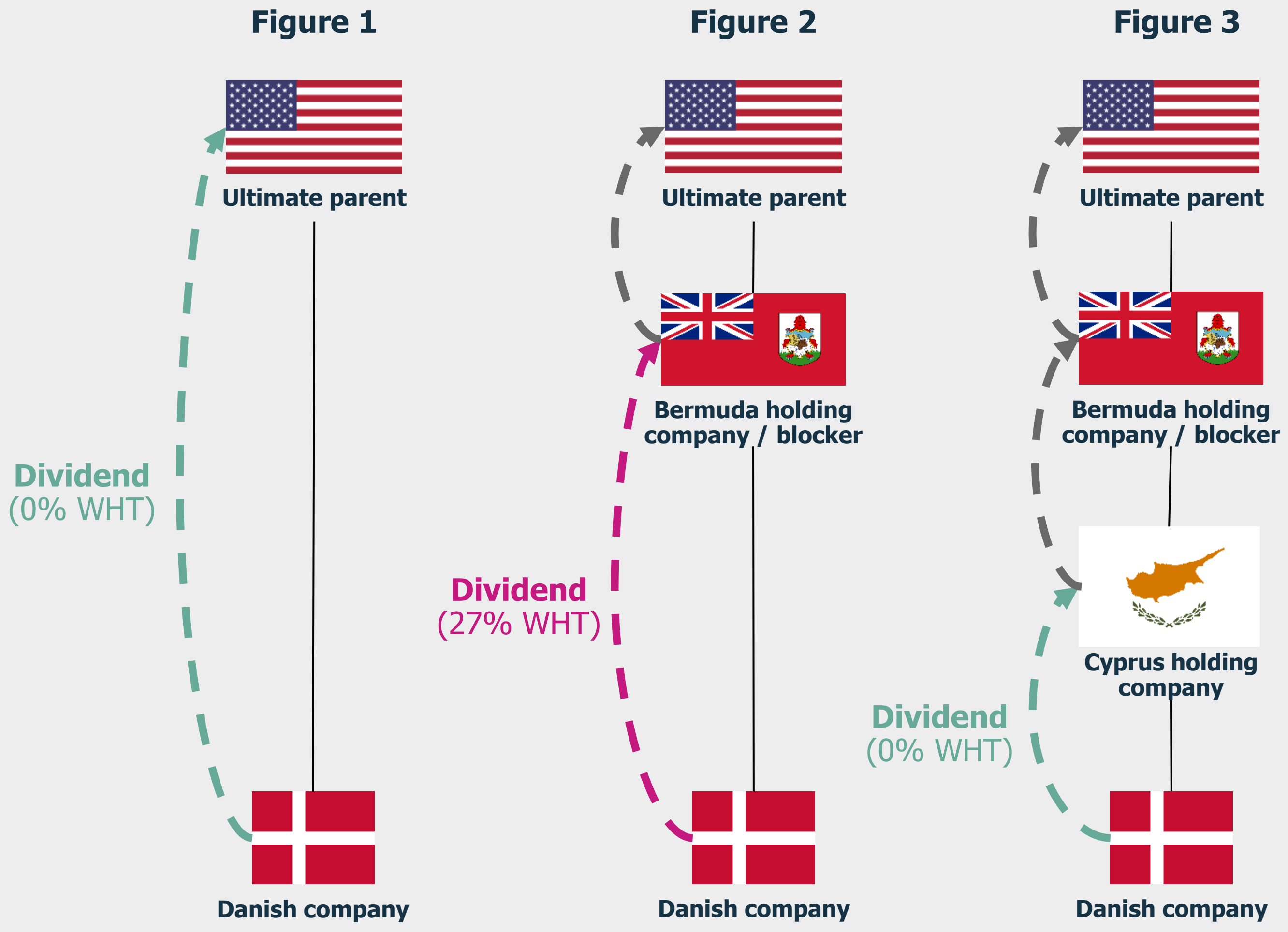
3 May 2021 Danish High Court judgment (Case C-117/16, *Y Denmark*)

- **The key facts**
  - A U.S.-based group with a Bermuda entitiy established a **Danish holdco**
  - After Denmark's reintroduction of dividend WHT, the group interposed a **Cyprus holdco**
  - The group paid dividends from its EU subsidiaries all the way to the U.S. parent company through Denmark, Cyprus, Bermuda (taxed under the American Jobs Creation Act of 2004)
  - One dividend was held by the Bermuda entity for **~5 months**, **invested in bonds**, and paid to the U.S.
  - Another dividend was paid to Bermuda after ~**4 years** (disputed whether it reached the U.S.)

- **The High Court's judgment**
  - No WHT on the first dividend: The U.S. parent company was the intended beneficial owner
  - WHT on the second dividend: The Bermuda entity was deemed to be the beneficial owner
  - Appealed to the Danish Supreme Court



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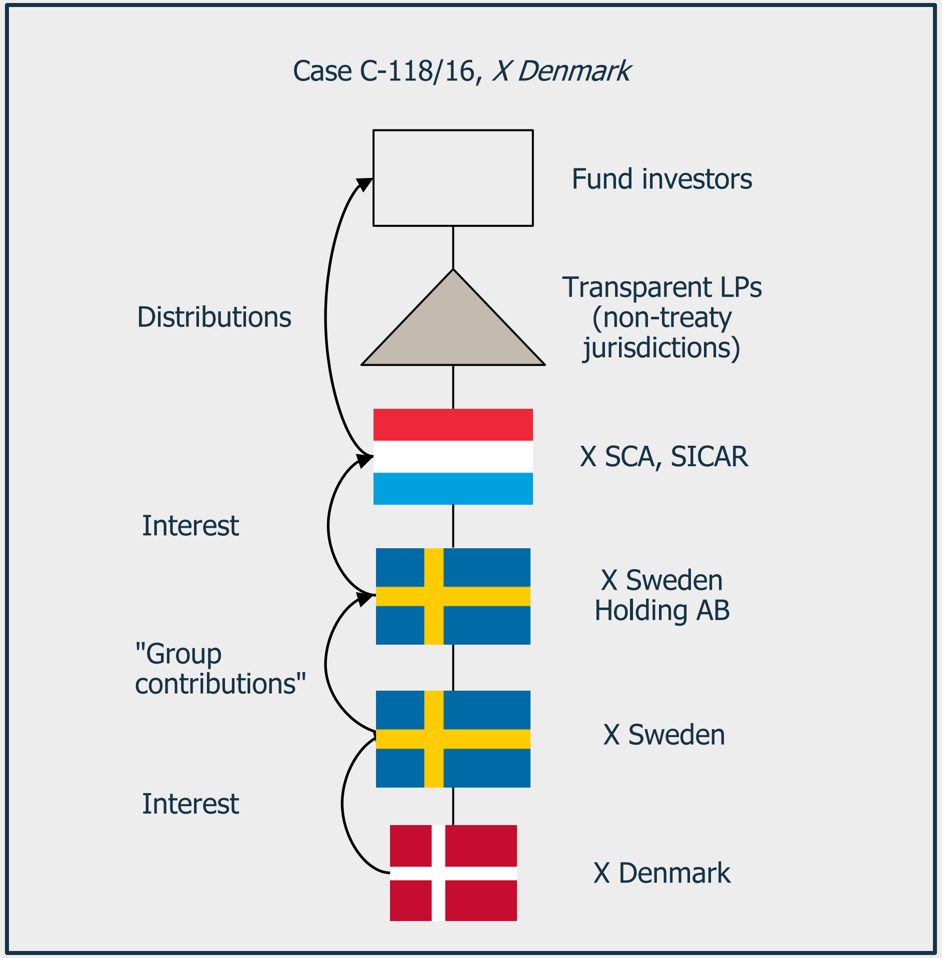
25 November 2021 High Court judgment (Case C-118/16, *X Denmark*)

- **The key facts**
  - A Danish group was acquired by private equity investors through transparent LPs in non EU, non-treaty jurisdictions, a Luxembourg *SICAR* and two Swedish holding companies
  - Interest accrued, but remained unpaid for the SICAR
  - When the Danish group was sold off, the accrued interest was converted to equity. Proceeds were distributed to the investors.

- **The High Court's judgment**
  - WHT on the interest accruals: The SICAR entity was deemed to be the beneficial owner. The Denmark – Luxembourg treaty did not apply to the SICAR.
  - The SICAR was the beneficial owner, even though:
    - It had no substance (a pure holdco)
    - It received no actual interest payments
    - It did not use the accrued funds
  - Expected to be appealed to the Danish Supreme Court.



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Tentative takeaways

- **Beneficial ownership as an "economic" control test**
  - Pure holdcos can be beneficial owners
  - Substance plays almost no role
  - Funds can change form without consequence
  - Funds can pass through non-treaty jurisdictions without WHT if:
    - For a limited time
    - With limited use
    - According to a pre-determined plan

- **Documentation is key**
  - The taxpayer bears the burden of proof
  - Contemporaneous documentation of the purpose of each part of the group structure
  - Detailed and precise tracking of fund flows

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The Danish cases' legacy?

- **A blow to the principle of legal certainty**
  - A surprising result that was unforeseen by the Danish minister of taxation, the Danish National Tax Tribunal (appeals body), the EU Commission and the EU AG
  - The general EU primary law principle of anti-abuse renders the optionality of the PSD and the IRD moot
  - By following later OECD commentaries, the ECJ might have opened the door for the OECD to change EU law

- **Guidance for the future**
  - The Danish Cases might offer guidance on post-GAAR, post-MLI PPT cases beyond beneficial ownership

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Principal purpose, anti-abuse rules and tax relief – new ways for allocating assets and income

Poland

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Main anti – abuse measures

- GAAR, SAARs
- PPT in almost 40 DTTs
- TP rules widely used instead of GAAR or SAARs
- Wide scope of CFC rules (extended)
- Minimal CIT for real estate companies
- Minimal CIT for loss making / low margin companies (new)
- WHT – pay and refund regime (new)
- Hidden dividend as non-deductible payment (new)
- Tax on shifted profits (new)
- Real estate company (target) as withholding agent in a share deal
- MDR/DAC6 – domestic hallmarks added
- Rules on tax deductibility
- Change in an interpretation of tax law

Danish CJEU cases

Headache of businesses

- WHT as one of the main risk area for MNEs
- Uncertainty as to past WHT treatment of payments
- No standard of substance
- Review of holding / financing structures – assessment in one state may impact the entire structure
- Internal policies regarding WHT compliance
- WHT opinions

Opportunity for tax authorities

- Targeted audits of MNEs with substantial cross-border payments
- Instrumental interpretation of CJEU cases – cherry picking
- Testing BO despite lack of BO requirement in domestic law
- Arguments from Danish cases used for past periods, even if there was no GAAR or SAAR
- No clear position of tax courts yet

Beneficial Ownership – Irish Experience

Beneficial Ownership Concepts:

- Exemptions from Irish withholding tax generally based on domestic law so consideration of beneficial ownership in a treaty context is not generally required.
- As a result, the concept of beneficial ownership has not been tested in the Irish courts in a tax context.

- From an Irish perspective, beneficial ownership issues can be encountered in analysis of Irish entities claiming treaty benefits elsewhere either through beneficial ownership questions or PPT considerations. This particularly can arise in a non-CIV fund context (eg. Section 110 companies with foreign source income seeking treaty relief)
  - OECD Public Discussion Draft on Action 6 (6 January 2017)
  - Analysis on PPT interpretation in a non-CIV context

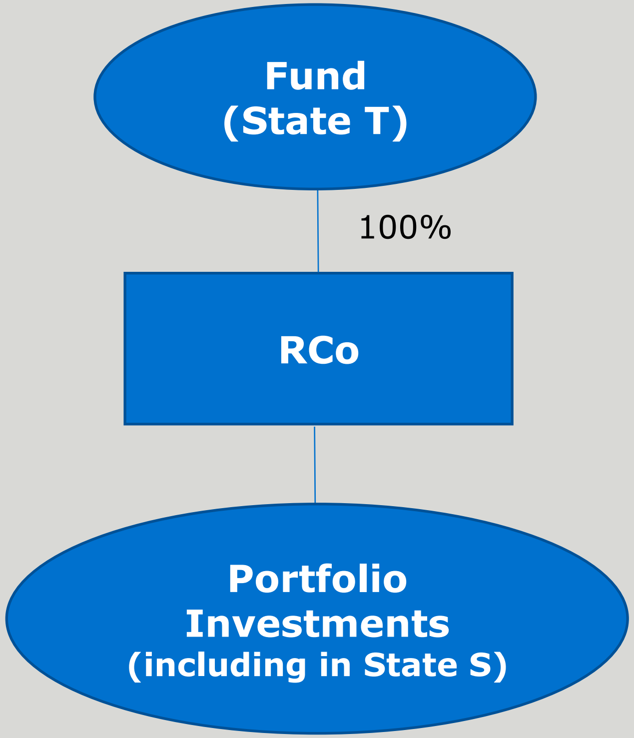
PPT for Non-CIV Funds

OECD Public Discussion Draft on Action 6 – Factors in determining PPT for non-CIV fund

- Context in which investment was made must be considered – availability of experienced directors, skilled multilingual workforce, extensive treaty network, common currency etc.
- Composition of ultimate investor base is relevant –investors entitled to similar or better treaty benefits on a direct investment (although existence of a differential in withholding tax rate on a direct investment vs. investment via non-CIV fund is not of itself sufficient to trigger PPT)
- Diverse portfolio also can be helpful
- Substance in the non-CIV fund also relevant – examples provided look to experienced personnel locally providing management services, experienced board of directors of which the majority are local residents, etc
- Tax treatment of non-CIV fund can be considered – if it is taxed in its own right, that can be helpful

PPT for Non-CIV Funds – Regional Investment Platform Example

- RCo, a resident of State R is a wholly owned subsidiary of a Fund (resident of State T). RCo is the regional investment platform for the Fund.
- RCo makes an investment in State S (among other investments).
- Withholding tax rates for dividends under the R-S Treaty is 5% compared to 10% under the S-T Treaty.
- Conclusion per discussion draft:
  - RCo would not fail PPT



Italy

The impact of Danish Cases in the position of the Italian Tax Administrations and Italian Supreme Court

1. *The Italian GAAR*

2. *The beneficial ownership concept under Italian Law*

3. *The Italian Tax Administration's position following the Danish cases*

4. *Supreme Court's position following the Danish cases*

The Italian GAAR - substantially aligned with the PPT rule of MLI

10-bis of L 212/2000: **one or more transactions constitute abuse of law where they lack economic substance and, even if formally consistent with tax law, they are essentially aimed at obtaining undue tax savings**.

- Transactions are deemed to be lacking economic substance where they consist of facts, acts and contracts, also interconnected, which do not generate significant effects other than tax savings

- Undue tax savings consist of tax benefits, even if not immediate, obtained in contrast with the purpose of tax provisions or the principles of the tax system.

- Transactions do not constitute abuse of law where justified by valid and non-marginal non-tax reasons, including those aimed at improving the structure or functionality of the taxpayer's business or professional activity;

- The taxpayer is always free to choose between different optional tax regimes provided by the law or between different transactions leading to different tax burdens; and

- The tax authorities can resort to the statutory GAAR only if the tax benefits cannot be challenged based on other specific tax provisions (e.g. specific anti-avoidance rules).

The Italian GAAR – Burden of proof

Under article 10-bis of L 212/2000 the tax authorities must comply with strict procedural requirements if they want to resort to the statutory GAAR. In particular,

- they have to engage the taxpayer in a discussion before issuing a notice of deficiency so that the taxpayer may explain the economic reasons underlying the transaction (or series of transactions) that the tax authorities are considering to challenge;

- **<u>the tax authorities must give evidence of the lack of economic substance and prove that just tax benefits were obtained</u>**

- failure to comply with the procedural requirements or with the burden of proof results in the notice of deficiency being invalid and void.

The Beneficial Owner concept under Italian Law

Article 26-quater DPR 600/1973 (implementing DLgs 143/2005 – Interest and Royalties Directve): outbound interest and royalty are exempt from any Italian tax imposed on those payments, whether by deduction at source or by assessment, **provided that the beneficial owner** of the interest or royalties is a company of another EU Member State or a permanent establishment situated in another EU Member State of a company of an EU Member State.

Position of Italian tax Administration in relation to BO concept:

- «…The receiving company qualifies as **BO if has the right to use and the availability** of the income received and has an economic benefit by the transaction carried out» (circ. 47/2005)

Introduction of abusive elements for BO concept purposes

- «…it is necessary to take into account (i) the economical and contractual aspects of the transactions realized, (ii) the presence **of an adequate structure, and (iii) also the financial risks capacity**» (circ. 41/2011)

- It may not be considered a BO of an interest payment, **a subject without a genuine and a substantial economic activity that is a mere conduit company subject to a legal and contractual obligation to pay back the income received with regard to a single transaction** (a typical back to back transaction) (circ. 6/2016)

The position of Italian Tax Authorities on the BO following Danish cases

On the basis of the principles of ECJ:

- par. 122: «*Article 1(1) of Directive 2003/49, read in conjunction with Article 1(4) thereof, must be interpreted as meaning that the exemption of interest payments from any taxes that is provided for by it is restricted* ***solely to the beneficial owners of such interest, that is to say, the entities which actually benefit from that interest economically and accordingly have the power freely to determine the use to which it is put***»

ITA - mainly based on the point above and not on the real and economic substance of the recipient - stated that :

- The recipient may not be qualified as final beneficial of the income in accordance to art. 26-quater of DPR 600/1973, **when it has not the right to use and the availability of the interest payments**

The position of Supreme Court – before the Danish cases

Traditionally, the position of Supreme Court has been aligned with the one of ITA, based on the economic availability of the income (although received through an interposed subject)

Cass. n. 25281/2015: anti-abuse nature of the BO clause:
for tax treaty purposes, the economic and legal availability of the income formally received has always to be verified, also in the lack of a written provision, considering that in the international tax law there is the beneficial ownership clause, which applies also in the lack of a written provision and having **a general anti-abuse purpose** that is aligned with the tax treaties purpose

- the decision above has been criticized, being in contrast with the OECD approach according to which such anti-abuse purpose has been attributed to the PPT in the MLI context

The position of Supreme Court following the Danish cases

Cass. n. 14756/2020: BO regarding holding companies

Facts

- In the context of MLBO transaction (referred to ABN AMRO Group), an Italian Newco acquired the shares of an Italian target (following the acquisition the target was incorporated in the Italian acquirer)

- The acquisition has been carried out through a loan between the Italian Newco and its Luxembourg controlling company, which in turn had a loan with its controlling company

- By the balance sheet of the Newco, it could be noted that the intra-group loans for the acquisition above were regulated by the same legal provisions, deriving a low mark-up (of 0,125%)

- Following such circumstance, ITA challenged the application of the WHT exemption provided by the IR Directive. In particular, in the ITA reasoning, Luxco was not the BO of the interest but a mere conduit company

Supreme Court conclusions

- On the basis of the OECD Commentary of 2014, for BO concept purposes it is relevant:
  - not if the recipient has the full and exclusive right to use/enjoy the income
  - but if such right is not limited or restricted by legal or contractual obligations to pass on/transfer the income to third parties

- On the basis of the Danish cases on dividends, the WHT exemption has to be denied in case of abusive arrangements realized for tax purposes, which may result from different following elements:
  - Transfer of the income, totally or about totally, within a limited period of time;
  - A limited mark up realized by the interposed/conduit company;
  - The circumstance that the only activity of the interposed company is the «re-transfer» to third parties the income received;

- However, the abusive nature of the interposed/conduit company has to be verified from a both objective (artificial arrangement) and subjective perspective (the creation of the artificial arrangements for tax purposes)

Supreme Court conclusion

- On the basis of previous decision (Cass. 27112/2016) a pure holding company may be considered as the BO of dividends, when:
  - those income are in the balance sheet of the company and may be attacked by the creditors
  - has the decisional power on the coordination and management of the shares held
  - acts as the real «financial» center of the whole group for the management of the financial needs of the same group,

- In this respect it is relevant:
  - not the simple use of back to back transactions, but
  - the lack of the legal obligations to pass the income to third subjects

- Therefore the Luxembourg holding company qualifies as beneficial owner of the interest

The position of Supreme Court following the Danish cases

Cass. n. 17446/2021: BO and the burden of proof

- With regard to WHT exemption of royalties paid to a Dutch company, the Court affirmed that:
  - The BO is the subject having the real legal and economical availability of the income receive
  - The BO clause has a special anti-avoidance function, aiming at combatting the abuse of tax treaties

- With specific regard to the burden of proof stated that:
  - The burden of proof of the beneficial ownership is on the Italian taxpayer (distributing the royalties), while the Italian administration has “only” to challenge the facts affirmed by the taxpayer
  - It is not relevant - for proof purposes – the documents issued by the non resident tax authorities

- The conclusion above shows that the “beneficial ownership” clause is improperly used by the tax authorities in order to not allow the taxpayers the use of the procedural grants provided by the Italian GAAR, according to which the burden of proof of the artificial arrangements is on the Italian tax administration

German Anti-Treaty Shopping Rule
Overview

- Withholding Tax
  - 25% (plus solidarity surcharge 5.5%, i.e. 27.375%) on dividend payments
  - 15% (plus solidarity surcharge 5.5%, i.e. 15.825%) on royalty payments
  - Generally levied irrespective of reduction under Double Tax Treaty or German domestic rules implementing the Parent Subsidiary Directive
- Exemption from WHT
  - WHT not levied or only levied at reduced rate if recipient of dividend / royalty has been granted by the German Federal Central Tax Office - upon application – an exemption certificate
- Refund of WHT
  - Full or partial refund possible upon application to German Federal Central Tax Office
- Anti-Treaty Shopping Rule, Sec. 50d para. 3 Income Tax
  - Both exemption from and refund of WHT are subject to requirements of Anti-Treaty Shopping Rule

German Anti-Treaty Shopping Rule
History

Version 2007 - 2011

- Introduced by Annual Tax Act 2007

- ECJ, decision dated 20 December 2017, C-505/16 and C-613/16 (*Deister Holding*) re. version until 2011

⇨ Violation of Parent Subsidiary Directive and Art. 49 TFEU

- Federal Finance Ministry, Administrative Decree dated 4 April 2018

⇨ Rule not applied

Version 2012 – 8 June 2021

- Introduced by BeitrRLUmsG
- Federal Finance Ministry, Administrative Decree dated 24 January 2012 re. interpretation of the rule

- Federal Finance Ministry, Administrative Decree dated 4 April 2018

⇨ Limited application of rule due to ECJ, Deister Holding

- ECJ, decision dated 14 June 2018, C-440/17 (*GS*)

⇨ Violation of Parent Subsidiary Directive and Art. 49 TFEU

Version 9 June 2021 onwards

- Introduced by Withholding Tax Relief Modernization Act
- Legislative materials refer to Art. 6 Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD) and ECJ, decisions dated 26 February 2019, C-115/16, C-118/16, C-119/16, C-299/16 (*N Luxemburg*) and C-116/16, C-117/16 (*T Danmark*)
- No Administrative Decree

⇨ In compliance with Parent Subsidiary Directive and Art. 49 TFEU?

⇨ Another ECJ decision?

German Anti-Treaty Shopping Rule
Wording Sec. 50d para. 3 Income Tax Act

1 A corporation, association of persons or estate shall not be entitled to relief from dividend withholding tax and from withholding tax to Sec. 50a on the basis of a double taxation treaty to the extent that

1. persons have an interest in it or are beneficiaries under its articles of association, foundation or other constitution who would not be entitled to this relief if they received the income directly,

and

2. the source of income has no significant connection with an economic activity of this corporation, association of persons or estate;

   the generation of income, its forwarding to participating or beneficiary persons and an activity insofar as it is carried out with a business operation that is not appropriately set up for the business purpose shall not be deemed to be an economic activity.

2 Sentence 1 shall not apply insofar as the corporation, association of persons or estate **proves that none of the principal purposes of its involvement is the obtainment of a tax benefit**,

or

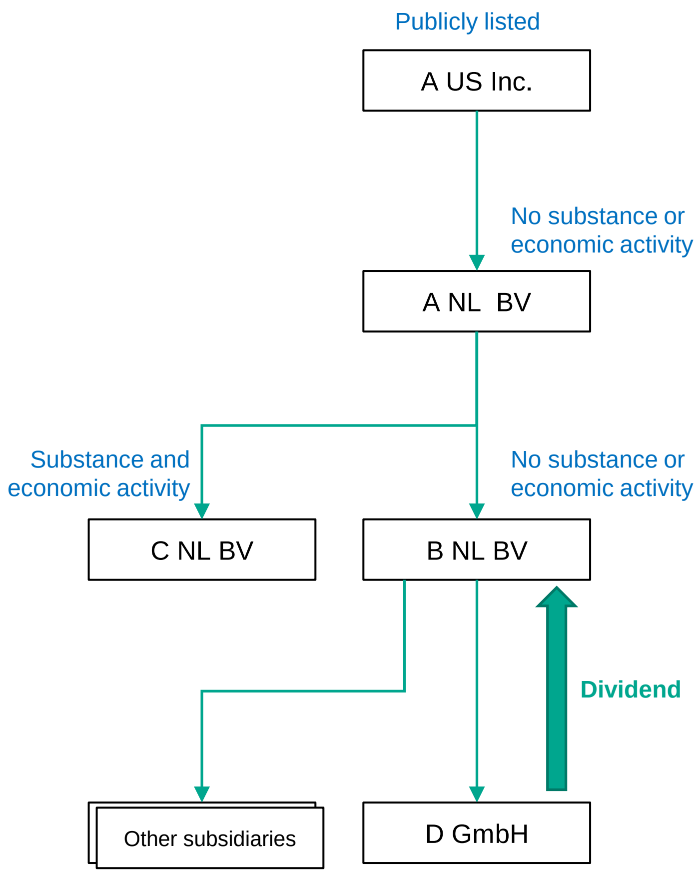
if substantial and regular trading takes place on a recognized stock exchange with the main class of shares in it.

3 Section 42 of the Tax Code shall remain unaffected.

German Anti-Treaty Shopping Rule
Requirements

- Sentence 1: Assumption of abusive structuring
  - No reduction of withholding tax to the extent
    - the shareholders of the applicant would not be entitled to this relief if they received the income directly (Shareholder Test) <u>and</u>
    - the source of income has no significant connection with an economic activity of the recipient of the income (Income Test).
- Sentence 2 part 1: Counter-evidence
  - Proof that none of the principal purposes of the involvement of the recipient of the income is the obtainment of a tax benefit (Principal Purpose Test)
  - All non-tax reasons must be considered, including those stemming from group relations
- Sentence 2 part 2: Exemption for publicly listed shareholders (Stock Exchange Exemption)
  - Recipient of the income itself needs to be listed
- Sentence 3: GAAR – Sec. 42 General Tax Code – also applicable
  - Legislative materials additionally state that Anti-Treaty Shopping Rule overrides LOB clauses in DTT

German Anti-Treaty Shopping Rule
Example



- Reduction German WHT to 0 % based on German rules implementing the Parent Subsidiary Directive
- Anti-Treaty Shopping Rule?
- <u>Old:</u>
  - Old Income Test (+) because substance of C NL BV could be taken into account for B NL BV (at least based on Administrative Decree dated 4 April 2018)
  - Old Shareholder Test indirectly (+) because of A US Inc. which would have been entitled to a reduction of WHT to 0% based on Super LOB clause in DTT Germany USA
- <u>New rule:</u>
  - New Income Test (?) – unclear whether substance of C NL BV may be taken into account for B NL BV (an activity insofar as it is carried out with a business operation that is not appropriately set up for the business purpose shall not be deemed to be an economic activity)
  - New Shareholder Test (-) – claim of A US Inc. under DTT not relevant because not the same claim (B NL BV relies on Parent Subsidiary Directive)
  - Stock Exchange Exemption (-) – only refers to direct recipient of dividend
  - Principal Purpose Test (?) – based on legislative materials A US Inc.'s entitlement to 0% WHT under DTT facilitates Principal Purpose Test

GAAR and Beneficial Ownership

- GAAR – Sec. 42 German Tax Code

  “*(2) An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. This shall not apply where the taxpayer provides evidence of nontax reasons for the selected option which are relevant when viewed from an overall perspective.*” (Para. 2)

- Beneficial Ownership – Sec. 39 para. 2 no. 1 German Tax Code

  „Where a person other than the owner exercises effective control over an asset in such a way that he can, as a rule, economically exclude the owner from affecting the asset during the normal period of its useful life, the asset shall be attributable to this person. (…)”

- Jurisdiction both on GAAR and beneficial ownership
  - e.g. Supreme Tax Courte re. Repo Transactions (case no. I R 44/17 – economic ownership denied, because interposition of additional corporation was accepted; anti-abuse denied because long-lasting interposition of additional corporation and foreign tax benefits not relevant) and Securities Lending Transactions (case no. I R 88/13 – economic ownership accepted because very short holding, ownership only considered to be empty shell – court points out extraordinary circumstances)
  - Recently Local Tax Courts re. Dividend Stripping Cases
  - Supreme Tax Court generally makes clear distinction between Beneficial Ownership and GAAR (exemption I R 88/13), hardly application of GAAR
  - German Tax Authorities tend to mix up GAAR and beneficial ownership aspects

Canada – Treaty Shopping and GAAR

- Canada v Alta Energy Luxembourg S.A.R.L.
  - Treaty-Shopping in the context of Canada's domestic General Anti-Avoidance Rule
  - Federal Court of Appeal found in favour of the taxpayer
  - Supreme Court of Canada upheld the FCA's decision on November 26th
    - By a majority of 6-3
  - How might the analysis differ if the principal purpose test applied?

Canada – Treaty Shopping and GAAR

2011

Formation of Alta Energy Partners, LLC by Blackstone Capital and Alta Resources LLC

Blackstone Group LP → Alta Energy Partners, LLC

Alta Resources LLC → Alta Energy Partners, LLC

June 13, 2011

Incorporation of Alta Energy Partners Canada Ltd. ("Alta Canada)

Alta Energy Partners, LLC → Alta Energy Partners Canada Ltd.

Pursual of Duvernay Shale project (Alberta)
Property Lease and License Acquisitions 11 separate PNG license acquisitions & 68,000 acres)

April 19, 2012

Formation of Alta Energy Luxembourg ("Alta Luxembourg") S.A.R.L. and Transfer of Alta Canada to Alta Luxembourg

Alta Energy Luxembourg S.A.R.L. → Alta Energy Partners Canada Ltd.

Vertical and Horizontal Well Drilling
(No income until January 1, 2013 and nominal Income for 2013)

September 10, 2013

Sale of Alta Canada By Alta Luxembourg (Approx. $680M)

- $380M Gain
- EUR3,210 tax paid in Luxembourg
- Claimed Exemption from Tax on Gain in Canada under *Canada-Luxembourg Tax Convention*

Canada – Treaty Shopping and GAAR

- Discrete question considered by the Court was whether the April 2012 restructuring under which the shares of Alta Canada were transferred to Alta Luxembourg resulted in a misuse or abuse of the *Income Tax Act* (Canada) or the Luxembourg Treaty for the purposes of the GAAR
- The *Canada-Luxembourg* Treaty provides relief in that Canada has surrendered its right to tax gains derived by a resident of Luxembourg from the sale of shares of a private corporation if the value of such shares is derived principally from immovable property (other than rental property) situated in Canada <u>in which the business of the corporation is carried on</u>.

Canada's GAAR – Recipe

<u>Ingredients</u>

1. Tax Benefit

2. Transaction resulting in tax benefit unless it was undertaken or arrangement primarily for *bona fide* purposes other than to obtain the tax benefit ("Avoidance Transaction")

3. Avoidance Transaction that may reasonable be considered to result directly or indirectly in a misuse of the provisions of the *Income Tax Act* (Canada) or a tax treaty or those provisions read as a whole

Canada – Treaty Shopping and GAAR

I. Canada attempting to re-write the Treaty

- The Supreme Court was critical of the Government's use of the GAAR on a negotiated treaty:
  - The Minister is asking this Court to use the GAAR to change the result, not by interpreting the provisions of the Treaty through a unified textual, contextual, and purposive analysis, but by fundamentally altering the criteria under which a person is entitled to the benefits of the Treaty, thus frustrating the certainty and predictability sought by the drafters.
  - In raising the GAAR, Canada is now seeking to revisit its bargain in order to secure both foreign investments and tax revenues. But if the GAAR is to remain a robust tool, it cannot be used to judicially amend or renegotiate a treaty.

Canada – Treaty Shopping and GAAR

II. Potential to Earn Income/Taxation (or lack thereof) in Luxembourg

- Government noted arrangements were in place that would result in Alta Luxembourg never realizing taxable income in Luxembourg (e.g. net effect being double non-taxation in Canada and Luxembourg)
- Court was not interested in the result in Luxembourg: "the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities"

> … The absence of any such anti-avoidance measure that would have limited access to the carve-out in a treaty with a country known for not taxing capital gains leads me to believe that Canada weighed the pros and cons and concluded that its national interest in attracting foreign investors, using Luxembourg as a conduit to take advantage of the carve-out, outweighed its interest in collecting more tax revenues on such capital gains.

Canada – Treaty Shopping and GAAR

III. Commercial or Economic Ties (e.g. substance)

- The Government did not raise the argument that Alta Luxembourg was not resident in Luxembourg for purposes of the Treaty
- Instead, they argued that the underlying purpose of the exemption is to benefit only persons who have "sufficient substantive economic connections" to Luxembourg
- The Court rejected reading in this requirement:

> It is worth noting that the words "sufficient substantive economic connections" are conspicuous by their absence in the text of both arts. 1 and 4. Although the GAAR invites courts to go beyond the text to understand the object, spirit, and purpose of the provisions, there are limits to this exercise, especially when attempting to discern the intent of bilateral treaty partners. In the face of a complete absence of express words, the inclusion of an unexpressed condition must be approached with circumspection … The proper approach is … not a purposive one in search of a vague policy objective disconnected from the text.

Canada – Treaty Shopping and GAAR

IV. Failure to Include Certain Provisions in the Treaty

- In concluding there was no abuse of the Treaty as drafted, the Court examined the Treaty in its entirety, OECD suggestions on treaty drafting and specific provisions in other treaties in Canada's network:

> … the parties did not follow the OECD's suggestion to include a "look-through" provision combined with a provision safeguarding *bona fide* business activities. Doing so would have excluded conduit corporations that were owned by residents of a third country and that conducted few "substantive business activities" in Luxembourg.
>
> Luxembourg and Canada added provisions reserving the benefits of the Treaty to the beneficial owners of certain income, but only in respect of dividends, interest, and royalties, not capital gains (arts. 10 to 12). If the parties had applied the concept of beneficial ownership to the carve-out, it would have prevented conduit corporations from taking advantage of this benefit where their beneficial owners were residents of a third country …

Canada – Treaty Shopping and GAAR

V. Abusive Treaty Shopping and GAAR

- The Treaty makes it clear that Canada and Luxembourg agreed that the power to tax would be allocated to Luxembourg where the conditions of the carve-out were met … In this case, the provisions operated as they were intended to operate; there was no abuse, and, therefore, the GAAR cannot be applied to deny the tax benefit claimed … This result accords with the true intention of the partners to the Treaty and must be respected.

- A final note on the Minister's implication that treaty shopping arrangements are inherently abusive. A broad assertion of "treaty shopping" does not conform to a proper GAAR analysis. In accordance with the separation of powers, developing tax policy is the task of the executive and legislative branches. Courts do not have the constitutional legitimacy and resources to be tax policy makers …

Canada – PPT and GAAR

- The decision in *Alta Energy* was rendered based on Canada's GAAR and without reference to the principal purpose test adopted by Canada via the MLI (it was not in effect at the time of the transaction)

GAAR

- A tax benefit arising in connection with an Avoidance Transaction will be denied if it may reasonably be considered that the Avoidance Transaction would result directly or indirectly in a misuse of the provisions of, *inter alia*, the *Income Tax Act* (Canada) or a tax treaty or an abuse having regard to those provisions read as a whole

PPT

- A benefit shall not be granted under a Convention if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was on of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, *unless* it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the particular Convention

Canada – PPT and GAAR

How might the approach under the PPT (contrasted with the domestic GAAR) alter the analysis or the outcome? What impact will the amended preamble have?

PPT:
…*unless* it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the particular Convention…

Amended Preamble:
Treaty is intended to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through evasion or avoidance

Alta Energy:
"The object, spirit and purpose of Articles 1, 4 and 13(4) is that a person will qualify for the exemption in issue in this appeal, which is applicable to gains arising on the disposition of certain shares, if:

(a) that person is a resident of Luxembourg for the purposes of the Luxembourg Convention, and

(b) the value of the shares is principally derived from immovable property (other than rental property) situated in Canada in which the business of that corporation is carried on."

Canada – Beneficial Ownership

- In one of the main Canadian cases, the court found that 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 received.

  - "When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it; for example, a stockbroker who is the registered owner of the shares it holds for clients."

Canada v. Prévost Car Inc., 2009 FCA 57

Canada – Beneficial Ownership

- In a subsequent case, the Canadian Tax Court analyzed whether a holding company was “a mere agent, nominee or conduit" with no discretion as to the use or application of the income.

- Critical was whether the entity had possession, use and control of the income – and assumed risks, such as exposure to creditors and foreign exchange fluctuations.

Velcro Canada Inc. v. The Queen, 2012 TCC 57

NORTON ROSE FULBRIGHT

PPT and Anti-Abuse Rules: A US Perspective

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December 2, 2021

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PPT Disfavored in US

- US not signatory to MLI
- US bilateral treaties rely on LOB provisions
  - If objective tests satisfied, subjective purpose is irrelevant
  - "Principal purpose" is used in discretionary relief provision of LOB
  - US Model Income Tax Convention (2016) Art. 22(6): "If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5 of this Article, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority a substantial nontax nexus to its Contracting State of residence and that neither its establishment, acquisition or maintenance, nor the conduct of its operations had as one of its principal purposes the obtaining of benefits under this Convention"
- Senate historically hostile to subjective PPT provisions in treaties
  - Implementation of US-Italy Treaty (1999) delayed for almost a decade over Senate objections to PPT provisions, which were ultimately removed

US Domestic Anti-Abuse Doctrines

- No generally-applicable GAAR statute
  - Several anti-abuse provisions appear in particular sections of the Internal Revenue Code and in Treasury Regulations applying to specific issues
- Courts have formulated common-law anti-abuse doctrines that allow IRS to recharacterize or disregard transactions that lack a non-tax business purpose
  - Economic substance doctrine allows the IRS to recharacterize a transaction unless the taxpayer had both an objectively reasonable expectation of profit and a substantial non-tax business purpose
  - Substance over form doctrine allows the IRS to disregard the form of a transaction and recharacterize it to match the actual substance
  - Step transaction doctrine allows the IRS to collapse multi-step transactions and disregard intermediate steps in order to match the tax consequences to the transaction as a whole
  - Sham transaction doctrine allows the IRS to disregard transactions that are illusory or have no substantive effect except tax benefits
- US Courts apply judicial doctrines to international as well as domestic transactions, including treaty issues, and often reaches a similar result to PPT

Codification of Economic Substance Doctrine

- In 2010, Congress enacted IRC 7701(o), “Clarification fo Economic Substance Doctrine”:
  - “In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”
  - “Economic substance doctrine” is defined as “the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”
- No practical effect on the application of judicial anti-abuse doctrines

Criticisms of Judicial Doctrines

- Application of judicial doctrines is asystemic; “I know it when I see it”
  - Different standards may apply depending on the appellate circuit in which the taxpayer resides, or whether a case proceeds in Tax Court versus a federal district court
- Ad hoc evolution of common-law doctrines complicates planning
- IRS overuse of judicial doctrines as a catch-all justification to recharacterize a transaction
  - E.g., *Summa Holdings* (6^{th} Cir. 2017): “the substance-over-form doctrine does not give the Commissioner a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take.”
- Judicial doctrines do not directly address treaty abuse
  - US Treasury takes position that the judicial doctrines address the same abusive behavior as PPT
  - That position has never been explicitly tested in court

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