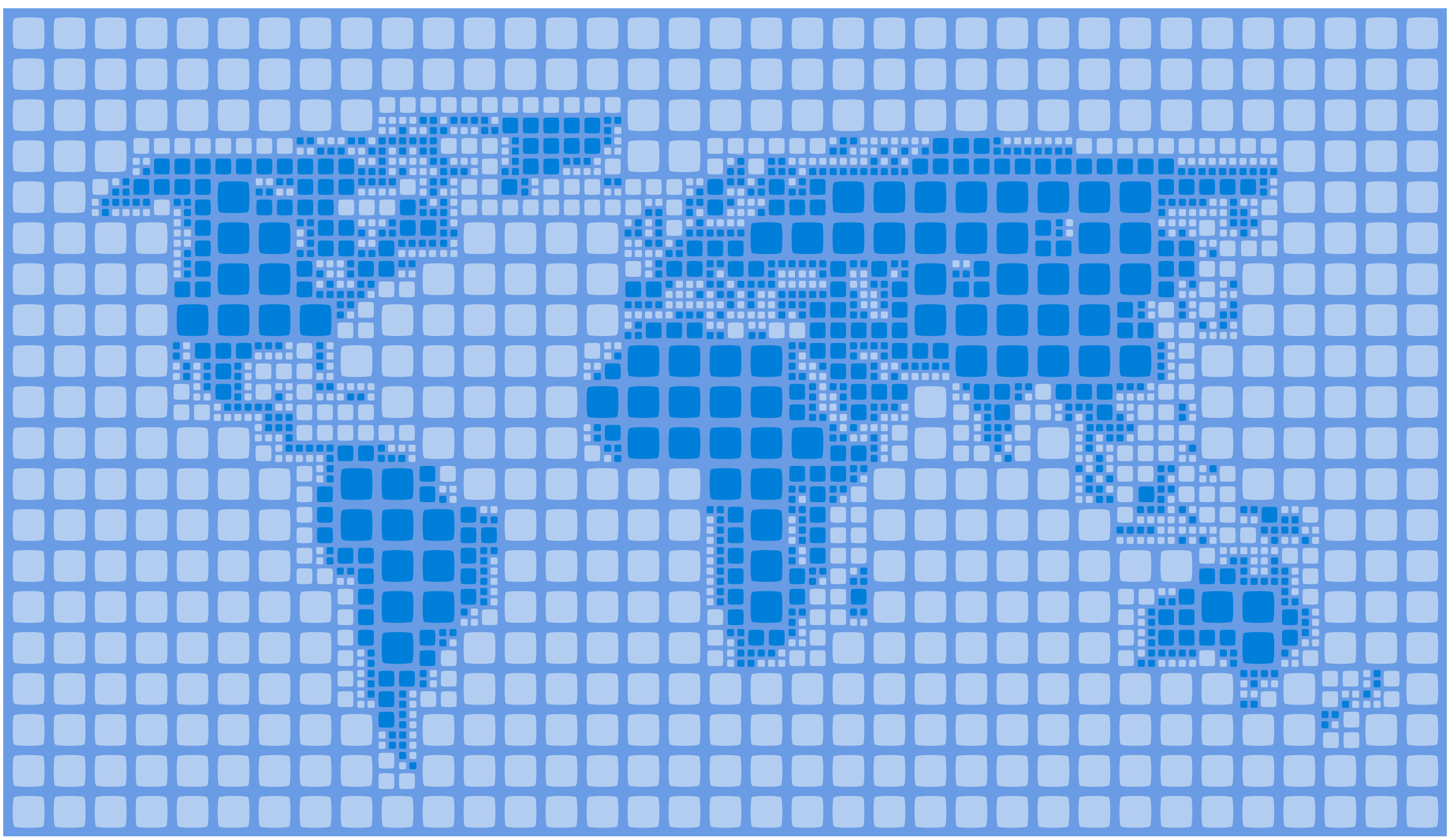
Advisory Panel on
Canada's System of
International Taxation

Access to Tax Treaty Benefits

David A. Ward

Research Report Prepared for the Advisory Panel on Canada's System of International Taxation

September 2008



Access to Tax Treaty Benefits

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Abstract

This report identifies and compares types of treaty shopping, anti-treaty shopping provisions, and trends in Canadian and international jurisprudence to provide a general assessment of the law on access to tax treaty benefits. The report provides an overview of the relevant portions of the OECD Model Tax Convention on Income and Capital, of Canada's two systems of international taxation, the tax treaty based system and the domestic law system, and of the purpose of tax treaties. It also provides an analysis of the beneficial owner provisions of tax treaties with reference to OECD reports and the evolving commentaries on the OECD Model. Through a survey of recent judicial decisions and writings on the abuse of rights principle in international law, the status of this principle and its application to tax treaties is examined, followed by a discussion of the application of Canada's general anti-avoidance rule to tax treaties. Finally, the report provides an analysis of the limitation on benefits articles that the United States has included in its tax treaties to deal with treaty shopping. As instructed, this report does not formulate specific recommendations.

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Available on the Internet at: www.apcsit-gcrcfi.ca

Cette publication est également disponible en français.

Cat. No.: 978-1-100-11624-2
ISBN: F34-3/12-2009E-PDF

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1. Introductory comments

The OECD Model Tax Convention on Income and on Capital

The Organisation for European Economic Co-operation (OEEC), the predecessor of the Organisation for Economic Co-operation and Development (OECD), took over the work of the League of Nations after World War II of establishing a Model Income Tax Treaty. The OEEC produced and published four parts of a new model and commentaries between 1958 and 1961. These were included in the Draft Model and commentaries published by the OECD in 1963. The OECD in 1977 published a revision, the 1977 Model and commentaries. In 1992 the Model and commentaries were further revised and published in loose-leaf form. Updates have since been made in intervals of approximately two years. The updates have recently been published in draft form for comment by interested parties and have focused more on the commentaries than on the Model itself. The various versions of the Model and commentaries are referred to herein by their year of final publication.

Although there is no precisely accurate count of the number of tax treaties that are now in force around the world, it has been estimated that the number may approach 3,000, most of which are based on a version of the OECD Model. This would include those based on the UN Models, as they are also based on the OECD Models, and their commentaries reflect and largely copy the OECD commentaries. Canada has 86 treaties now in force, it has signed a further three treaties which are awaiting implementation, and it has announced negotiations with a further 14 countries. Canada now has one of the largest treaty networks which has grown substantially since the tax reform of 1972 when Canada had only 16 tax treaties in place.

Canada's two systems of international taxation

Some of the tax changes made to the Income Tax Act in 1972, at the time of tax reform, were designed to encourage other countries by the "carrot and stick" method to negotiate tax treaties with Canada. The "stick" changes seem to have been designed to encourage other countries to negotiate tax treaties by taxing income arising in Canada derived by non-treaty country residents by imposing higher Canadian taxes for residents of non-treaty countries. The "carrot" changes seem to have been designed to encourage Canadian residents to invest in treaty countries and presumably discourage them from investing in non-treaty countries by giving them Canadian tax benefits in addition to the foreign tax benefits they receive in respect of income received or earned in tax treaty countries. The provisions that were included in the Income Tax Act in 1972 that had a "stick" purpose include an increase from 15 percent to 25 percent of the rate of tax to be withheld on payments such as interest, dividends and royalties to non-residents of Canada, while the tax treaty policy remained the same, namely that the rate should be 15 percent or less.[1]

1 See the discussion of the purpose of this in the Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform (October 1970) at pp. 84-85.

Other provisions introduced as part of the 1972 tax reform have the same effect, and probably the same purpose, namely:

- a limitation of 15 percent as a foreign tax credit in respect of foreign source non-business income received by residents of Canada encouraged other countries (by treaty) to reduce their withholding taxes to 15 percent or less to attract Canadian investors (a "carrot");
- the design of the system of taxation of dividends received by Canadian parent corporations from non-resident subsidiaries to create an exemption system for dividends paid out of exempt surplus and a foreign tax credit system for taxable surplus dividends (also a "carrot");[2] and
- a wide definition of taxable Canadian property, i.e., property held by non-residents the capital gains on which are taxable by Canada, while Canada's treaty policy was and is to exclude from tax capital gains on many of such properties realized by residents of tax treaty countries (a "stick").

There are, therefore, effectively two systems of international income tax that discriminate based on whether or not a treaty exists between Canada and the country of residence of the taxpayer or the country of source of the income. Under the tax treaty system, residents of Canada who have income sourced in countries with which Canada has completed and brought into force a tax treaty enjoy not only reduced foreign taxes but also reduced Canadian taxes, and residents of such countries that have tax treaties with Canada are taxed by Canada more favourably than non-residents of Canada who reside in non-treaty countries.[3] In short, residents of treaty countries enjoy Canadian tax privileges not provided to others, while Canadians enjoy Canadian (and foreign) tax privileges on income earned in treaty countries that are not available in non-treaty situations.

Purpose of tax treaties

It has often been said that the purpose of a tax treaty is to avoid double taxation. That was the original purpose of tax treaties as foreseen by the League of Nations when it commenced its work on tax treaties in 1923. However, since that time Canada and many other countries, including the United Kingdom, the United States, Belgium, Germany, Japan, Italy, the Netherlands and Sweden, to name but a few, have adopted, in their internal law, relieving provisions to eliminate or substantially reduce double taxation (either by credit or exemption provisions or both). Therefore, the provisions in Canada's tax treaties (and many other tax

2 See the discussion of the purpose of this in Annex 5, Tax Measures: Supplementary Information, The Budget Plan 2007, March 19, 2007, under the heading "Updating the Scope of Exempt Surplus". Broadly speaking, business income of non-resident subsidiaries earned in a treaty country creates the more favourable exempt surplus while business income earned in non-treaty countries creates less favourable taxable surplus. This distinction was recently changed, effective 2008, so that business income earned in countries that enter into information exchange treaties with Canada will also qualify for exempt surplus treatment. If a country does not conclude such a treaty with Canada within five years after receiving an invitation to negotiate one, such income will become foreign accrual property income (FAPI). The change is obviously designed to encourage countries to negotiate information exchange treaties.

3 See R. Alan Short, "Purposes and Effects of Income Tax Treaties", 1972 Canadian Tax Foundation Conference Report, at p. 100.

treaties) to relieve double taxation in respect of foreign source income are actually found in the Income Tax Act (or similar taxing statutes of other countries) and not in the tax treaties (or if dealt with in tax treaties, the treaty provisions may only clarify some of the details, for example, the source of income for purposes of credit or exemption relief). The purpose of avoiding double taxation is therefore probably no longer the dominant purpose of many tax treaties.[4] This should be recognized by tax authorities and courts when interpreting treaties in accordance with their object and purpose as required by Article 31(1)(a) of the *Vienna Convention on the Law of Treaties* ("Vienna Convention").

Perhaps the principal aspect of the avoidance of double taxation not addressed in Canada's internal law is the absence of a foreign tax credit on non-business income where the foreign taxes exceed 15 percent. This is normally dealt with in a tax treaty, not by allowing a greater credit, but by reducing the withholding rate of taxes imposed on Canadian residents on dividends, interest and royalties and income from trusts and estates to 15 percent or less.

The principal purposes of a tax treaty, at least from Canada's perspective, therefore would seem to be to allocate the taxing power between the country of source of the income and the country of residence of the taxpayer, usually giving the country of source the right to tax various classes of income (business profits attributable to a permanent establishment, income from immovable property, shipping and air transport profits, dividends, interest, royalties, employment income, pension payments, income from estates and trusts, and any other income not expressly dealt with in the treaty, arising in that country) while limiting the rate of tax on non-business income (other than such "other income") and also allowing the country of residence to tax all income wherever sourced provided it allows credit for the taxes paid to the treaty country of source or, alternatively, agreeing not to tax the income a second time.

Tax treaties also include provisions prohibiting discriminatory tax practices, allowing for exchanges of tax information between governments, providing for the resolution of disputes over inconsistent tax assessments, resolving interpretations of the treaty by each country, and sometimes providing for collection of taxes by one country from its residents which are owing to the other country. These provisions also reflect additional purposes of tax treaties.

The overall or perhaps primary purposes of many tax treaties now should be regarded as (a) allocating between the state of source and the state of residence the right to tax specific types of income, (b) assisting tax authorities by reducing tax evasion, providing information to assess taxes, assisting in collecting taxes across borders, and dealing with tax avoidance schemes, and (c) assisting taxpayers (and indirectly their respective countries of residence or the countries of source of income) by removing obstacles to the development of economic relations between countries for taxpayers engaged in commercial, industrial, financial, and other activities, including settling on a uniform basis the most common problems that arise in the field of international taxation.[5]

4 The OECD in 1992 changed the title of the Model, dropping the reference to "Double Taxation Convention", and replacing it with "Tax Convention". Authors and courts have been slow to recognize that the principal purpose of tax treaties has changed. Many still refer to tax treaties as "DTCs", meaning "double tax conventions".

5 Paragraphs 1-3, Introduction to the OECD Model still espouse the point that the main purpose of the Model is to eliminate double taxation.

Access to tax benefits

Generally, tax treaties apply to persons who are residents of one or both of the contracting states and extend treaty benefits to such persons. Tax treaties also generally follow the OECD Model and define a resident of a contracting state to mean any person who, under the laws of that state, is liable to tax therein by reason of domicile, residence, place of management or any other criterion of a similar nature. Canada sometimes adds to these three specific criteria a specific reference to place of incorporation as this is the principal test of corporate residence in the Income Tax Act. Since the 1995 update, the OECD Model provides that a resident of a contracting state also includes that state or any political subdivision or local authority thereof. Some Canadian treaties adopt this wording. This change was sometimes thought advisable because the contracting state itself or a political subdivision or local authority is very often not "subject" to tax and it is sometimes therefore thought that it is not "liable" to tax and cannot be a resident of the contracting state as defined.[6] This view is not widely held. The OECD Commentary on Article 4 states:

> It has been the general understanding of most Member Countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that state for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.

The point is probably most relevant to the increasingly important question of whether or not sovereign wealth funds are entitled to treaty benefits (quite aside from the application of the principle of sovereign immunity which may exempt such funds from any taxation at source even in the absence of a treaty).

The OECD Model definition of a resident of a contracting state does not include as a test to qualify a corporation or other entity to the entitlement to treaty benefits any reference to the residence of the controlling shareholder or shareholders or any requirement that the corporation must itself carry on business in whole or in part in the country of residence or that the corporation must not be merely an investment holding company not carrying on business at all. Many Canadian treaties however (e.g., Argentina, Armenia, Azerbaijan, Barbados, Cyprus, Iceland, Ivory Coast, Jamaica, Jordan, Kazakhstan, Kyrgyz, Lithuania, Luxembourg, Malta, Mexico, Moldova, Mongolia, Nigeria, Norway, Oman, Peru, Philippines, Poland, Romania, Slovak Republic, Slovenia, Sri Lanka, Tanzania, Trinidad and Tobago, and Uzbekistan) state that particular tax-favoured corporations owned by non-resident persons (usually "ringed-fence corporations" entitled to favourable tax treatment and controlled by non-residents of that state) are excluded from tax benefits. Other treaties (e.g., Ireland, Malaysia, Malta, Mongolia, and the United Kingdom) limit the access to treaty benefits for "remittance basis" taxpayers resident in such countries. The Latvia treaty excludes non-taxable corporations from treaty benefits if the main purpose of such corporations is to receive treaty benefits. The Lebanon treaty has its own unique limitation of benefits article in paragraph 4 of Article 27. Apart from these treaties,

6 For a discussion of the meaning of "liable" to tax, see David A. Ward et al., "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries", *1996 Canadian Tax Journal,* at p. 408.

Canada's treaties, like the OECD Model, do not usually include provisions relating to Canadian treaty entitlements of corporations resident in the treaty partner state to exclude such corporations from treaty benefits based only on the fact that the controlling direct or indirect shareholder of the corporation is not resident in the other contracting state or based on the fact that the corporation does not carry on business.

The United States first included a (rudimentary) limitation on benefits article in its treaty with the United Kingdom in 1945. An early similar provision is also found in the Netherlands treaty in 1963, dealing principally with Antilles companies. The United States has included complex and more substantial limitation on benefits articles in many of its tax treaties since 1981 when Article 16 of the 1981 U.S. Model contained a formal limitation on benefits article.[7] Those articles in current U.S. treaties are not all the same. They are summarized in Attachment A. The United States included such a limitation on benefits article in the current tax treaty with Canada which was signed in 1980 and came into force in 1984 which was applicable only in respect of the access to U.S. tax benefits under that treaty. The fifth Protocol to the Canada-U.S. treaty will, for the first time, include in a Canadian tax treaty a lengthy and sophisticated limitation on benefits article to limit the access of U.S. resident entities to Canadian tax benefits under the treaty. Indications have been made by officials of the Department of Finance that this should not be interpreted as a signal that Canada proposes to attempt to include similar provisions in other treaties as a general policy.[8]

7 Perhaps the most complex of such provisions is the limitation on benefits article in the U.S.-Netherlands treaty of 1992 which covers seven pages of text and required 38 pages of explanation in the Technical Explanation. See also Karen Brown, "Tax Avoidance, Treaty Shopping and the Economic Substance Doctrine in the United States", *2008 British Tax Review*, at p. 160, for a discussion of U.S. treaty provisions.

8 Presumably the inclusion by Canada of the limitation on benefits article in the United States treaty was motivated by the zero withholding tax on non-arm's-length interest that the fifth Protocol will provide in that treaty which may not be provided in other treaties.

2. The beneficial owner provision of tax treaties

The 1977 Model and commentaries

Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) of the OECD Model and the equivalent provisions of most of Canada's tax treaties state that the treaty rates of withholding tax provided for in those articles apply only if the beneficial owner (in French, *le bénéficiaire effectif*) of the dividends, interest or royalties, as the case may be, is a resident of the other contracting state. This was first introduced in the 1977 OECD Model. The wording was slightly changed in the 1992 version to make it clear that the treaty rate applied if the beneficial owner was a resident of the other contracting state even if the intermediary recipient was not such a resident. The commentaries however indicated that the wording change in the Model was not intended to change the way in which the previous wording had been interpreted.

The 1977 commentaries on Articles 10, 11 and 12 explained the intended meaning of "beneficial owner" as follows:

> [T]he limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, [in French, *un intermédiaire, tel qu'un agent ou autre mandataire*], is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

As explained by the 1977 commentary, the introduction of the concept of beneficial owner merely excluded from treaty benefits an intermediary such as an agent or nominee and limited the treaty beneficial rates of withholding tax on dividends and interest and royalties to those amounts that are paid either directly to the beneficial owner who is resident in the other contracting state or to an intermediary provided the beneficial owner is a resident of the other contracting state.

Apart from what was explained in the commentaries quoted above, the term "beneficial owner" was not further defined or explained in 1977.

The Conduit Companies Report

The OECD Council on November 27, 1986 adopted four related studies which were published in 1987 in *International Tax Avoidance and Evasion*. One of the studies entitled "Double Taxation Conventions and the Use of Conduit Companies" (the "Conduit Companies Report")[9] is particularly relevant to the subject of access to tax treaty benefits.

The Conduit Companies Report should be read in the context of its purpose, namely it was part of the effort of the OECD to deal with tax avoidance. It noted that the Committee on Fiscal Affairs had expressed its concern about the improper use of tax conventions by a person acting through a legal entity with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person. In the words of the Report, it "deals with the most important situation of this kind, where a company situated in a treaty country is acting

9 Republished in Volume II of the Model Tax Convention on Income and on Capital.

as a conduit for channelling income economically accruing to a person in another State who is thereby able to take advantage 'improperly' of the benefits provided by a tax treaty. This situation is often referred to as 'treaty shopping'. The 'conduit company' which is characteristic of such schemes is usually a corporation but may also be a partnership, trust or a similar entity."

The Conduit Companies Report classifies conduits as "direct conduits" and "stepping stone conduits". A direct conduit is described as a company resident in State A that receives dividends, interest or royalties through State B and claims the benefit of the State A/B treaty rates of withholding tax. The company is wholly-owned by a resident of a third state not entitled to those treaty benefits but to gain those treaty benefits has transferred assets and rights to the company that give rise to the dividends, interest, or royalties which by virtue of the parent-subsidiary regime in State A are exempt from tax in that State A. A stepping stone conduit is described in the same way except that the company is fully taxable in State A and therefore pays interest, commissions, service fees or similar expenses to a related company set up in a third state and deducts those payments in State A and those payments are tax-exempt in the third State.

In both cases, the conduit company is not subject to substantial tax in the conduit states.

The Report points out that, in the cases discussed, the conduit company takes advantage of treaty provisions in its own name in the state of source but economically the benefit of the treaty goes to persons not entitled to use that treaty. This is said to be unsatisfactory because the treaty benefits negotiated between the two states are economically extended to persons resident in a third state in an unintended way thus breaching the principle of reciprocity and the income may be exempted from taxation altogether or subject to an inadequate taxation in an unintended way. The result, according to the Report, is the state of residence of the ultimate income beneficiary has little incentive to enter into a tax treaty with the state of source.

The Report notes that the 1977 OECD Model would regard the conduit company as a person resident in one of the contracting states and entitled to claim the benefits of the treaty in the other contracting state in its own name. The Report refers to the "beneficial owner" requirement in Articles 10, 11 and 12 of the Model and attempts to narrow its meaning stating:

> Thus the [treaty] limitation is not available when, *economically*, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income… [emphasis added]

The Report notes the reference in the commentaries to a nominee or agent but says that the provisions would apply also in other cases to a person who has a similar function.

> Thus 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 administrator acting on account of the interested parties (most likely the shareholders of the conduit company).

The Conduit Companies Report also notes there is a difference of opinion as to whether the absence of an overall solution to the conduit problem at the time of the finalization of the 1977 Model was a serious flaw. However, the problem is said to have become more acute since 1977 and called for further study involving questions as to whether the OECD should set out policies regarding conduit companies in more detail to prevent improper use of tax treaties and whether the Model and the commentaries should offer solutions taking into account the Conduit Companies Report and whether the existing commentaries should be further revised.

The Conduit Companies Report offers several sample limitation on benefits provisions that might be included in tax treaties to deal with the conduit company issue which were classified as (1) the look-through approach, (2) the exclusion approach, (3) the subject to tax approach, (4) the channel approach, and (5) the bona fide provisions. The look-through approach would involve piercing the corporate veil. The exclusion approach would exclude tax-exempt or nearly tax-exempt companies from treaty benefits. The subject to tax approach would require the residence state to tax the particular income sourced in the state of source in order for the corporation to claim the treaty benefits in the state of source. The channel approach would disentitle a corporation to treaty benefits if more than 50 percent of the treaty-protected income is paid out to a person or persons not resident in that state. The bona fide provisions would require that a taxpayer prove the principal purpose of the company, the conduct of its business, and the acquisition of the shareholding or other property are not motivated primarily to obtain treaty benefits but are motivated by sound business reasons.

The Conduit Companies Report notes respective weaknesses and strengths in each of the suggested alternative approaches.

In respect of existing treaties, the Conduit Companies Report suggests that where treaties do not contain specific provisions dealing with conduit companies, treaty benefits would have to be granted under the international law principle of "pacta sunt servanda"[10] even if considered improper.[11]

Finally, the Conduit Companies Report discusses whether a state may wish to protect itself against "abuse of law" by applying general anti-abuse provisions of domestic laws and then deny the benefits of the treaty when it has reason to suspect the improper use of the Convention. The Report notes that this raises the question whether the denial of treaty benefits is compatible with treaty obligations and that relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differed, some countries taking the view that where the taxpayer fulfills the conditions set in the treaty (beneficial ownership, residence) the treaty should apply notwithstanding domestic law provisions of the country of source, while other countries take a contrary view.

In summary, therefore, the Conduit Companies Report recognized specifically the issue of the access to treaty benefits in respect of amounts paid to a corporation or other entity resident in the other treaty state where the shareholders are not resident in that state and the amounts are not taxable either because of a participation exemption in that state or because the larger

10 This is a principle recognized in international law and codified in Article 26 of the Vienna Convention.

11 It is debatable whether this statement is a correct reflection of international law. It never seems to have been included in the OECD commentaries. See the discussion below of abuse of rights in international law and its application to tax treaties.

part of the payments is paid on a tax deductible basis to residents in a third non-treaty state and received on a tax-free or largely tax-free basis. However, apart from some suggestions of specific limitation on benefits articles to be included in tax treaties, the Conduit Companies Report did not offer any particular interpretative assistance other than to suggest that domestic law anti-avoidance rules might be applied, and to state that a substance-over-form approach or an economic approach to the relevant facts could be used in determining who is the beneficial owner to expand the concept originally included in the OECD Model in 1977 thereby narrowing the meaning of the term "beneficial owner".

Although some countries, for example the United States and Switzerland, routinely apply substance-over-form or an economic approach to determine the facts in tax cases, it is questionable whether this suggestion of broadening the interpretation process by applying a substance-over-form or economic approach to the facts can be applied in Canada in light of the statement of the Supreme Court in *Shell Canada*[12] where speaking for the Court, McLaughlin, J. (as she then was) said:

> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form: *Bronfman Trust*, supra at pp. 52-53, per Dickson, CJ; *Tennant*, supra, at para. 26, per Iacobucci, J. but there are at least two caveats to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary, or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to a particular transaction does not properly reflect the actual legal effect: *Continental Bank Leasing Corp.* v. *Canada*, [1998] 2 SCR 298 at para. 21 per Bastarache, J.
>
> Second, it is well established in this Court's tax jurisprudence that a searching inquiry for either the 'economic realities' of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied…

The invitation in the Conduit Companies Report to narrow the meaning of the term "beneficial owner" so that treaty benefits are not available "when, economically, it would benefit a person not entitled" to the treaty benefits who interposed the conduit company as an intermediary between himself and the payer of the income is an interpretation of the facts based on economic realities which Canadian courts probably would not adopt.

The suggestion may also be inconsistent with the general rule of interpretation of treaties as codified in Article 31 of the Vienna Convention which basically provides that a textual approach or ordinary meaning to interpretation is to be applied, not an investigation ab initio into the intention of the parties.[13] The ordinary meaning of "beneficial owner" should be determined, it is suggested, without the application of substance-over-form rules or an economic approach to the facts which are not applied in Canada in dealing with tax statutes.

12 *Shell Canada Limited* v. *The Queen*, 99 DTC 5669 at p. 5676.

13 See the commentary on Article 27 of the draft articles (which ultimately became Article 31) of the Vienna Convention, republished in *The Interpretation of Income Tax Treaties With Particular Reference to the Commentaries on the OECD Model* (IFA, Canadian Branch and IBFD, 2005) pp. 239 et seq.

In this respect the recent decision of the English Court of Appeal in *Indofood*[14] is illustrative. In this case the English Court of Appeal reversed the decision of the High Court,[15] holding that a Mauritius court would probably find the interposition of a Dutch "stepping-stone" conduit corporation (to adopt the terminology of the Conduit Companies Report) between an Indonesian company and members of the public holding notes of the Dutch company not to be entitled to the reduced rate of withholding tax under the Netherlands-Indonesia treaty. Indonesian law applies substance-over-form rules to determine the facts in tax cases, and Indonesian courts are strongly influenced by the interpretation of the tax authorities. On the facts considered in the case, virtually all the interest received would be paid almost immediately by the Dutch company to the noteholders and the Indonesia revenue authorities had ruled that the proposed Netherlands company would not be considered to be the beneficial owner for treaty purposes. Under Indonesian law the Netherlands company would not be considered the beneficial owner of the interest paid to it by the Indonesian corporation.

In reversing the decision of the High Court, the Chancellor in his reasons for judgment[16] said the High Court judge determined how an English judge applying English rules would decide the issue and incorrectly substituted his own view for that which an Indonesian Court would find under Indonesian civil law based on the facts established by substance-over-form. On that basis, the Chancellor gave full weight to the OECD analysis as set out in the commentaries. The difference is relevant because applying the principle of substance-over-form to determine the facts, the Chancellor held that the Dutch company would not have the full privilege over the funds received to qualify as the beneficial owner but rather would be the "equivalent" of an "administrator of the income".[17]

14 *Indofood International Finance Ltd.* v. *JP Morgan Chase Bank NA, London Branch*, (2006) 8 ITLR 653.

15 Reported, (2005) 8 ITLR 236.

16 Paragraph 29 of the reasons.

17 See para. 44 of the Chancellor's reasons for judgment. For an analysis see Ross Fraser and JDB Oliver, "Beneficial Ownership: HMRC's Draft Guidance on Interpretation of the *Indofood* Decision", *2007 British Tax Review*, at p. 39.

3. Tax conventions and base companies

The Base Companies Report

Published at the same time as the Conduit Companies Report, the OECD published a report, "Double Taxation Conventions and the Use of Base Companies" (the "Base Companies Report"). As stated in the Base Companies Report, the main issue dealt with is the compatibility of domestic anti-abuse measures with international tax relations. The base company dealt with in the report is a company used to minimize tax in the country of residence of its controlling shareholders. The subject of the Report is related to the problem of avoidance (and evasion) through tax havens which is dealt with in a separate report.[18] Although base companies are often established in "tax havens", they can also occur in high tax countries particularly where taxpayers take advantage of special tax regimes for the unintended consequences of domestic tax laws. The most important function of a so-called base company is to receive income that would otherwise flow directly to the taxpayer that when intercepted by the base company does not normally become liable to tax.

In dealing with what is perceived to be the problem of base companies, the Report recommends the use of what is called "measures from the top", namely, measures in the shareholders' country of residence which the Report classifies as: (1) disregarding the legal personality of the base company; (2) treating the base company as a resident because of its place of effective or central management and control; (3) deeming the base company to have a permanent establishment in the shareholders' country of residence because it has a place of management there; and (4) disregarding the sheltering of income by treating the activities or income of the base company as the activity or income of the taxpayer himself.

Also highlighted is the use of the controlled foreign corporations systems to tax the income received by the base company in the hands of its ultimate shareholder under systems similar to the Canadian foreign accrual property income system applicable to controlled foreign affiliates.

The Report integrates somewhat with the Conduit Companies Report and in particular with the discussion on who is the beneficial owner in the Conduit Companies Report and states:

> [T]he question arises as to whether, quite generally, domestic rules as to who is regarded as the recipient of specific income for tax purposes are compatible with treaties. This question especially arises in the case of 'anti-abuse' or 'substance-over-form' rules according to which it is not the base company itself but its shareholder, who is regarded as the true recipient of the income shifted to the base company.

18 "Tax Havens: Measures to Prevent Abuse by Taxpayers", the first of the reports in *International Tax Avoidance and Evasion, Four Related Studies*.

> The large majority of OECD Member countries consider that rules of this kind are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. … A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use. …
>
> The main problem seems to be whether or not general principles such as 'substance-over-form' are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are mentioned in bilateral conventions. On the dissenting view, to give domestic rules precedence over treaty rules as to whom, for tax purposes, is regarded as the recipient would erode the protection of taxpayers against double taxation … However it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.

The Base Companies Report then goes on to discuss controlled foreign corporation rules and other issues not particularly relevant to the subject of access to tax treaties but more relevant to the question whether such rules override tax treaties and therefore more relevant to the question of the interpretation of tax treaties.

4. The evolving commentaries on the OECD model

The proper role of the OECD commentaries in the interpretation of tax treaties

Frank Engelen of the Netherlands in his published doctoral thesis, *Interpretation of Tax Treaties Under International Law*[19] argued that because OECD member countries represented on the Committee on Fiscal Affairs have an opportunity to enter observations where they disagree with the interpretation of the Model by the commentaries, they can be taken to have acquiesced in the interpretations given in the commentaries if they have not recorded an observation. Therefore, OECD member countries in negotiating and interpreting tax treaties are entitled to take the position that other OECD countries not entering an observation are precluded or estopped in international law from departing from the commentaries in their interpretation and application of tax treaties that contain provisions based on the OECD Model and consequently the commentaries are binding in international law on member countries of the OECD.[20]

Engelen's theory has not been widely accepted. The International Tax Group[21] has considered this theory, noted the widespread lack of support and rejected it.[22] The *Convention on the Organisation for Economic Co-operation and Development* (the "OECD Convention") makes it clear that although decisions of the OECD made by Council are binding on the members, recommendations are not. The Rules of Procedure of the OECD confirm this by stating that "recommendations of the organization… shall be submitted to the members for consideration in order that they may, if they consider it opportune, provide for their implementation." The OECD Model and commentaries are not supported by a decision of Council, but by a recommendation, the last being dated October 23, 1997 recommending, inter alia, that tax administrations of member countries follow the commentaries, as modified from time to time, when applying and interpreting their bilateral tax conventions based on the articles of the Model. Since then, updates have merely been "adopted" by the Council.

In September 2006 a two-day seminar attended by a group of experienced tax lawyers, tax professors, international lawyers and international law experts debated the issue. Those attending participated in an unrecorded vote with the majority expressing the view that there was no binding obligation in international law to follow the commentaries.[23]

19 IBFD, 2004.

20 His views were repeated in his article, "Some Observations on the Legal Status of the Commentaries on the OECD Model", 2006 *Bulletin for International Taxation* at p. 105.

21 A group of practising lawyers and professors from the United Kingdom, Canada, the United States, France, Germany, the Netherlands, Belgium, Sweden, Switzerland, Italy, Japan and Australia who write extensively on international tax law subjects.

22 See David A. Ward et al., *The Interpretation of Income Tax Treaties With Particular Reference to the Commentaries on the OECD Model* (IFA, Canadian Branch and IBFD, 2006). For a summary, see David A. Ward, "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process", *2006 Bulletin for International Taxation* at p. 97.

23 Although the voting results were not published, the papers presented to the seminar were published. See *Legal Status of the OECD Commentaries*, S. Douna and F. Engelen, eds. (IBFD, 2008).

In Engelen's December 2005 lecture, published in *On Values and Norms, The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular*[24] at p. 37, he stated his position is unorthodox and, even in the most favourable scenario, is shared by only a handful of colleagues.

From a Canadian perspective, as Iacobucci, J. wrote in *Crown Forest Industries,*[25] the OECD Commentaries are of "high persuasive value" as they form part of the "legal context" of a tax treaty, the text of which is closely based on the articles in the OECD Model.

Therefore, although the OECD Commentaries are not and should not be considered binding in international law or binding in the internal law of a country, they remain of high persuasive value. However, as the International Tax Group noted,[26] the commentaries that are of high persuasive value are those published before the conclusion of the particular tax treaty in question as only those commentaries are "legal context" in respect of that particular convention.[27]

Commentaries published after a treaty has been concluded may be in a somewhat different position. They do not form part of the legal context of the particular treaty but nevertheless may be useful in respect of the interpretation and application of such treaties provided they do not change the meaning of the treaty, or its interpretation based on commentaries current when the treaty negotiations were concluded.[28] Although reference to later commentaries was summarily dismissed by the Tax Court of Canada in *MIL (Investments)*[29] and described as "somewhat suspect" in *Cudd Pressure*,[30] there has been no particular consistency noted in recent decisions by the Tax Court of Canada in resisting references to later commentaries in interpreting tax treaties.[31]

24 Kluwer, 2006.

25 1995 DTC 5389 at 5398.

26 See the publication mentioned in note 22.

27 See Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes* (4th ed. Butterworths, Toronto, 2002) at p. 260 for an explanation of "legal context".

28 Klaus Vogel, in *Klaus Vogel on Double Taxation Conventions* (3rd ed., 1997, Kluwer), Introduction, at para. 82 et seq., took a similar position.

29 *MIL (Investments) SA* v. *The Queen*, 2006 DTC 3307.

30 1995 DTC 559.

31 For example, in *Prévost Car Inc.* v. *The Queen*, 2008 DTC 3080, para. 32 et seq. and *American Income Life Insurance Company* v. *The Queen*, 2008 DTC 3631, para. 73.

The role of the commentaries on the OECD Model in interpreting tax treaties based on that Model is thoroughly canvassed by the International Tax Group[32] where the views of the authors are summarized[33] making the following points:

1. Much of the commentaries can be given a proper and effective role in the interpretative process because those that existed at the time of the conclusion of a bilateral treaty form part of the legal context and can be presumed to reflect the intended interpretation, particularly in the case of a treaty between member states of the OECD.

2. If the commentaries go beyond a fair interpretation, because of the importance of interpreting treaties in accordance with their terms, legitimate questions can arise as to whether such commentaries should be adopted in interpreting the treaty.

3. Where an undefined treaty term is explained or defined in the commentary existing at the time the treaty was concluded, the meaning in the commentary, which is part of the context of the treaty, should govern the interpretation of the undefined term.

4. If one or both tax treaty partners are not OECD members, the commentaries have lesser value, particularly if the non-member state or states have not been included amongst those non-member states that have been provided with the opportunity and taken it to record their positions on the various Articles and commentaries on the Model as published in Volume II of the loose-leaf OECD Model. Even those non-member states that have had the opportunity to express their views have had no opportunity to participate in the discussions and formulation of the commentaries themselves and therefore the commentaries even in those cases may have lesser weight.

5. Commentaries are not binding interpretations in international law and are therefore not binding on tax administrations or in municipal or internal law, not binding on taxpayers or the courts although they may be helpful and important in the interpretative process.

6. Where a country has entered an observation on the commentary to an Article of the OECD Model, in interpreting tax treaties made by that country, the observation must be considered and where the provision of the treaty requires a single symmetrical interpretation, that interpretation should be arrived at disregarding both the commentary and the observation.

7. Commentaries adopted by the Committee on Fiscal Affairs and the OECD Council and published after the conclusion of a bilateral treaty should be carefully evaluated to determine to what extent, if any, such commentaries if applied would shift or alter the meaning of the bilateral treaty provision in question, and if the later commentaries are considered to change the meaning of an existing bilateral treaty, they should not be applied.

32 See note 22.

33 See pages 111 et seq.

The expanded commentaries on Articles 1, 10, 11 and 12 of the OECD Model

The commentary on Article 1 of the OECD Model was substantially amended in 1992, 1995, 2003, and 2005.[34] Much of what appears in this new commentary appeared in the Conduit Companies Report and Base Companies Report. This amended commentary repeats and expands suggested particular limitation on benefits articles that might be included in tax treaties to deal with conduit company cases which are again classified as a look-through provision, general subject-to-tax provisions, a provision dealing with the channel approach, and a provision dealing with what are called "stepping stone devices". All of these provisions are, it is said, required to be accompanied by specific qualifying provisions to ensure that they are not made applicable to what are described to be bona fide cases. Finally, paragraph 20 of the new commentary on Article 1 provides a lengthy and complex suggested limitation on benefits provision which is an amalgam of the other more limited provisions and reflects much of what is commonly found in U.S. treaties. It has an important bona fide provision, worded in the negative, effectively treating a resident of a contracting state who would otherwise not be a qualified person entitled to treaty benefits as nevertheless being a qualified person if the competent authority of the state source of the income determines that the establishment, acquisition or maintenance of the person or the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.[35]

In the 2003 update, a paragraph was added to the commentary on each of Articles 10, 11 and 12[36] which reflects what had originally been said in the Conduit Companies Report:

> Where an item of income is received by a resident of a Contracting State acting in the capacity of an agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State.[37] The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled 'Double Taxation Conventions and the Use of Conduit Companies' concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

34 As discussed in the prior section of this paper, this raises the question of the role of such revisions in interpreting tax treaties concluded before the publication of the various revisions.

35 It is unfortunate that this part of the suggested limitation on benefits provision does not contemplate that the courts would be able to review any competent authority determination.

36 Paras. 12.1, 20 and 4.1 of the respective commentaries to Articles 10, 11 and 12.

37 This is what occurred in *MacMillan Bloedel Limited* v. *MNR*, 70 DTC 297 (TRB), a decision under the 1942 Canada-U.S. treaty that did not have a beneficial owner provision.

Although these new paragraphs in the commentaries do not state, as the Conduit Companies Report did, that this interpretation is based on substance-over-form or an economic approach to the facts, it is nonetheless apparent that this is the case. Therefore, as has already been indicated, the approach of the Supreme Court in determining the facts in tax cases which has never been based on "economic realities" makes it questionable whether this interpretation of the expression "beneficial owner" is one that Canadian courts are likely to embrace. In fact, in *Prévost Car*,[38] the Tax Court of Canada did not apply this expanded explanation of the term "beneficial owner" even though it referred extensively to the Conduit Companies Report and the recent commentaries. Whether the Tax Court of Canada would have done so had the so-called conduit corporation been bound by contract to pay on to its shareholders the amounts it received by way of dividends from Canadian sources is, of course, a matter of speculation.

It should also be noted that the assessments made in *Prévost Car* did not involve the application of the general anti-avoidance rule (GAAR) (discussed below) and therefore there was not an issue as to whether the structure by which a Dutch holding company received treaty-benefited dividends from its Canadian subsidiary and paid them on to its Swedish and UK shareholders was in itself abusive. There was, however, put into evidence (but not referred to in the reasons for judgment) an exchange of emails amongst senior officials of Canada Revenue Agency and Finance Canada that reflected a very much divided view as to whether the structure was abusive or not. Copies of these emails are attached as Attachment B. That exchange of emails probably explains why the GAAR was not relied on in the assessments and argued an alternative basis to support the assessments, and may explain the apparent reluctance of the court to adopt the narrower interpretation of beneficial owner arising out of the Conduit Companies Report and now in the commentary on Article 10 of the OECD Model which would have required a substance-over-form or an economic approach to be taken to determine the facts.

38 Note 31.

5. Abuse of rights in international law and its application to tax treaties

Views of authors

It is clear, in dealing with treaties, including tax treaties, that the international law rules of interpretation should be applied.[39] There is an unresolved issue whether international law recognizes abuse of rights. The trend of the most recent judicial decisions and writings of authors indicates by preponderance of evidence that it does exist. Bin Cheng, as early as 1953, recognized that it does exist in international law.[40] Klaus Vogel has also recognized that it does and stated his view that international law, as a general principle, allows the cautious application of anti-avoidance rules so that artificial, inadequate transactions should, exceptionally, be judged according to their substance rather than according to their form. As to the extension of the principle which Bin Cheng stated applies between states that are parties to treaties to taxpayers who are not parties to tax treaties, but who benefit from them, Vogel wrote in 1990:

> [I]f a contracting State need not tolerate a circumvention of a treaty by the other contracting State, it would be absurd for it to be committed to tolerate circumvention by a private person and to apply the treaty in a strictly formal way notwithstanding such circumvention. Consequently, [tax treaties] are subject to a general 'substance v. form proviso' based on international law. That proviso restricts the treaty's binding effect under international law and thus also its binding effect under domestic law, since only so much of the treaty's contents can become domestic law as is applicable by virtue of international law.[41]

Vogel clarified his views somewhat in a later edition of his work where he ultimately concluded in 1996:

> However, there should be no doubt that application of a double tax convention in accordance with its substance rather than in accordance with its form should continue to be an *exception* and that the threshold for allowing such application should be fixed at a high level rather than a low one.[42]

David A. Ward[43] argued in 1993 from the good faith principle in international law, the recognition of abuse of rights in at least three instances in the International Court of Justice and in some international treaties, its recognition by Sir Gerald Fitzmaurice and Sir Hersch Lauterpacht in their writings and its recognition in municipal or domestic law of a great

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39 See, for example, *Fothergill* v. *Monarch Airlines Ltd.*, [1981] AC 251 (HL); *Parisien* v. *The Queen*, [1981] 1 SCR 950; *Thomson* v. *Thomson*, [1994] 3 SCR 551; and *The Queen* v. *Crown Forest Industries Ltd.*, [1995] 2 CTC 64, 95 DTC 5389 (SCC).

40 Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (1953, Stevens & Sons Limited, reprinted 1994, Cambridge University Press), chapter 4.

41 *Klaus Vogel on Double Taxation Conventions* (2nd ed., Kluwer, 1990) Introduction, at para. 121.

42 *Klaus Vogel on Double Taxation Conventions* (3rd ed., Kluwer, 1996) art. 1, at para. 95.

43 "Abuse of Tax Treaties" in *Essays on International Taxation in Honour of Sidney I. Roberts*, H. H. Alpert and K. Van Raad eds. (Kluwer, 1993) at p. 397.

number of countries, that an anti-abuse rule in taxation matters could be recognized as part of international law and "should be recognized by tax administrations and courts generally in interpreting and applying tax treaties."[44]

Frank Engelen in 2006 also recognized that the principle of abuse of rights can be applied in interpreting and applying tax treaties.[45] Engelen states:

> In my opinion, it would indeed be unreasonable and unfair in certain situations if contracting States could require each other to perform the treaty also in cases where the conditions laid down for obtaining the benefits from the treaty are created by means of wholly artificial arrangements only set up for the purpose of avoiding tax, and the granting of these benefits would be against the object and purpose of the treaty. … [T]he principle of good faith, which is codified in Articles 26 and 31(1) of the Vienna Convention, provides a sound legal basis for the application of the doctrine of fraus pacti … . [I]t would not be necessary, in my opinion, that support for this is found either in the text of the treaty or in the explanations of the parties. In this context, I would also like to mention that, when assessing the question of whether in certain circumstances the granting of tax treaty benefits would be against the object and purpose of the treaty, it would be appropriate to consider that promoting the free movement of goods, persons, services and capital by avoiding international (juridical) double taxation is the principal purpose of tax treaties. If and to the extent that there is no double taxation to begin with, which means that the granting of treaty benefits would result in a complete tax exemption of (part of the) income, and, but for the artificial arrangements only set up for the purpose of avoiding tax, there is no genuine economic activity carried on either, this provides strong evidence, in my opinion, that the granting of treaty benefits would be against the object and purpose of the treaty.

Stef van Weeghel in 1998, however, tentatively expressed a contrary view stating:

> Doctrines developed in non-tax law, most notably the abuse of rights doctrine as employed in domestic and international non-tax law, cannot be readily applied in the area of tax treaties for various reasons, the most important two being (i) the difference in character between an agreement — whether or not in the form of a treaty — between two parties and tax law, both domestic and in treaty form, and (ii) the fact that a taxpayer is a third party to a tax treaty.[46]

Finally, it should be noted, as Vogel has said, that a substance-over-form interpretation based on an implied abuse of rights application to the treaty should be cautiously applied and form an exception, the threshold for which should be fixed at a high level rather than a low one. Engelen expressed the view that the application of an unwritten treaty anti-abuse concept would be similar to that which has been applied by the Court of Justice of the European Community, namely that it is a "wholly artificial arrangement".[47]

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44 Op. cit at p. 403.

45 F. A. Engelen, *On Values and Norms: The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular* (Kluwer, 2006) at p. 36, after quoting from paragraphs 9.3-9.5 of the OECD Commentary on Article 1, added in 2003.

46 Stef van Weeghel, *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States* (Kluwer, 1998) at p. 116.

47 See, for example, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd.* v. *Commissioners of Inland Revenue*, decision of the EC Court of Justice, September 12, 2006.

Views of courts

Vogel, Ward, and van Weeghel expressed their views before any tax treaty cases were decided by courts that clearly, or expressly, applied the abuse of rights principle. Engelen, however, was able to support his views by reference to the 2005 decision of the Swiss Federal Court in the *A Holdings ApS* case.[48] In that case the taxpayer, a Danish resident company, had acquired all the shares of a Swiss resident company that subsequently paid a dividend which, under Swiss domestic law, was subject to a withholding tax of 35 percent. The Danish company applied for repayment of the taxes so withheld relying on the dividend article of the Switzerland-Denmark Tax Convention made in 1973. The sole shareholder of the Danish corporation was a Guernsey corporation whose sole shareholder was a Bermuda corporation whose director was a "person" with its "seat" in Bermuda.

The application for the refund of the withholding tax was refused by the Federal Tax Administration of Switzerland on the ground that the Danish corporation did not carry on any real economic activity and was incorporated solely for the purpose of taking advantage of the Denmark-Switzerland treaty which in itself did not contain any anti-abuse provisions. In dismissing the appeal from the application for the refund of withholding tax, the Federal Court said (in translation):

> 3.4.1 … A treaty is binding upon the parties and must be performed by them in good faith pursuant to art 26 of the Vienna Convention on the Laws of Treaties. Thus the parties have an agreement which 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'. …
>
> 3.4.2 Therefore, good faith, the aim and purpose of the convention are to be taken into account when an international convention is applied. Every contracting state can expect that the other contracting state acts in accordance with these principles (cp art 26 of the Vienna Convention on the Laws of Treaties) … This includes the tackling of abuses. Because the prohibition of abuses is part of the principle of good faith. … It prohibits the use of an institute of law against its purpose to realize interests which are not protected by it. … Accordingly, the prohibition of an abuse of rights as regards conventions is not only recognized in Switzerland as a general principle of law but also on the European level without being necessary to adopt an explicit provision in the respective convention. …
>
> 3.4.4 Additionally, the principle of an abuse of rights is — against the opinion of the complainant — recognized in Denmark. [*references to authorities omitted*][49]

48 *A Holdings ApS* v. *Federal Tax Administration*, (2005) 8 ITLR 536.

49 In the reasons for judgment, the Court goes on to refer to the recent anti-abuse commentaries added to the OECD Model Convention and states that as member states of the OECD, Switzerland and Denmark "are in principle obliged to take into account" these commentaries and even the suggested limitation on benefits treaty provision in para. 13 of the commentary on Article 1 (which of course was not included in the Switzerland-Denmark treaty).

An even more recent decision involving anti-abuse doctrines is the *Bank of Scotland* case,[50] a decision of the French Conseil d'État of December 29, 2006. In that case the Bank of Scotland, a UK resident company, acquired from a U.S. company a usufruct for three years over 17,036 preference shares in the U.S. company's French subsidiary. The shares were issued specifically for the particular transaction. The usufruct entitled the Bank of Scotland to preference dividends in an aggregate amount slightly in excess of 270 million francs whereas the usufruct was acquired for a sum slightly in excess of 267 million francs. When the French subsidiary paid the dividends, it was obligated under French law to deduct a withholding tax of 25 percent whereas the rate of withholding tax under the UK-France treaty of 1968 was 15 percent. The Bank filed a claim for a refund of the amount of the withholding tax in excess of the treaty rate. In addition, the treaty entitled a UK shareholder to a repayment of the *avoir fiscal* which was not repayable under the France-U.S. treaty. The claims made pursuant to the treaty would, if successful, have provided the bank with approximately 344.25 million francs being 270 million francs from the French company and 74.25 million francs from the French treasury, and therefore a suitable profit on its investment in the usufruct.

This case involved both the concept of beneficial owner as well as questions of abuse of rights.

In dealing with the question, the Conseil d'État seemed to mix the concepts of beneficial owner and of sham. The Conseil d'État said (in translation):

> An analysis of these arrangements reveals that the beneficial owner of the dividends under dispute was the American company … had simply delegated to its French subsidiary the repayment in its place of the loan contracted with the British bank. Thus, the company cannot claim the reimbursement of the excess withholding at source paid by reason of the distribution of the dividends by the company … no other reimbursement of the dividend tax credit (avoir fiscal) attached to those dividends.

The opinion of the Commissaire du Gouvernement, François Séners is, however, more clear:

> The notion of beneficial or real owner, to which tax treaties often make reference and which is contrasted with the apparent recipient, has never been defined in treaties themselves. It was inserted into the Model Convention of the OECD in 1977 and, according to the commentaries of the Committee for Fiscal Affairs of that organization, a beneficial owner is a person who acts through the interposition of another legal entity created in a state, with the essential objective of obtaining a reduction in taxation provided for by the treaties concluded by that state to which the person would not have been directly entitled. The commentaries of the OECD do not exclude any forms of intermediary but cite in particular agents and nominees …
>
> The doctrinal analyses are united on the fact that the direct recipient of income is not entitled to obtain the advantages granted by international tax treaties if he is not the ultimate recipient of this income and if he has only received it in the status of an intermediary for another person to whom the income is destined to be transferred in one form or another …

50 *Ministère de l'Économie, des finances et de l'industrie* v. *Société Bank of Scotland*, (2006) 9 ITLR 683.

> I think nevertheless that this case reveals that the notion of beneficial ownership cannot be reduced to cases of transfer of intended benefits that, by its nature, it encompasses situations of fraud on the law.[51] It appears to me in effect quite natural that the recognition of a fraud on the law leads one to reject the image portrayed by the arrangement. You have not been more explicitly moved along this terrain, which was only outlined in the *Diebold Courtage* judgment and in the ministerial instructions cited above relating to the Franco-Uzbek treaty. But the logic appears strong to me. Since it tends to exclude the fiscally advantageous effects of a misleading appearance, the notion of beneficial owner also leads to the neutralization of situations where the envisaged sums are paid back in one form or another as well as situations where an abusive arrangement has permitted X to be substituted for Y to benefit from treaty advantages, to the detriment of the taxing state …
>
> The fraud on the law thus characterized must, in accordance with the scheme that I have outlined, lead to rejection of the impression created by the contract and to judge that the American parent company was the beneficial owner of the dividends and that it has conceded the apparent benefit to the Bank of Scotland only for the reimbursement of its debts by a mechanism reducing its burden to the detriment of the French public treasury. Moreover it appears to me that pressing ahead with this logic, if you agree with it, you would come to consider that the dividends paid by the French subsidiary constituted, for the Bank of Scotland, not dividends in the sense of art 9 of the Franco-British convention, but interest which would present an even more radical obstacle for the acceptance of its demand.

The concept of abuse of rights applied to tax treaties as a matter of international law was also recognized even more recently in the *Yanko-Weiss Holdings* case,[52] a December 30, 2007 decision of the District Court of Tel Aviv, Israel. This was a decision dealing with the pleadings in a tax case where a company incorporated in 1996 in Israel changed its place of management in 1999 to Brussels and registered as a Belgium company for the purpose of becoming a resident of Belgium under the Israel-Belgium tax treaty to gain certain Israeli tax treaty benefits. The benefits were denied by the assessing office based on an anti-avoidance provision in the internal law, the *Income Tax Ordinance*. The taxpayer company sought to strike out reliance on domestic anti-avoidance provisions to support the assessment. The motion was denied. In the course of the judgment, the Court dealt with both the internal law and international law, in translation, as follows:

> Tax treaties were not designed, nor can it be said that any such intent existed, whether they include express provisions or not, for use that will be made of them in a manner which is not in good faith and in an acceptable manner, or that use can be made of them which constitutes improper use of provisions set forth and the benefits which they grant. The states which conclude a tax treaty are entitled to raise arguments against such. They can do so by virtue of provisions of domestic law which contain anti-avoidance provisions which are the basis for determination of tax liability …
>
> An additional justification for the use of anti-avoidance measures against tax treaty abuse is found in the implied condition which is to be read into every treaty that they are not to be used for improper purposes. This is based in part on art 31 of the Vienna Convention. …

51 This expression does not connote any actual fraud, but is rather an alternate term, or a more accurate term to use rather than abuse of rights in tax cases. See David A. Ward et al., "The Business Purpose Test and Abuse of Rights", *1989 British Tax Review*, p. 68, footnote 1.

52 *Yanko-Weiss Holdings (1996) Ltd.* v. *Holon Assessing Office*, (2007) 10 ITLR 524.

> Although the terms 'improper use', 'application which is not in good faith' and 'artificial transaction' are not identical it appears that the respondent bears the burden to substantiate that the assessee acted in a manner that constitutes an artificial transaction which constitutes 'improper use' and in any case in the context of the laws of taxation as one who failed to act in good faith and not according to an acceptable manner in which the act was done. If the act was done 'in an accepted commercial manner', the respondent would not bear the burden to demonstrate the artificiality of the transaction …
>
> The doctrine of 'preventing improper use' is capable of including additional standards and anti-avoidance measures, in addition to that of artificial transactions: for example, substance-over-form, reclassification, the commercial essence of the transaction, etc. … One can say that the treaties for the prevention of double taxation to which Israel is a party are to be read as if they contain limitation on benefits provisions in cases where it is proven that there exists improper use of a tax treaty, according to standards of domestic law and international law.
>
> This approach is in line with the interpretation of the OECD of recent years (since 2003) from its model convention, although in my opinion, it should have been included even earlier in light of the language of the provisions of the Vienna convention and the doctrine of good faith that applies in Israel generally …
>
> Paragraph 35 to the introduction makes clear that where changes are made in articles of the model they are to be applied from the time they appear; however the commentaries which have been changed with regard to articles which appear in the model are to be applied even to treaties which were signed prior to the changes where they relate to existing articles in the model, since the commentaries give expression to consensus between the states which are members of the organization as to the correct application ('proper interpretation') of existing provisions and their application in present circumstances …

In *MIL Investments*,[53] the Tax Court of Canada dealt with an argument made on behalf of the CRA, as an alternative to a GAAR argument, that seemed to take the position that tax treaties have an inherent anti-abuse principle that can be applied even if the GAAR does not apply. To establish this "inherent rule", counsel presented the evidence of a Luxembourg expert, Prof. Steichen, who seemed to testify that the inherent anti-abuse principle can only be applied in situations where both treaty partner states have domestic anti-avoidance rules that would deny treaty benefits.[54] He therefore sought to establish the fact that Luxembourg law would apply to deny treaty benefits in a "reversed scenario". However, his opinion indicated that to apply anti-abuse provisions to a tax treaty would require provisions in the tax treaty itself defining various elements of avoidance transactions. Further, his evidence was that only in the case of an ambiguity under the treaty could one refer to the principles of international public order to infer the proper meaning of the treaty. The expert in his opinion stated that silence in the treaty concerning the application of anti-avoidance principles constituted an "ambiguity" and that ambiguity could only be avoided by a specific provision of the treaty stating that the internal law GAAR rules cannot affect the application of the treaty. He seemed to state that in the absence of such a provision there would be an ambiguity as to whether there is an implicit anti-abuse provision existing in the treaty or not.

53 Note 29.

54 This seems to come from Vogel's writings. See note 43, para. 94 art. 1. It is suggested, however, that it is not correct to limit the application of international law rules based on differences in internal law rules.

In considering this confusing expert evidence, the Court stated:

> Overall, I found Steichen's opinion and testimony not substantially convincing. In particular, in light of the OECD Commentary and the decision by Canada and Luxembourg not to include an explicit reference to anti-avoidance rules in their carefully negotiated Treaty, I find there is no ambiguity in the Treaty permitting it to be construed as containing an inherent anti-abuse rule. Simply put, the 'ordinary meaning' of the Treaty allowing the Appellant to claim the exemption must be respected.

The decision of the Tax Court was upheld on appeal.[55] The Federal Court of Appeal in a very brief judgment stated:

> The appellant urged us to look behind this textual compliance with the relevant provisions to find an object or purpose whose abuse would justify our departure from the plain words of the disposition [sic]. We are unable to find such an object or purpose.
>
> If the object of the exempting provision [of the tax treaty] was to be limited to portfolio investments, or to non-controlling interests in immovable property (as defined in the Tax Treaty), as the appellant argues, it would have been easy enough to say so. Beyond that, and more importantly, the appellant was unable to explain how the fact that the respondent or Mr. Boulle had retained influence of [sic] control over DFR [the Canadian corporation the shares of which were sold by the Luxembourg corporation], if indeed they did, was in itself a reason to subject the gain from the sale of the shares to Canadian taxation rather than taxation in Luxembourg.

The position stated in the OECD Commentary

The current commentary on Article 1 of the Model states, in respect of anti-abuse, that there are two possible ways to deal with this in the absence of specific anti-avoidance rules in a tax treaty. The question first is to consider whether benefits of tax treaties must be granted when transactions constitute an abuse of their provisions, in other words, whether there is an inherent anti-abuse doctrine that can be applied in abusive tax treaty situations. The second is whether the anti-abuse provisions of an internal law statute or judicially developed in internal tax law of a contracting state conflict with tax treaties and whether or not they therefore can be applied in abusive tax treaty situations. The answers given in the commentary on Article 1 are that the abuse of a tax treaty can also be characterized as an abuse of domestic law so that to the extent that anti-abuse rules in domestic law create the basis for determining the facts giving rise to tax liability, these rules are not affected by tax treaties themselves so that the facts as determined by domestic anti-avoidance rules in tax cases can also be applied to determine the facts for the purposes of the application of a tax treaty. The answer to the second question in the commentary is that some states view abuses as being abuses of the treaty itself and consider that the proper interpretation of the treaty allows the state to disregard abusive transactions (those entered into with a view to obtaining "unintended benefits") presumably on the application of the international law rule against abuse of rights. That interpretation, the commentary states, results from the object and purpose of tax treaties as well as the obligation

55 2007 DTC 5437.

to interpret them in good faith under Article 31 of the Vienna Convention. The standards that should be applied to distinguish abusive transactions from others is in the commentary stated as follows:

> It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable tax treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.[56]

56 Paragraph 9.5 of the Commentary on Article 1 added in 2003.

6. Application of the general anti-avoidance rule to tax treaties

As first announced in the 2004 Budget, retroactive to 1988, section 245 of the Income Tax Act (the general anti-avoidance rule or "GAAR") was amended to apply to tax treaties. It allows avoidance transactions to be recharacterized in determining their tax consequences "as is reasonable in the circumstances in order to deny a tax benefit that would but for section 245 result, directly or indirectly, from an avoidance transaction." An avoidance transaction is (a) a transaction that but for section 245 would result directly or indirectly in a tax benefit unless it may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit, or (b) a transaction that is part of a series of transactions which series but for section 245 would result directly or indirectly in a tax benefit unless *the transaction* may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. A tax benefit is defined, in the tax treaty context, to include a reduction, avoidance or deferral of tax or other amount otherwise payable under the Income Tax Act but for a tax treaty or an increase in a refund of tax or other amount under the Act as a result of the tax treaty.[57] Where a transaction is an avoidance transaction, the tax consequences are determined as is reasonable in the circumstances in order to deny the tax benefit that would result directly or indirectly from the transaction or from the series that includes the transaction. Importantly, in the tax treaty scenario, section 245 contains a savings provision stating that the recharacterization applies to a transaction only if it may be considered that the transaction would result directly or indirectly in a misuse of the tax treaty or would result directly or indirectly in an abuse having regard to its provisions read as a whole.

It is therefore clear that the GAAR as now worded provides an anti-abuse rule applicable to tax treaties effective for 1988 and subsequent taxation years.

Although it is understood that several taxpayers have been reassessed for tax by CRA on the basis of the abuse of tax treaties with reliance on the GAAR, some of which have not been resolved, and that many have settled with CRA, only one case seems to have proceeded to the Courts. In that case, *MIL (Investments)*,[58] CRA was unsuccessful in the Tax Court but that lack of success turned on the particular and perhaps unique facts of that case and a finding by the Tax Court judge, based on the evidence and argument that the particular transaction, involving the sale of shares that constituted taxable Canadian property (but treaty-protected property under the Canada-Luxembourg treaty) and the earlier transaction involving that the change of the corporate seat (and residence) of the taxpayer from the Cayman Islands to Luxembourg although admittedly an avoidance transaction, were not part of a series of transactions,[59] and that the sale transaction was neither an avoidance transaction nor abusive.[60] Further, there was

57 It seems every reduction of Canadian tax otherwise payable under the Act but for a tax treaty, results in a tax benefit as defined.

58 Note 29.

59 Paras. 42 et seq. of the reasons for judgment.

60 Paras. 70 et seq. of the reasons for judgment. At para. 74 of the reasons for judgment, the judge said: "The Appellant's reliance on a Treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as being a misuse or abuse. Canada, if concerned with the particular tax rates of any of its treaty partners, instead of applying section 245 should seek recourse by attempting to renegotiate selected tax treaties."

a finding on an abuse analysis under the GAAR that the transaction was not a misuse or abuse of the treaty. On appeal to the Federal Court of Appeal,[61] the Court seemed to be unimpressed by the abuse argument indicating that it would have been easy to set out in the treaty specific rules saying what was not intended to be covered.

Although the current OECD Commentary on Article 1 of the Model seems to set a relatively low threshold, "one of the main purposes" for the application of the international law abuse of rights principle to tax treaties, as has already been said, respected authors and court decisions seem to set a much higher threshold that the transaction is an "artificial transaction", or a "wholly artificial transaction", or one that is an *exception* the threshold for which is at a high level, presumably one devoid of a business purpose or virtually devoid of any business purpose. On the other hand, the GAAR under section 245 properly construed may, depending on the facts, have a wider application because the application of the GAAR is dependent on there being an avoidance transaction which is one not undertaken or arranged primarily for bona fide purposes other than to obtain a tax benefit. In other words, the bona fide purposes other than obtaining the tax benefit (e.g., the business purposes) must outweigh the tax benefit purposes of the transaction otherwise it is an avoidance transaction as defined in the GAAR. This should be an easier test for CRA to meet than the abuse of rights test that some courts have now recognized (but not the Tax Court of Canada or the Federal Court of Appeal in the *MIL* case) is inherent in tax treaties.

This leaves the question, however, of determining, in respect of either test, whether the transaction in question results directly or indirectly in an abuse or misuse of the tax treaty provisions. In this respect, as indicated by the decision of the Israeli court in *Yanko-Weiss,*[62] there is an obligation on the taxing authority to establish that the treaty was abused. The jurisprudence under the GAAR indicates that CRA bears the same onus. As stated by the Supreme Court in *Canada Trustco*:[63]

> It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated when the provisions of the Act are interpreted in a textual, contextual or purposive manner. The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

While this statement is made in respect of the application of the GAAR to the Income Tax Act, there is no reason to believe that the onus would be different in respect of the application of the GAAR to a tax treaty.

There is now in the Conduit Companies Report and the OECD Commentaries a plethora of evidence as to what the OECD Committee on Fiscal Affairs considers to be abusive in respect of tax treaties. It is not clear from the jurisprudence nor from the writing of respected authors to what extent these views, which obviously have changed and evolved over the years, should or will be adopted by Canadian courts in considering what is abusive and what is not, and if so,

61 Note 55.

62 Note 52.

63 *The Queen* v. *Canada Trustco Mortgage Company*, 2005 DTC 5523, para. 65.

whether they should only be adopted prospectively.[64] The Tax Court and the Federal Court of Appeal in the *MIL (Investments)* case did not get to this question because, on the evidence, it was found that the admitted avoidance transaction, the changing of the corporate residence from the Cayman Islands to Luxembourg, was not part of the series of transactions that included the sale of shares. Both the Tax Court and the Court of Appeal, however, stated that anti-abuse provisions, if relied on by the tax authority, should be written into the treaty and not implied.

Also, there may be a divided view as to whether transactions or structures designed to access tax treaty benefits are per se abusive. This is reflected to some extent in the exchange of emails that went into evidence in the *Prévost Car* case which is Attachment B hereto.

Further, because of the duality of Canada's tax system in providing one system of taxation for the benefit of Canadians dealing in tax treaty countries and the benefit of taxpayers residing in tax treaty countries and the less favourable system of taxation in other cases, there probably is a legitimate question whether the access to the more favourable system of tax is in fact abusive if the distinction between the two systems was created and maintained principally to assist Canada in negotiating and completing treaties with other countries and not because one system, the non-treaty system, is inherently a better tax policy system than the other system, the treaty tax system.

This can perhaps be illustrated by reference to a 2003 decision of the Supreme Court of India in the *Andolan* case,[65] a public interest case where the interpretation of the India-Mauritius treaty was at issue. The Indian tax authorities in a circular had instructed tax assessors to regard, for purposes of the capital gains article of the treaty, Mauritius direct conduit corporations which tax authorities of Mauritius certified were residents of Mauritius for tax purposes to be residents of Mauritius under the tax treaty even though such Mauritius corporations were mere holding companies, were not liable to Mauritius tax on capital gains on the disposal of shares of Indian companies, and were owned by non-residents of Mauritius, thereby allowing for tax treaty shopping by residents of third party countries.[66] A public interest group in India attempted to have the circular declared ultra vires and of no effect. In dismissing the claim of the public interest group, the Supreme Court said:

> Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc. …

64 The Swiss Federal Court decision in *A Holdings*, note 48, adopted the commentaries, not only as if they were binding, but also applied them retroactively.

65 *Union of India and another* v. *Azadi Bachao Andolan and another*, (2003) 6 ITLR 223.

66 For an interesting discussion of the views of the Indian tax authorities in respect of this treaty, see JDB Oliver, JB Libin, S. van Weeghel and C. Toit, "Beneficial Ownership and the OECD Model", *2007 British Tax Review*, 27 at p. 37 et seq.

Developing countries need foreign investments, and treaty shopping opportunities can be an additional factor to attract them … in recent years, India has been the beneficiary of significant foreign funds through the 'Mauritius conduit' …

Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to other non-tax benefits to their economies …

There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example is one; treaty shopping, in our view is another. Despite the sound and fury of the respondents over the so-called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into.

Attachment A

1. The United States has comprehensive income tax treaties with a limitation on benefits (LOB) provision with Australia, Austria, Barbados, Bangladesh, Belgium, Canada, China, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, the Netherlands Antilles, New Zealand, Portugal, Russia, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, Turkey, Ukraine, the United Kingdom, and Venezuela. Several comprehensive income tax treaties lacked a comprehensive LOB provision, for example those with, Egypt, Greece, Hungary, Iceland, Korea (ROK), Morocco, Norway, Pakistan, Philippines, Poland, Romania, Trinidad and Tobago and Tunisia.

2. Every LOB article provides that "an individual" who is resident in the other contracting state is entitled to treaty benefits.

   Except for treaties with Cyprus, India, Jamaica, Kazakhstan, Russia and Ukraine, the LOB provisions extend the application of the convention to a contracting state, political subdivision or a local authority thereof.

3. Corporations:

   3.1 LOB articles other than those in the China, Cyprus and Jamaica treaties extend treaty benefits to:

   > A company if, (i) the beneficial owners of at least 50 percent of each class of the company's shares are residents of that State that are entitled to the benefits of this Convention; and (ii) amounts paid or accrued by the company during its taxable year to non-qualified residents or non-U.S. citizens and that are deductible for income tax purposes in the company's State of residence do not exceed 50 percent of the gross income of the company for that year.

   In the Austria treaty, there is a minimum requirement of at least 90 percent of each class of interests.

   3.2 LOB articles in the treaties with Canada, China, India, Israel, Italy, Jamaica, Luxembourg, New Zealand, Switzerland and Turkey entitle the following corporations and other entities resident in the other State to treaty benefits:

   > A person if, i) beneficial interests representing at least 50 percent of the value of each class of interests in that person are substantially and regularly traded on a recognized stock exchange; or ii) the direct or indirect owners of at least 50 percent of each class of interests in that person are persons entitled to benefits under clause i), provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits of the Convention under this paragraph.

   In the Cyprus, Jamaica and New Zealand treaties, there is a minimum requirement of more than 75 percent.

In the treaties with Australia, Ireland and the United Kingdom, LOB articles have a provision similar to the following to extend qualified status to:

> A person other than an individual or company if (i) the principal class of units in that person is listed or admitted to dealings on a recognized stock exchange […] and is regularly traded on one or more of the recognized stock exchanges; or (ii) the direct or indirect owners of at least 50 percent of the beneficial interests in that person are qualified persons […].

3.3 In the treaties with Belgium, Denmark, Finland, Germany, Luxembourg, New Zealand, Sweden and the United Kingdom, the LOB articles have a provision that extends qualified status to companies worded in a way similar to the following:

> A company that is resident of a Contracting State shall also be entitled to the benefits of the Convention if: (a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries; and (b) less than 50 percent of the company's gross income, as determined in the company's State of residence, for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the payor), that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.

3.4 In treaties other than those with Cyprus, Indonesia, Italy, Jamaica and New Zealand, the LOB articles have a provision that extends qualified status as follows to:

> A resident is entitled to the benefits of the Convention with respect to an item of income derived from the other State if engaged in the active conduct of a trade or business in the first-mentioned State, if, (i) the resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company); (ii) the income is connected with or incidental to the trade or business; and (iii) the trade or business is substantial in relation to the activity in the other State generating the income (subject to restrictions, including not managing or making investments and the determination of whether a trade or business is substantial, and whether the income is derived in connection with trade or business if the activity in the other State generating the income is a line of business that forms a part of or is complementary to the trade or business).

3.5 The treaties with Australia, Austria, Belgium, France, the Netherlands and Switzerland have an LOB article with a provision extending the benefits of the Convention to "recognized headquarters company for a multinational corporate group".

3.6 The treaties with Australia and Luxembourg have an LOB article with a provision similar to the following to limit the qualification of companies to treaty benefits:

> Notwithstanding the preceding provisions of this Article, if a company that is a resident of one of the Contracting States, or a company that owns at least 50 percent of the aggregate vote or value of such a company, has outstanding a class of shares: (a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements ("the disproportionate part of the income"); and (b) 50 percent or more of the voting power and value of which is owned by persons who are not qualified persons, the benefits of this Convention shall not apply to the disproportionate part of the income.

4. The treaties with Canada, Estonia, France, Latvia, Lithuania, New Zealand, Portugal, South Africa, Switzerland and the United Kingdom have an LOB article with a provision extending the benefits of the treaty to estates and trusts. In these treaties, the estates and trusts provisions contain the same conditions for application of benefits under the treaty as corporations under 3.1 above except for New Zealand.

5. The treaties with Australia, Barbados, China, Denmark, Finland, Germany, Japan, the Netherlands and South Africa have an LOB article with a similar provision to the following, which deals with pension plans:

> An entity organized under the laws of one of the Contracting States and established and maintained in that State to provide, pursuant to a plan, pensions or other similar benefits to employed and self-employed persons, even if the entity is generally exempt from tax in that State, provided that more than 50 percent of the entity's beneficiaries, members or participants are individuals resident in either Contracting State.

6. Every treaty other than those with Cyprus, Indonesia, Italy, Jamaica and New Zealand has overriding discretion to allow the competent authorities of the source state to extend qualified treatment to persons who would otherwise be disqualified. The New Zealand treaty, however, imposes a duty to consult with the other contracting state prior to denying the benefits of the treaty.

One can identify four main models (reproduced below) of the LOB articles used in the United States treaties:

> The first model is derived from the treaties with Estonia, Latvia and Lithuania, which are identical. The treaties with Australia, Austria, Bangladesh, Canada, Ireland, Luxembourg, the Netherlands, Portugal, Thailand and the United Kingdom use a modified version of this model.

The second model is derived from the treaties with Belgium, Denmark, Finland, France, Germany, Slovenia, South Africa, Sri Lanka, and Sweden. Of these treaties, the treaties with Belgium and Finland contain only a few departures to the second model. The treaties with Slovenia and Sri Lanka are more simplified versions of the second model. Denmark, France, Germany, Japan and South Africa use a more modified version.

The third model is derived from the treaties with Kazakhstan, Russia and Ukraine. The treaties with the Czech Republic and Slovakia are only slightly modified versions of the third model. Mexico, Spain and Venezuela use a more modified version of this model.

The fourth model is derived from the treaties with Cyprus, Jamaica, India, Italy and New Zealand. Cyprus is a slightly modified version of the fourth model. India, Italy and New Zealand use a more modified version.

The treaties with Barbados, China, Indonesia, Israel, the Netherlands Antilles, Switzerland and Turkey are not similar to any of the four models.

Limitation on benefits — Model 1

1. A resident of a Contracting State shall be entitled to all the benefits of this Convention only if it is a "qualified resident" as defined in this Article.

2. A resident of a Contracting State is a qualified resident for a taxable year only if it is either:

   a) an individual;

   b) a Contracting State, a political subdivision or a local authority thereof, or an agency or instrumentality of such State, subdivision or authority;

   c) a company, if:

      i) on at least half the days of the taxable year the beneficial owners of at least 50 percent of each class of the company's shares are qualified residents by reason of subparagraphs a), b), e), or f) of this paragraph, or U.S. citizens, provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits of the Convention under this paragraph;

      and

      ii) amounts paid or accrued by the company during its taxable year:

         a) to persons that are neither qualified residents nor U.S. citizens, and

         b) that are deductible for income tax purposes in the company's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property),

      do not exceed 50 percent of the gross income of the company for that year;

   d) a trust or estate, if the ownership of its beneficial interests satisfies the requirement of subparagraph c) i) and its payments to persons who are not qualified residents or U.S. citizens satisfy the requirement of subparagraph c) ii);

   e) a person, if:

      i) beneficial interests representing at least 50 percent of the value of each class of interests in that person are substantially and regularly traded on a recognized stock exchange; or

      ii) the direct or indirect owners of at least 50 percent of each class of interests in that person are persons entitled to benefits under clause i), provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits of the Convention under this paragraph;

f) a person described in subparagraph 3 b) of Article 4 (Resident) provided that more than half of the beneficiaries, members or participants, if any, in such persons are qualified residents; or

g) a United States Regulated Investment Company, or a similar entity in [the Contracting State] as may be agreed by the competent authorities of the Contracting States.

3. a) A resident of a Contracting State that is not a qualified resident shall be entitled to the benefits of this Convention with respect to an item of income derived from the other State, if:

   i) the resident is engaged in the active conduct of a trade or business in the first-mentioned State,

   ii) the income is connected with or incidental to the trade or business, and

   iii) the trade or business is substantial in relation to the activity in the other State generating the income.

   b) For purposes of this paragraph, the business of making or managing investments will not be considered an active trade or business unless the activity is banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer.

   c) Whether a trade or business is substantial for purposes of this paragraph will be determined based on all facts and circumstances. In any case, however, a trade or business will be deemed substantial if, for the preceding taxable year, or for the average of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the first-mentioned State equal at least 7.5 percent of the resident's (and any related parties') proportionate share of the asset value, gross income and payroll expense, respectively, that are related to the activity that generated the income in the other State, and the average of the three ratios exceeds 10 percent.

   d) Income is derived in connection with a trade or business if the activity in the other State generating the income is a line of business that forms a part of or is complementary to the trade or business. Income is incidental to a trade or business if it facilitates the conduct of the trade or business in the other State.

4. A resident of a Contracting State that is not a qualified resident pursuant to the provisions of paragraph 2 may, nevertheless, be granted benefits of the Convention with respect to income arising in the other Contracting State if the competent authority of that other Contracting State so determines.

5. For the purposes of this Article, the term "recognized stock exchange" means:

   a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934;

   b) the Stock Exchange [of the Contracting State] (Name); and

   c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

6. The competent authorities of the Contracting States shall consult together with a view to developing a commonly agreed application of the provisions of this Article, including the publication of public guidance. The competent authorities shall, in accordance with the provisions of Article 26 (Exchange of Information and Administrative Assistance), exchange such information as is necessary for carrying out the provisions of this Article.

Limitation on benefits — Model 2

1. A resident of a Contracting State shall be entitled to benefits otherwise accorded to residents of a Contracting State by this Convention only to the extent provided in this Article.

2. A resident of a Contracting State shall be entitled to all the benefits of this Convention if the resident is:

   a) an individual;

   b) a Contracting State or any political subdivision or local authority thereof;

   c) a company, if:

      i) its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either:

         A) its principal class of shares is primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident (or, in the case of a company resident in [the Contracting State], on a recognized stock exchange located within the European Union or in any other European Economic Area state,[67] or, in the case of a company resident in the United States, on a recognized stock exchange located in another state that is a party to the North American Free Trade Agreement); or

         B) the company's primary place of management and control is in the Contracting State of which it is a resident; or

      ii) at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company are owned directly or indirectly by five or fewer companies entitled to benefits under clause i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

   d) a person described in subparagraph c) of paragraph 1 Article 4 (Residence), provided that, in the case of a person described in clause ii) of that subparagraph, either:

      i) more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or

      ii) the organization sponsoring such person is entitled to the benefits of this Convention pursuant to this Article; or

67 This is usually included in treaties with EU member countries.

e) a person other than an individual, if:

i) on at least half the days of the taxable year at least 50 percent of each class of shares or other beneficial interests in the person is owned, directly or indirectly, by residents of the Contracting State of which that person is a resident that are entitled to the benefits of this Convention under subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of this paragraph; and

ii) less than 50 percent of the person's gross income for the taxable year, as determined in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the payor).

3. A company that is a resident of a Contracting State shall also be entitled to the benefits of the Convention if:

a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries; and

b) less than 50 percent of the company's gross income, as determined in the company's State of residence, for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the payor), that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.

4. a) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is entitled to benefits under paragraph 2 or 3, if the resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.

b) If a resident of a Contracting State or any of its associated enterprises carries on a trade or business activity in the other Contracting State which gives rise to an item of income, subparagraph a) of this paragraph shall apply to such item only if the trade or business activity in the first-mentioned State is substantial in relation to the trade or business activity in the other State. Whether a trade or business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.

c) In determining whether a person is "engaged in the active conduct of a trade or business" in a Contracting State under subparagraph a) of this paragraph, activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company) or another person possesses, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

5. Notwithstanding the preceding provisions of this Article, where an enterprise of [the Contracting State] derives interest, or royalties from the United States, and the income consisting of such interest, or royalties is exempt from taxation in [the Contracting State] because it is attributable to a permanent establishment which that enterprise has in a third state, the tax benefits that would otherwise apply under the other provisions of the Convention will not apply to such income if the tax that is actually paid with respect to such income in the third state is less than 60 percent of the tax that would have been payable in [the Contracting State] if the income were earned in Belgium by the enterprise and were not attributable to the permanent establishment in the third state. Any interest or royalties to which the provisions of this paragraph apply may be taxed in the United States at a rate that shall not exceed 15 percent of the gross amount thereof. The provisions of this paragraph shall not apply if:

   a) in the case of interest, as defined in Article 11 (Interest), the income from the United States is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third state (other than the business of making, managing, or simply holding investments for the enterprise's own account, unless these activities are banking, or securities activities carried on by a bank, or registered securities dealer); or

   b) in the case of royalties, as defined in Article 12 (Royalties), the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself.

6. A resident of a Contracting State that is not entitled to benefits pursuant to the preceding paragraphs of this Article shall, nevertheless, be granted benefits of the Convention if the competent authority of the other Contracting State determines that the establishment, acquisition, or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention. The competent authority of the other Contracting State shall consult with the competent authority of the first-mentioned State before denying the benefits of the Convention under this paragraph.

7. For the purposes of this Article:

   a) the term "principal class of shares" means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company;

   b) the term "disproportionate class of shares" means any class of shares of a company resident in a Contracting State that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments, or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company when compared to its participation in overall assets or activities of such company;

   c) the term "shares" shall include depository receipts thereof;

   d) the term "recognized stock exchange" means:

      i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934;

      ii) the [Contracting State's] Stock Exchange;

      iii) the Irish Stock Exchange and the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, Hamburg, Helsinki, London, Madrid, Milan, Oslo, Paris, Reykjavik, Riga, Tallinn, Toronto, Vienna, Vilnius, and Zurich;[68] and

      iv) any other stock exchanges agreed upon by the competent authorities of the Contracting States;

68 This is the list in the Swedish treaty. The list is not always the same.

e) a class of shares is considered to be regularly traded on one or more recognized stock exchanges in a taxable year if the aggregate number of shares of that class traded on such stock exchange or exchanges during the preceding taxable year is at least 6 percent of the average number of shares outstanding in that class during that preceding taxable year;

f) a company's primary place of management and control will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state, and the staffs conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other state;

g) the term "equivalent beneficiary" means a resident of a member state of the European Union or of any other European Economic Area state or of a party to the North American Free Trade Agreement, or of Switzerland, but only if that resident:

   i) A) would be entitled to all the benefits of a comprehensive tax convention between any member state of the European Union or any other European Economic Area state or any party to the North American Free Trade Agreement, or Switzerland, and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraph a), subparagraph b), clause i) of subparagraph c) or subparagraph d) of paragraph 2, provided that if such convention does not contain a comprehensive limitation on benefits provision, the resident would be entitled to the benefits of this Convention by reason of subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of paragraph 2 if such person were a resident of one of the Contracting States under Article 4 (Resident); and

      B) with respect to insurance premiums and to income referred to in Article 10 (Dividends), 11 (Interest), or 12 (Royalties), would be entitled under such convention to a rate of tax with respect to the item of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

   ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of paragraph 2;

h) with respect to dividends, interest, or royalties arising in [the Contracting State] and beneficially owned by a company that is a resident of the United States, a company that is a resident of a member state of the European Union will be treated as satisfying the requirements of subparagraph g) i) B) for purposes of determining whether such United States resident is entitled to the benefits of the Convention under this paragraph if a payment of dividends, interest, or royalties arising in [the Contracting State] and paid directly to such resident of a member state of the European Union would have been exempt from tax pursuant to any directive of the European Union, notwithstanding that the tax convention between [the Contracting State] and that other member state of the European Union would provide for a higher rate of tax with respect to such payment than the rate of tax applicable to such United States company under Article 10, 11, or 12.

Limitation on benefits — Model 3

1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other State only if such person is:

   a) an individual;

   b) engaged in the active conduct of business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from that other State is derived in connection with, or is incidental to, that business;

   c) a company the shares of which are traded in the first-mentioned State on a substantial and regular basis on an officially recognized securities exchange or a company which is wholly owned, directly or indirectly, by another company that is a resident of the first-mentioned State and the shares of which are so traded;

   d) a not-for-profit organization that is generally exempt from income taxation in its Contracting State of residence, provided that more than half of the beneficiaries, members or participants, if any, in such organization are entitled, under this Article, to the benefits of this Convention; or

   e) a person that satisfies both of the following conditions:

      i) more than 50 percent of the beneficial interest in such person, or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares, is owned directly or indirectly by persons entitled to the benefits of this Convention under subparagraphs a), c), or d), and

      ii) not more than 50 percent of the gross income of such person is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this Convention under subparagraphs a), c), or d).

2. A person that is not entitled to the benefits of the Convention pursuant to the provisions of paragraph 1 may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines.

3. For purposes of subparagraph (e)(ii) of paragraph 1, the term "gross income" means gross receipts, or where a person is engaged in a business which includes the manufacture or production of goods, gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Limitation on benefits — Model 4

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

    a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

    b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State, other than any such persons who are individuals subject to tax in a Contracting State on their worldwide income by reason of citizenship.

    A company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed, solely for purposes of subparagraph (a), to be owned by individual residents of the Contracting State in which the company is resident, as determined under Article 4 (Residence).

2. Paragraph 1 shall not apply if it is determined that the acquisition, ownership or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under this Convention.

3. The requirements of paragraph 2 are satisfied, in particular, where a company resident in [the Contacting State] and owned by individual residents of third States derives income with respect to which the company claims United States tax benefits under this Convention, the company does not use such income in the manner described in paragraph 1(b) and:

    a) the company is engaged in business operations in [the Contacting State] and the income with respect to which the company claims United States tax benefits is incidental to or derived in connection with the business operations in [the Contacting State]; or

    b) the individuals owning the company are residents of countries that have income tax conventions in force with the United States and, pursuant to such conventions, the individuals would have been entitled to United States tax benefits the same as, or substantially similar to, the United States tax benefits claimed by the company under this Convention, had the individuals earned the income directly.

    The provisions of this paragraph shall apply, mutatis mutandis, to a company resident in the United States and owned by residents of third States that derives income with respect to which [the Contacting State] tax benefits are claimed under this Convention.

Attachment B

The original emails attached, sorted chronologically and edited to conceal the identities of the senders and recipients, read as follows:

1. Email from FIN-A to CRA-A, June 8, 2004, at 2:18 p.m.

   "Here's my email address. Thank you for letting me know about Jacques' talk; much appreciated."

2. Email from CRA-A to FIN-A, June 8, 2004, 3:48 p.m.

   "You are welcome. As discussed, Jacques will give the presentation on GAAR & Treaty Shopping tomorrow starting at 1:00 p.m. at Rigaud. Use my name as authority to attend if there are any questions. CRA-B of the Ottawa TSO is one of the organizers and he knows me quite well. CRA-C, my counterpart here at HQ, will be there as well. If there are any problems, ask for him. Bring your ID with you. I hope it will be helpful.

   The Competent Authority person that were (sic) involved in the treaty-shopping case is CRA-D. His phone number is XXX-XXXX."

3. Email from CRA-A to CRA-E, July 5, 2004, 1:37 p.m.

   "CRA-F informs me that the reduced rate for the UK rate were (sic) known at the time that the transactions were undertaken to reduce withholding tax in the Prévost case but there were delays. Can you plese (sic) verify for me when the reduced rate was first known.

   Also, it is the same for the Sweden treaty?"

4. Email from CRA-A (attaching email number 3) to CRA-G, July 5, 2004, 1:39 p.m.

   "CRA-G, could you please answer the question below?"

5. Email from CRA-G to CRA-A, July 5, 2004, 3:32 p.m.

   "Hi CRA-A:

   Sorry I do not know the dates of the Prévost transactions.

   However, we started negotiating with the UK in 1996 and our draft included the same rates to the UK that we gave to the Netherlands and to the U.S. in 1994. Both these treaties contemplated a phase-in such that the 5% rate did not apply until 1997. This may have been to give Finance time to renegotiate with major trading partners such that those countries would not be unduly disadvantaged by older, higher rates.

Also, in May 1994 we signed a protocol with Hungary and in November 1995 with France giving similar 5% phased-in rates. Those rates reflected our official position at that time and would have been available to any country that we were negotiating with. I do not have the history of the Swedish treaty handy. It was signed in 1996 which means that negotiations were taking place earlier.

The rates being offered in negotiation are officially secret although general policies on rates are usually public or discerned by the public. FIN-B is on vacation this month. He would probably have a better idea of when the shift in policy from 10 to 5% took place. Likely the shift took place in the negotiations with the U.S. on the Third Protocol which started about 1987. Once the decision was made there, it affected other concurrent treaty negotiations some of which came to fruition prior to the announcement of the rates in the Third Protocol. I think the Netherlands Treaty (Protocol) was likely the first of these. Finance indicated in its press release for the France Treaty that the move was reflective of the lower OECD rates, a pretty clear signal.

Certainly by the time Hungary, France and the U.S. came on stream by 1995, tax people were pretty sure of Canada's position.

Let me know if you need something more specific."

6. Email from CRA-A to CRA-G, July 5, 2004, 4:01 p.m.

   "CRA-G, the UK Protocol was not signed until May 7, 2003. It provides for the reduced dividend rate of 5%. Pursuant to Article XIV of the Protocol, it appears this rate is effective January 1, 2004. Am I wrong in my reading of that? Are we expected to accept avoidance transactions in the 90s to avoid tax based on what the rate will be when the protocol is signed years later notwithstanding no retroactivity is provided? If negotiations with the UK began in 1996, when would it be known to the public what figure is in the negotiations or if UK is in agreement with it before the Protocol is even signed?"

7. Email from CRA-G to CRA-A, copy to CRA-E, July 5, 2004, 5:08 p.m.

   "Your comments are valid.

   Still, at the start of negotiations both sides undoubtedly put out a call for public input. The UK had no withholding tax under domestic law, the OECD direct dividend rate was 5 percent and Canada had recently agreed to the 5 percent rate with other treaty partners. I think the public would have been amazed if the rates were not reduced during the negotiations. I am sure they were amazed that it took 8 years to actually conclude although going to 5 percent was not the stumbling block (other than the UK insisting that we go down to 0 percent). It does seem quite a penalty (5 percent) on taxpayers for those 8 years given that it was the Finance departments that dropped the ball on what was really a simple protocol, that (sic) could have been concluded quickly.

I agree that less Canadian tax was paid by routing the payments through a country with a lower dividend withholding rate. In a perfect world we would have negotiated and signed new treaties with European countries to provide them with the 5 percent rate all on the same date. Under that scenario, Canada would have been happy in policy terms to collect 5 percent on payments to the UK and Sweden.

Given that we were negotiating with Sweden and UK at this time and our apparent willingness to provide the 5 percent rate as a matter of policy in any new treaty, I think it will be difficult for a court to smell the nastiness of this scheme by two multinationals resident in treaty countries, to avail themselves of the policy rate." [Emphasis in original.]

8. Email from CRA-A to CRA-G, copy to CRA-E, July 5, 2004, 5:42 p.m.

"AH!!! CRA-F has been chatting with you, I see.

CRA-G/CRA-E, if that is a policy, it should be published as we do with other items such as interest expense on borrowed money to pay dividends or in-house loss utilization rules, in order that all taxpayers are treated fairly and on a consistent basis. What about all other Canadain (sic) taxpayers that withheld rates at 10 percent versus 5 percent over the last 8 years. Are we going to refund them? All non-resident shareholders should be allowed to avail themselves of a 5 percent withholding tax versus specified treaty rates and not have to go through avoidance transactions if it reflects policy to allow what the future rates will/might be according to the OECD model — even if the rate is not contracted until 8 years down the road. If you are going to ignore contracts based on policy, then it must be done consistently.

Also, this policy should be known for consideration for all treaty-shopping cases involving a reduction of Part XIII tax as often treaties are under negotiation to reflect OECD models. However, I do not know of any CRA published policy that expresses your view. Neither was this view expressed at the GAAR committee by Finance or the representatives from your area. What am I suppose (sic) to do if the policy is not known and the case is made known to all areas for input and no mention is made of such policy? We at HQ should not direct auditors to go through extensive audit work, including in this case the cost of going to the Netherlands, to learn after the reassessments that it is not offensive in policy terms as eventually the treaty will be changed to reflect the OECD directive. I spoke to CRA-H, the auditor, about 15 minutes ago and she advised that she discussed this actual aspect with you and CRA-E during the audit process. However, I do recall a discussion with you as well during the CA inquiry where you implied what you have written below.

I must admit, I am confused but what else is new. I will have to address this 'policy' with FIN-A at Finance as FIN-B is on vacation."

9. Email from CRA-A to FIN-A, July 6, 2004, 11:52 a.m.

   "FIN-A, I understand that FIN-B is away.

   Related to the Prévost treating shopping case, could you please discuss with whomever is responsible for policy matters on treaty issues to determine if a policy exists as discussed in the attached email. I trust that the concerns raised in the emails are self-explantory (sic). Otherwise, call me at XXX-XXXX."

10. Email from FIN-A to CRA-A, July 6, 2004, 1:52 p.m.

    "Hi CRA-A,

    Will do."

11. Email from CRA-G to CRA-A, copies to CRA-E and CRA-F, July 7, 2004, 9:30 a.m.

    "CRA-A:

    Actually we were chatting with CRA-F.

    I wasn't saying that Finance or CRA had a policy of ignoring rates set out in treaties, even given that we were offering lower rates at the time, but I did say that it was <u>less objectionable</u> if we were negotiating and would have provided those rates anyway. We apply the law and payments to Sweden (till 1997) and the UK garner higher withholding rates. Payments to the Netherlands garner better rates.

    You assured us that using GAAR and beneficial ownership you could demonstrate that the payments were payments out to the UK and Sweden. To the extent that remains true we should apply the law. Our concern is our ability to convince a court that the payments were made to the UK and Sweden. [redacted portion] Certainly the view we have given you is that beneficial ownership in this case is an uphill battle made even tougher in the context of the alleged mischief. You had assured us that with GAAR you can make the argument. On that one, CRA-E and I have conceded our failings in our knowledge of the application of GAAR. We do have some knowledge of beneficial ownership and without very technical LOB provisions in a treaty, we are hampered in preventing treaty shopping. We are not stopped from doing so; our point remains that for a court to consider treaty shopping offensive under current law we think we may need more than temporary arbitrage rates between treaty partners. A taxpayer will not need us to tell them what rates would have been offered to the UK, etc. They will be able to discern from the same facts we have offered to you and make the argument in front of the judge.

    I did meet with CRA-H on this issue. They were very gung ho about looking for these and that CRA was in a position <u>to prove no beneficial ownership in the Netherlands</u> etc. I have no recollection of whether I expressed enthusiasm or not for their work. I know I raised the issue with Finance at the time which indicated that they did not find this treaty shopping particularly offensive vis-à-vis residents in a non-treaty country availing themselves of lower rates." [Emphasis in original.]