Canada's Consultation on Treaty Shopping

KPMG Submission to the Department of Finance Canada

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1 Summary

KPMG Canada LLP (KPMG) compliments the federal government for launching a consultation process with the release of the paper titled *Consultation Paper on Treaty Shopping – The Problem and Possible Solutions* on August 13, 2013 (the Consultation Paper). KPMG welcomes the opportunity to contribute to the public debate on this important matter. KPMG has considered the points and questions raised by the Department of Finance (Finance) in the Consultation Paper and has surveyed various KPMG member firms on their countries' approach to treaty shopping.

Our submission outlines items that we believe Finance should consider in determining whether a separate treaty shopping measure is required or appropriate at this time. Our key recommendations are as follows:

- **Define purpose for entering into tax treaties** — Canada does not appear to have made a clear, coherent tax policy statement to determine the countries with which it enters into treaties (i.e., they are not necessarily high tax countries). In contrast, entering into Tax Information Exchange Agreements appears to have clear policy objectives. This situation would seem to support the view that economic investment may be a primary driver in negotiating tax treaties. Further, it appears that from a policy perspective, Canada seeks to negotiate similar provisions in its treaties regardless of the country with which it is negotiating. If this is correct, then it should not be a significant concern from a tax policy perspective if the benefit of one treaty is used over another.

  We appreciate that certain of Canada's policy choices will have evolved over time and therefore some of Canada's older treaties may not reflect Canada's current tax policy choices. However, it is expected that Canada will renegotiate these treaties over time to reflect current policy objectives. On this basis, it is not clear that treaty shopping ought to be a major tax policy concern (in terms of the use of one treaty over another).

  Further, we note that where Canada has deviated from its preferred treaty policy, a comprehensive limitations-on-benefit provision was included in the treaty (i.e., the 2007 Protocol to the Canada-U.S. Tax Convention). Without a clear understanding of the policy that informs Canada's decisions to negotiate tax treaties, it is not clear what perceived abuses treaty shopping measures are intended to combat, which makes it difficult to formulate an effective solution.

- **Avoid unilateral override to bilateral relationships** — Tax treaties are the result of bilateral negotiation and agreement with foreign jurisdictions. As such, Canada has a responsibility to uphold the mutually agreed upon benefits in its bilateral treaties as stated in those treaties. The unilateral creation of a domestic rule that overrides the provisions of treaties in certain circumstances may be viewed as contrary to the spirit in which those treaties were negotiated.

- **Monitor results from OECD and its BEPS Action Plan** — Canada should consider delaying any substantial action on treaty shopping until the Organisation for Economic Co-operation and Development (OECD) has released its findings on the Action Plan on base erosion and profit shifting (BEPS Action Plan).

  Although it does not explicitly address treaty shopping, delaying substantial action is consistent with the approach recommended by Canada's Standing Committee on Finance in its recently issued report on "Tax Evasion and the Use of Tax Havens". This report encourages the federal government "to continue to support the efforts of the Group of Twenty finance ministers and central bank governors to develop measures to address base erosion and profit shifting, to take necessary collective actions and to examine the Organisation for Economic Co-operation and Development's forthcoming comprehensive action plan."

- **Wait to see international experiences before taking action** — A survey of KPMG's international member firms indicated that there was no perfect model or singular tool available to combat treaty shopping. This lack of consensus may be a further indication that it would be inadvisable to draft a unilateral domestic rule and that Canada should wait to see other countries' experiences and reactions to the work of the OECD on BEPS before implementing a course of action that may not be effective.

- **Consider two-pronged approach to treaty shopping if immediate action is desired** — Alternatively, if Canada wishes to take immediate action (contrary to our main recommendation that Canada consider a more prudent collective approach consistent with the advice of the OECD and the Standing Committee on Finance), we recommend that Canada take a two-pronged approach that includes:

  i. The renegotiation (or termination) of treaties, as desired and/or necessary, and
  ii. The use of the current general anti-avoidance rule (GAAR) provisions.

  We believe that if treaty shopping is a concern, the number of treaties that Canada would seek to renegotiate (or terminate) is probably relatively limited. If so, renegotiation (or termination) of these specific treaties may be a more preferable and targeted approach, rather than introducing a separate domestic rule with a broad brush that may create uncertainty in the tax system and that might ultimately inhibit foreign investment in Canada.

  With this approach, the GAAR could still be used to address perceived treaty shopping abuses. In our view, it is in the government's best interest to allow the GAAR to function as it was intended, until such time as it has proven itself ineffective in this regard.

- **Provide examples of treaty shopping** — If Canada pursues this two-pronged approach, it would be very helpful if the government would issue a clear statement of its anti-treaty shopping policy and provide specific examples of treaty shopping. This clear policy would provide taxpayers with some predictability and certainty as to when the GAAR should apply to investment in Canada through another country.

2 Introduction

Treaty shopping is not a new topic in Canada or internationally. In preparing our submission, we have reviewed international and Canadian studies on treaty shopping, including the OECD's BEPS Action Plan and the report by the Advisory Panel on Canada's System of International Taxation.

OECD BEPS Action Plan
Recently, treaty abuse including treaty shopping was included as one of the 15 items in the OECD's BEPS Action Plan. The policy concern giving rise to this item and the BEPS Action Plan in general relates to the gaps that arise due to the interaction of tax systems and bilateral tax treaties.

Of note in the BEPS Action Plan is a concern about the potentially adverse consequences of countries taking unilateral action:

> *If the [BEPS] Action Plan fails to develop effective solutions in a timely manner, some countries may be persuaded to take unilateral action* for protecting their tax base, resulting in avoidable uncertainty and unrelieved double taxation. It is therefore critical that governments achieve consensus on actions that would deal with the above weaknesses. As the G20 Leaders pointed out, "Despite the challenges we all face domestically, we have agreed that multilateralism is of even greater importance in the current climate, and remains our best asset to resolve the global economy's difficulties"(G20, 2012) [emphasis added].

Report of Canada's Advisory Panel on International Taxation
In Canada, an Advisory Panel on Canada's System of International Taxation was established in 2008 (the 2008 Panel). Its mandate was to provide recommendations to the government in establishing an international policy framework for investment into and out of Canada.

The 2008 Panel also specifically commented on treaty shopping. The 2008 Panel's report to Finance stated that:

> Canada has one of the largest tax treaty networks among developed countries. Tax treaties offer benefits to investors, including lower withholding taxes on cross-border payments, reduced taxation of capital gains in the countries where the gains arise, and double tax relief in investors' home countries for taxes imposed abroad. Tax treaties also enable governments to exchange information, provide mutual assistance in tax collection, and encourage foreign investment.
>
> If Canada's tax rules are to create a level playing field for domestic business activity carried on in Canada by foreign and Canadian businesses while ensuring Canadian-source income is properly measured and taxed in Canada, then Canada's treaty network has a critical role to play.

Further, during its consultations, the Panel heard that "businesses use treaties to mitigate the effect of delays in the negotiation or ratification of treaties when lower withholding rates are expected, to reduce the cost of capital on foreign investments, and to ease compliance burdens when treaty benefits are ultimately available. The Panel also heard that businesses select treaties to reduce tax on capital gains and real estate, to minimize income tax on active business income, and to move such income within a group with no or lower withholding taxes."

The 2008 Panel noted that:

> Businesses should be able to organize their affairs to obtain access to treaty benefits. Tax treaties are complex and the relationships among tax treaties even more so. While inappropriate access to tax treaties may arise in some situations, the Panel believes that Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping.

However, the Panel did add that the government should continue to monitor developments in this area.

3 KPMG's Observations

3.1 Treaty Shopping – The Hallmarks

The Consultation Paper defines treaty shopping as "a situation under which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits." The Consultation Paper refers to the OECD Glossary of Tax Terms, which defines treaty shopping slightly more broadly than Finance but does specifically include or indicate that "the term is normally applied to a situation where a person not resident in either of the treaty countries establishes an entity in one of the treaty countries to obtain treaty benefits." Likewise, a 2006 UN Paper on "Treaty Abuse and Treaty Shopping"[1] also indicates that "treaty shopping, especially using a 'conduit', is perceived as improper use of tax treaties by both the OECD and the UN."[2]

Thus, it appears that Canada has chosen to generally follow the notion of treaty shopping considered by the OECD and UN definition of treaty shopping — that is, the use of intermediary entities or conduits to obtain treaty benefits indirectly. Canada's specific concern in the Consultation Paper appears to be the use of treaties and subsidiary entities to obtain a reduction of Canadian taxes, which would not have been available if a taxpayer invested directly in Canada.

However, since treaty shopping can be defined in different ways, it will be important for Canada to provide a definition and clear examples if it chooses to implement any anti-treaty shopping measures. The Consultation Paper has provided a preliminary basis for doing so by providing the following "hallmarks" of circumstances in which Canada has generally found treaty shopping to exist:

- An entity (intermediary entity), resident in a country with which Canada has a tax treaty, claims the application of the tax treaty to obtain a reduction of Canadian tax otherwise payable on income earned in Canada
- The intermediary entity is owned or controlled mainly by residents of another country that are not entitled to at least the same treaty benefits (third country residents)
- The intermediary entity pays no or low taxes in its country of residence on the item of income earned in Canada (taking into account deductible amounts paid to third country residents and other relevant aspects of the tax system in the country where the intermediary is resident), and
- The intermediary entity does not carry on real and substantial business activities (other than managing investment income) in its country of residence.

KPMG recommendations for hallmarks
Regarding the circumstances listed above, we make the following suggestions if anti-treaty shopping measures are implemented:

- More specific examples be provided where appropriate.
- Regarding the fourth circumstance, that a "main purpose" or "business purpose" exception be considered to ensure that an anti-treaty shopping measure does not inadvertently apply to situations where a legitimate business or commercial purpose exists for the use of an intermediary entity. For example, there may be instances in which treaty shopping should *not* be found to exist, despite the presence of the above factors. In particular, we suggest that legitimate holding companies should not be found to be engaged in treaty shopping simply by virtue of their presence in a jurisdiction that is perceived by Finance to be a problematic jurisdiction. These companies may include:

[1] United Nations Economic and Social Council, Treaty Abuse and Treaty Shopping, (Geneva, 16 October 2006), reference no. E/C.18/2006/2
[2] Ibid., at paragraph 22. Footnotes removed.

- Holding companies for private equity houses
- Holding companies for joint venture investors
- Regional holding companies.

Also, holding companies should not generally be found to be engaged in treaty shopping in situations where the ultimate foreign investors may reside in countries that have treaties with Canada, but it is inefficient for them to invest directly from their home country into Canada because of their domestic tax systems.

3.2 International Experience on Treaty Shopping

In surveying KPMG's member firms in the top 10 countries with foreign direct investment into Canada,[3] it became increasingly apparent that no quick fix or perfect model for anti-treaty shopping provisions exists. Some countries have chosen to negotiate limitation-on-benefits clauses into their bilateral treaties. Other countries have legislated domestic rules that attempt to combat treaty shopping specifically. Still other countries rely on their domestic equivalent of the GAAR. None of these options appears to be free of problems in practice. For example:

- Limitation-on-benefits clauses have proven extremely complex and difficult to navigate. Their complex nature tends to result in "false positives", wherein legitimate structures are mischaracterized and wrongfully denied treaty benefits.
- Domestic anti-treaty shopping measures were in some cases viewed to be too far-reaching in their application, and have been seen as going beyond the OECD and international standards, not reflecting modern commercial reality, and not sufficiently flexible to address the evolving business environment.
- Even domestic general anti-avoidance rules have given rise to some uncertainty when countries fail to provide adequate guidance and tax policy justification as to when it is expected that the rules should apply to deny treaty benefits, including a main purpose test.

No clear consensus arises out of the international experience in our survey. It seems that most countries are struggling to find an appropriate balance between protecting their tax base and maintaining access to the global market. Given the absence of a clear answer, we reiterate that the most appropriate option might be to "wait and see", because this approach will allow Canada to observe other countries' experiences with anti-treaty shopping provisions over the longer term (and follow the OECD work on BEPS) and formulate a measured response. Until the government takes any further action, GAAR remains available to the Canada Revenue Agency (CRA) to combat treaty shopping.

3.3 Canada's Position and Experience on Treaty Shopping

Canada has had relatively limited experience in addressing perceived treaty shopping through the courts. In fact, to our knowledge, the GAAR was only argued in one treaty-shopping case, *MIL (Investments) S.A.* v. *The Queen* (2007 FCA 236). In that case, the transaction at issue was the continuance of a corporate taxpayer from Cayman Islands to Luxembourg prior to realizing a capital gain on the disposition of taxable Canadian property. In this transaction, the Court could not find an abuse or misuse of the object and purpose of the Act or a tax treaty**.**

Aside from *MIL*, the CRA has not argued GAAR in court in the context of treaty shopping. Moreover, the Supreme Court of Canada has not considered the application of GAAR to treaty shopping. It may therefore be prudent to wait until the Supreme Court of Canada has had an opportunity to weigh in

[3] According to the Consultation Paper at pages 8-9, these countries are the United States, Netherlands, United Kingdom, Switzerland, Brazil, Japan, Luxembourg, Germany, China and Australia.

on the issue of treaty shopping (or has had the opportunity to at least consider the 2004 amendments to GAAR) before unilaterally undertaking more extreme courses of action.

On the basis of the above, we suggest that there may still be ample room for a court to determine whether the GAAR applies to certain instances of treaty shopping under the right set of facts. We also suggest that with the clear statements now made by the Canadian government, backed by statements made by the G20 and OECD against treaty shopping, it remains open for the courts to consider the potential application of the GAAR to prevent treaty shopping in appropriate cases. Consequently, we encourage Canada to continue to rely on the GAAR as the primary tool to address perceived treaty shopping as appropriate.

3.4 Relevance of Treaty Shopping

3.4.1 Evidence of Treaty Shopping

While we recognize that treaty shopping is currently the subject of much international discussion, we are not convinced that, empirically speaking, treaty shopping is as broad a concern as the Consultation Paper suggests. The Consultation Paper argues that in order to assess the scale of treaty shopping, it is necessary to consider aggregate statistics on foreign direct investment (FDI), in particular, comparing a country's ranking as an FDI investor into Canada with its ranking as a trading partner.

The Consultation Paper specifically identifies certain countries as problematic because of perceived discrepancies in their rankings (i.e., the Netherlands and Switzerland). We are not convinced that these statistics support the contention that treaty shopping is an issue with regard to certain countries over others. In fact, the Consultation Paper recognizes that these statistics cannot provide a clear identification of which countries are used for treaty shopping.

The Consultation Paper goes on to identify specific countries that have high inbound and outbound FDI through special purpose vehicles (SPE), stating that "the concentration of inbound and outbound FDI in these countries by SPEs, together with their extensive treaty networks and favourable domestic tax regimes, suggests that these countries may be used extensively for treaty shopping purposes". In at least some examples, these countries have very little purely domestic activity that would result in strictly bilateral investment into Canada. We assume that Canada was aware of these facts when it negotiated with and entered into treaties with many of these countries. If this is the case, should Canada now take issue with investment into Canada through these countries?

In addition, presumably Canadian-based taxpayers, at the time of the negotiation, indirectly accessed the benefits of these treaties to facilitate outbound investment by Canadian-based multinationals. These treaties can therefore benefit Canada both by increasing inbound investment, and facilitating growth of Canadian multinationals through outbound investment. In any event, as noted above, if Canada remains particularly concerned with these specific countries, we submit that the most appropriate course of action might be to undertake targeted treaty renegotiations or even possibly termination of existing treaties.

Canada has treaties with all of its major trading partners[4] and the top 10 countries investing into Canada. We submit that it is unlikely that there is substantial investment from investor countries with which Canada has not concluded a tax treaty. Therefore, it appears that treaty shopping in the Canadian context is not likely to be a significant concern for non-treaty country investors.

[4] According to Foreign Affairs, Trade and Development Canada's *Trade and Investment Update 2012* (April 30, 2013), the top 10 import sources were: the United States, China, Mexico, Japan, Germany, South Korea, France, Algeria, and Italy. The top 10 export destinations were: the United States, the United Kingdom, China, Japan, Mexico, South Korea, Netherlands, Germany, France and Hong Kong.

Instead, it seems that a person who may be entitled to treaty benefits in their own country would be looking to use a more favourable tax treaty with Canada. It is also possible that certain foreign entities may have domestic reasons for choosing to invest into Canada through a third-country holding company. As we have mentioned, it is not clear to us that the latter two reasons should be perceived as a problem from a Canadian perspective unless it is Canada's position that it will not be modernizing its treaty network through renegotiations in the future.

3.4.2 Tax Policy Considerations

Canada does not appear to have made a clear, coherent tax policy statement to determine the countries with which it enters into treaties (i.e., they are not necessarily high tax countries). In contrast, entering into Tax Information Exchange Agreements appears to have clear policy objectives. This situation would seem to support the view that economic investment may be a primary driver in negotiating tax treaties. Canada has recently indicated that it targets the same outcomes in its approach to treaty negotiation and that in most cases, it adopts policies in treaty negotiation that it aims to apply worldwide.[5] In contrast, top U.S. treaty negotiation advisors have indicated that the U.S. aims to achieve the best possible deal that it can with each treaty partner. Consequently, the U.S. bilateral tax treaties will not necessarily be similar and certain bilateral treaties may include more beneficial terms compared to others.[6]

If the intention historically has been to apply a consistent policy in negotiating treaties worldwide, then given the reality of Canada's extensive treaty network, it is not clear that Canada has (at least in recent history) a specific tax policy concern about either the use of one treaty over another, or the use of a treaty by an investor from a non-treaty country. We acknowledge that Canada's policy preferences may not always prevail in negotiations and that there are factual differences between Canada's various treaties. We note the recent example in the 2007 protocol to the Canada-U.S. Tax Convention, where Canada agreed to a zero percent withholding tax on interest, which is a deviation from Canada's typical treaty policy. However, in that circumstance a comprehensive limitation-on-benefits provision was included as a compensating measure (which is also a deviation from Canada's typical tax treaty policy). It therefore appears in situations where Canada agrees to provisions that it views as significant deviations from its preferred tax treaty policy, it will ensure compensating measures are implemented. In our view, this is a reasonable approach and is the preferred method to address potential treaty shopping concerns.

Finance has stated that its concern is that third countries may obtain treaty benefits without reciprocal benefits to Canada. We assume that Finance is partly concerned about reciprocity where the investor is located in a non-treaty country (and therefore Canadian investors do not benefit from treaty relief when making investments in the third country). As noted above, it does not appear that significant worldwide investment is flowing from non-treaty countries indirectly to Canada or from Canada indirectly to non-treaty countries. Further, reciprocity may be implicit where non-treaty countries impose low or no taxes and, as a result, Canadians are not subject to any tax for which treaty relief is necessary. Alternatively, for non-treaty countries that levy a reasonable tax rate, we expect that Canada will either negotiate a treaty with that country or, if a treaty is not negotiated, we assume that trade or investment with that country is not sufficient to warrant treaty discussions and consequently treaty shopping is also not a concern.

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[5] See, for example, the comments in "Insiders' View of Treaty Negotiations" in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2009), 25:7.
[6] Ibid., see, for example, the comments of David Rosenbloom at 25:7.

4 Alternative Approach

4.1 Consider two-pronged approach if immediate action is desired.

Alternatively, if Canada wishes to take immediate action (contrary to our main recommendation that Canada consider a more prudent collective approach consistent with the advice of the OECD and the Standing Committee on Finance), we recommend that Canada take a two-pronged approach that includes:

i. The renegotiation (or termination) of treaties, as desired and/or necessary, and
ii. The use of the current general anti-avoidance rule (GAAR) provisions.

We believe that if treaty shopping is a concern, the number of treaties that Canada would seek to renegotiate (or terminate) is probably relatively limited. If so, renegotiation of these specific treaties may be a more preferable and targeted approach, rather than introducing a separate domestic rule with a broad brush that may create uncertainty in the tax system and that might ultimately inhibit foreign investment in Canada.

With this approach, the GAAR could still be used to address perceived treaty shopping abuses. In our view, it is in the government's best interest to allow the GAAR to function as it was intended. This recommendation is also consistent with the Standing Committee on Finance's report, which advised that "the Canada Revenue Agency [should] commit to applying the General Anti-Avoidance Rule in the Income Tax Act to aggressive international tax planning."

While we understand that, in the government's view, it has been unsuccessful in applying the GAAR where it perceives treaty shopping to have occurred, we note that the application of the GAAR in the context of an anti- treaty-shopping policy has only been considered in a single court case. The Supreme Court of Canada has never considered the application of GAAR to treaty shopping, and GAAR has never been applied to a situation where treaty shopping is undertaken and a clause (like a limitation-on-benefits clause) is present in the bilateral treaty.

4.2 Provide examples of treaty shopping

If Canada pursues this two-pronged approach, it would be very helpful if the government would issue a clear statement of its anti-treaty shopping policy and provide specific examples of treaty shopping. This clear policy would provide taxpayers with some predictability and certainty as to when the GAAR should apply to investment in Canada through another country.

5 Conclusion

In summary, KPMG welcomes the opportunity to contribute to the consultation on this important issue for Canadian businesses.

Overall, KPMG suggests that it may not be necessary to introduce new measures to combat treaty shopping at this time and that unilateral measures could even be detrimental for Canadian multinational businesses and Canada's relationships with its trading partners. We agree with the 2008 Panel that Canada has adequate resources and tools to police treaty shopping in its tax treaties and domestic law, including GAAR, and in international jurisprudence.

We submit that a "wait-and-see" approach may be the most prudent course of action for Canada. For example, Canada could consider delaying any substantial action on treaty shopping until the OECD has released its findings on BEPS. Canada may also want to wait to see other countries' experiences before taking any action because no clear consensus has yet arisen out of the international experience. It seems that most countries are struggling to find an appropriate balance between protecting their tax base and maintaining access to the global market. Given the absence of a clear answer, the "wait and see" approach may allow Canada to observe other countries' experiences with anti-treaty shopping provisions over the longer term and formulate a measured response.

We look forward to answering any questions from Finance about this submission and to providing further comments if new proposals are released.

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