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and
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Mr. Ernewein:

Enclosed is our submission on the consultation regarding treaty shopping that was released by the Department of Finance on August 12, 2013.

Several members of the Joint Committee and others participated in discussions concerning our submission and contributed to its preparation, in particular:

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We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience.

Yours very truly,

P. Woolford

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Consultations on Treaty Shopping
Submission by the Joint Committee on Taxation
December 11, 2013

In Economic Action Plan 2013, the Government announced that it would call for consultations on possible measures to prevent treaty shopping. This was followed by News Release 2013-102, which contained a Consultation Paper (the "Paper") on treaty shopping, and set out seven questions to be addressed.

The Joint Committee appreciates the opportunity to provide the Department of Finance (the "**Department**") with its views on this important subject.

To frame our responses to the questions posed in the Paper, we first set out below some general observations. We then review and respond to the questions. We have found that there is considerable overlap among the questions and, therefore, our responses also overlap to some degree. At the end of our submission, we present some recommendations.

Introduction

The Committee suggests that the following observations should be considered in determining whether to enact any new anti-treaty shopping rule:

(a) tax treaties are contractual arrangements entered into between Contracting States for a host of public policy reasons, and reflect in each case what may be a different balance of compromises; they should not be altered materially without the consent of the other Contracting State through re-negotiation;

(b) express limitation-on-benefits ("LOB") provisions, such as Article XXIX-A of the Canada-US Treaty (the "US LOB"), are the internationally accepted method for limiting access to tax treaty benefits to a person that otherwise would be entitled to those benefits because the person meets the test of residence;

(c) while no LOB provision is perfect, the inclusion of an LOB clause in a treaty provides the best balance among the elements of certainty, predictability and fairness; and

(d) potentially abusive transactions, where taxpayers seek to obtain treaty benefits that were never intended by the Contracting States, may be addressed appropriately by existing domestic and treaty-based anti-avoidance provisions and doctrines, including the general anti-avoidance rule ("GAAR").

On balance, the Committee suggests that it may be premature for the Government to take unilateral legislative action at this time, for the following reasons:

(a) the Committee believes that GAAR is in fact an important tool. Even though the Government has been unsuccessful in applying GAAR in one treaty-shopping case (*R.* v. *MIL Investments S.A.,* 2007 DTC 5437), GAAR was considered to be applicable to defeat the use of a treaty in circumstances that are found to be abusive (*Antle* v. *R.*, 2010 DTC 5172, which is not mentioned in the Paper). The presence of GAAR (along with reputational factors) tends to deter many taxpayers from engaging in overly aggressive transactions.

(b) the ultimate outcome of the OECD's initiative on "Base Erosion and Profit Shifting" (the "BEPS Initiative") is not yet known. The BEPS Initiative encompasses treaty shopping, with a final output due date of September 2014.[1]

(c) the Committee is not aware of any economic analysis that quantifies the additional Government revenues likely to be gained from a new anti-treaty-shopping rule, or that compares those incremental revenues with the potential costs arising from a consequential reduction in capital inflows.

While the Committee believes that unilateral legislative action would be premature, nevertheless, in an effort to be as responsive as possible to the Paper, our submission attempts to provide constructive observations with respect to the advantages and disadvantages of alternative approaches set out in the Paper. Our comments should not be taken as an endorsement of the view that a new measure is in fact needed at the present time.

A definition—what is treaty shopping?

A key starting point is definitional – what is "treaty shopping"?

The Paper defines treaty shopping as "a situation in which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits to obtain indirectly those benefits."

The Committee suggests that this definition is both overly broad and somewhat vague. In addition, we agree with the statement in the Paper that "distinguishing between acceptable uses of a tax treaty and treaty shopping can be difficult given the complexity of international transactions and the increasing sophistication of international tax planning."

The Committee believes that the focus of any treaty-shopping rule should be on whether a particular treaty benefit was intended to be enjoyed by a particular person in a particular situation. For example, where an intermediary entity is entitled to no better treaty benefits than its stakeholders, then it is inappropriate to characterize the use of the intermediary entity as treaty shopping. As another example, where an entity (e.g., a public company, collective investment vehicle ("CIV") or an operating company) "belongs" in or is established or maintained in a particular treaty country for a variety of reasons other than to obtain any "better" treaty benefits, it is inappropriate to characterize the entity as an instrument of treaty shopping, even if its stakeholders are not residents of that treaty country and even if they do not themselves have access to the same treaty benefits as the entity.

Why is treaty shopping "bad"?

The Paper describes several "unintended consequences" of treaty shopping. First, the Paper observes that "if third country residents obtain reductions in Canadian taxes by treaty shopping into Canada, the benefits flow only in one direction as those third country residents enjoy Canadian tax relief on their indirect investments in Canada, but Canadian residents may not enjoy the same benefits on their investments in that third country." While we understand this comment, the logic suggests that it <u>is</u> acceptable for a third country resident to use an intermediary entity to obtain benefits if those benefits are in fact equivalent to those that a Canadian resident is granted by the third country – whether under its domestic laws or its own treaty network. For example, where a third country does not impose withholding tax on interest paid to non-residents, it is difficult to say

[1] According to the latest OECD work plan, a discussion draft on "treaty abuse" is due in March 2014, to be followed by public consultations. In addition, we understand that parallel discussions are ongoing in the EU.

that “the benefits flow only in one direction” where a resident of that country uses an intermediary entity to avoid or reduce Canadian withholding tax on Canadian-source interest income.

Second, the Paper states that “the benefits of a tax treaty may flow to persons residing in a country with which Canada does not have a significant bilateral economic relationship or possibly to countries with which Canada had decided for other reasons that it did not wish to conclude a tax treaty.” In addition, it is noted that this “may also allow residents of that third country to enjoy Canadian tax reductions while remaining insulated from exchange of information provisions under Canada’s tax treaties that enable the CRA to obtain information relevant to the administration and enforcement of the Income Tax Act.” While we understand this perspective, we suggest that additional factors should be considered. In particular, with the widespread adoption of Tax Information Exchange Agreements and the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*, recently ratified by Canada, the likelihood that there would be inadequate information exchange with the third country seems small as a practical matter.

Third, the Paper states that “when Canada intends to reduce Canadian taxation on non-residents (whether resident in a tax treaty country or not), it does so by amending the Income Tax Act and not indirectly by accepting treaty shopping practices.” This comment seems reasonable as a general sentiment. However, it is equally reasonable to observe that the Government of Canada must have been aware of the fact that entities resident in a particular treaty country may be expected to have stakeholders that are not resident in that country. Some of the so-called “treaty shopping practices” being referred to in this statement cannot in the Committee’s view be properly characterized as giving rise to unintended tax reductions, but rather are the inevitable consequence of Canada having generally accepted treaty terms that have no material LOB provisions.

Cost-Benefit Analysis

A specific legislative measure focused on treaty shopping would be somewhat unprecedented in Canada. From a public policy perspective, we believe that a rigorous cost-benefit analysis is appropriate before proceeding with such a measure. We are not economists. As such, we are neither in possession of economic data nor able to quantify, analyze or determine the overall economic impact – whether positive or negative – of treaty shopping into Canada or of any measure to curtail such practices. Our comments regarding costs and benefits are therefore purely qualitative.

<u>Benefits</u>

Presumably, the main benefit of a new measure would be enhanced revenue. It is unclear to the Committee whether the Department has any estimate of the quantum of currently foregone revenue arising from treaty shopping. We suspect this is inherently difficult to measure. Nonetheless we do not see that as a reason not to attempt to quantify the potential revenues that might be raised through a new measure.

Another potential (and even more difficult to quantify) benefit might be the perceived improvement to the overall tax system’s “integrity”.

<u>Costs</u>

The costs associated with a new treaty-shopping measure include potential reductions in inbound trade and investment due to higher source country taxation and, depending on the scope of the measure, interpretive uncertainty.

With respect to the possible effects on inbound trade and investment, consider the case of a non-treaty resident investor that currently invests into Canada through an intermediary entity resident in a treaty country. If the intermediary entity were to be denied treaty benefits, the withholding tax rate on direct dividends would rise from 5% to 25%. Taking into account the corporate income tax rate on earnings, the overall effective Canadian tax rate is over 43%. This might be viewed as uncompetitive by some investors, and therefore would logically tend to have a negative impact on inbound capital flows.[2]

This may in turn lead to consequential increases in the cost of capital to Canadian businesses that now indirectly benefit from the treaty-shopping "subsidy" enjoyed by some non-resident investors. We understand that the 2008 amendments to unilaterally eliminate withholding tax on arm's length interest payments were motivated at least partly by an expectation that the tax reduction would reduce the cost of capital to Canadian businesses; a treaty shopping measure may tend to have the opposite effect.

A reduction in capital inflows could also affect other sources of federal and provincial government revenues, such as for example mining taxes.

Furthermore, unless very carefully targeted, any new measure risks being over-inclusive, thereby denying treaty benefits to residents of Contracting States otherwise entitled to those benefits under the relevant treaty. This could lead to controversies with other countries regarding potential taxation by Canada in a manner considered by the other country not to have been contemplated by the treaty. As a matter of international law, countries are generally not entitled to invoke a provision of internal law as justification for failure to perform a treaty.[3] So a Contracting State may well be justified in challenging the denial of treaty benefits to entities resident in that State based solely on internal Canadian law.

More generally, a rule that is too vague tends to diminish certainty, predictability and fairness, which in turn may itself tend to reduce incremental inbound investment.

Finally, any revenue increases must be evaluated on a net basis taking into account the costs of enforcing the new measure, which could be considerable given the inevitable need to obtain foreign-based information.

In brief, we believe that any decision that Canada makes to enact a new rule should not be based on a general aversion to treaty shopping in theory, but rather on a rigorous analysis of costs and benefits. It is possible that a multilateral approach arising under the BEPS Initiative may produce a very different balance of costs and benefits. It is therefore prudent for the Government to await the outcome of that process before enacting a new measure.

Concluding introductory remarks

As the Committee reflected on this matter, it became clear that there is a necessary trade-off between principle and pragmatism. In our view, neither principle nor pragmatism necessarily requires a domestic law approach, as opposed to a treaty-based approach. A treaty-based approach may be effective and efficient if pursued on a strategic and selective basis.

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[2] We understand that Mongolia recently cancelled treaties with 4 countries – Kuwait, UAE, Luxembourg and the Netherlands, and that this (and other domestic changes) resulted in significant decreases in capital inflows, with certain mining projects then being put on hold. We cannot predict the actual impact of a new Canadian measure, but this real-world example suggests that treaty access does affect inbound investment.

[3] *Vienna Convention on the Law of Treaties,* Article 27.

The Committee submits that governmental resources could most effectively be deployed by notifying the relatively small number of countries whose treaties are most frequently being used to “treaty shop” that Canada wishes to negotiate a Protocol aimed at deterring such arrangements, either through an LOB, a change to the treaty definition of “immovable property”, or another similar measure. The announcement of such a re-negotiation would be likely to deter many taxpayers from engaging in transactions that might conceivably be caught. The inclusion in such Protocols of definitive LOB rules would tend to reduce treaty shopping, but in a way that best preserves certainty, predictability and fairness.

Pragmatic considerations would also favour the identification of which items of income are thought to be most at risk. With respect to interest, dividends and royalties, there is considerable uniformity in rates across most of Canada’s tax treaties (except the US Treaty, which already contains a comprehensive LOB), so to the extent this is the area of concern, we presume the main focus is with respect to residents of non-treaty countries that do not benefit from sovereign immunity, as opposed to residents of other treaty countries.

With respect to capital gains, we note that the domestic definition of “taxable Canadian property” is now largely consistent with most treaties, so residents of non-treaty countries are granted essentially the same treatment as treaty investors. It is true that there are some treaties which have adopted slightly narrower definitions of “immovable property”, excluding real or resource property used in a business. It is difficult to assess the effects of this favourable provision on inbound investment, particularly in the mining, oil and gas and other resource sectors. However, it seems to us that any policy decision to eliminate or narrow access to this provision should be carefully considered, as it may have been a factor in previous investment decisions, and its disappearance could affect future investment decisions, particularly in the natural resource sector. To the extent this is the main area of perceived concern, the treaties in question are easily identifiable, and the affected countries could be notified that Canada wishes to negotiate a Protocol to amend these provisions. The Committee suggests that if the Government no longer believes the narrower “immovable property” definition is appropriate, the Department should carefully weigh the potential effectiveness of any new domestic treaty shopping measure, which would have a potentially broad application, against the effectiveness of such a negotiated Protocol which would target and address the specific concern.

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In the remainder of our submission we address the specific questions posed in the Paper, and then present our recommendations.

Question 1 – The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.

The Paper suggests that any new anti-treaty shopping rule should be a domestic rule, because it would take too long to renegotiate all of Canada's treaties and even renegotiating the four or five most relevant treaties might cause other treaties to be used more for treaty shopping.

Renegotiating all of Canada's treaties would take a long time. However, our suggestion is that this is really not necessary; as a matter of pragmatism, much could be accomplished simply by notifying the key treaty shopping jurisdictions that Canada wishes to negotiate a Protocol to address treaty shopping.

The imposition of a domestic rule would result in, essentially, a unilateral amendment to all of Canada's treaties. The negative effects of doing this as far as trade and inbound investment are concerned must be taken into account, as well as the potential cost to Canada's international reputation for adherence to internationally accepted norms and to Canada's treaty obligations.

The Paper suggests that the OECD and the UN endorse the use of domestic anti-abuse rules to deny benefits arising unintentionally under treaties. The Committee's perspective is slightly different. As we read them, the OECD and UN Commentaries suggest that if a country has a domestic anti-abuse rule in place before the Contracting States conclude a treaty, then that rule may continue to apply to deny treaty benefits even after the treaty is concluded, provided that a proper interpretation of the treaty's text, context and purpose indicates that the Contracting States intended the domestic rule to continue to apply. We question whether the OECD or UN Commentaries support the view that, after a treaty has been negotiated, a State may amend its domestic laws to overrule or amend the treaty to add clauses to which the other State did not agree and which the other State may have opposed had they been part of the negotiations in the first place.

Furthermore, it seems clear to the Committee that any legislative measure runs the risk of being over-inclusive or under-inclusive. A domestic legislative measure inevitably amounts to a "one-size fits all" approach. The Committee suggests that it would be more effective to adopt a treaty-based approach that recognizes the inherent diversity of approaches and systems adopted by Canada's treaty partners.

A treaty-based approach, while perhaps involving a longer time horizon, would be more consistent with accepted international norms. A treaty-based approach would ensure that the outcome reflects the usual give-and-take of bilateral negotiation, and allow other countries an opportunity to negotiate an adjusted balance of compromises. It is far less likely to lead to tax controversies based on alleged taxation in a manner not contemplated by the treaty or by international law, as any denial of otherwise available treaty benefits would be based on wording actually found in the treaty.

Overall, the Committee believes that when one assesses the competing priorities of principle and pragmatism, a treaty-based approach is preferable. The Committee accepts that a treaty-based approach may take longer and may present some risk to the Government, but no approach is completely free from risk.

Question 2 – The government invites stakeholders' comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping

The various approaches to address treaty shopping identified by the OECD are generally limited to treaty-based approaches, though the Commentary to Article 1 of the OECD Model Convention notes that domestic anti-abuse rules may also be applied in a treaty context.

First, we have focused on the relative merits of the approaches identified by the OECD. The examples referred to by the OECD were derived from provisions that have been incorporated in bilateral conventions concluded by Member States.

These approaches consist of:

(a) the "look-through approach"[4], which disallows benefits to companies owned or controlled, directly or indirectly, by persons who are not residents of a Contracting State;

(b) the "subject-to-tax approach", which grants treaty benefits in the Source State only if the income is subject to tax in the Residence State;

(c) the "channel (base erosion) approach", which disallows treaty benefits where an intermediary receives treaty-protected income and more than 50% of that income is used to satisfy payments to a resident of a third State where that resident has substantial influence over the management or control of the intermediary; and

(d) finally, the OECD has noted that States wishing to address perceived abuses in a more comprehensive way could adapt a detailed LOB provision such as the US LOB.

As the Paper notes, the OECD has cautioned that these approaches are of a general nature and can be over-inclusive. Accordingly, it has been suggested they should be supplemented with appropriate exceptions. The exceptions to the general rule might include exceptions for:

(a) *bona fide* business transactions;

(b) active trade or business;

(c) an entity that pays a specified amount of tax;

(d) an entity whose equity is listed on a stock exchange; and

(e) derivative benefits.

A "main purpose" test has been included in several of Canada's existing treaties. Where applicable, it denies access to specific treaty benefits where one of the main purposes of the transaction was to obtain such benefits. Our detailed comments on this approach are found in our answer to Question 4; the relative merits of this approach are identified briefly in this section for purposes of comparison with alternative approaches.

The factors that should be considered in assessing the relative merits of each approach include effectiveness, fairness, and the extent to which the approach is likely to be accepted by other

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[4] This includes more targeted "exclusion provisions", which disallow treaty benefits with respect to entities that benefit from specific preferential regimes.

jurisdictions. The BEPS Initiative may itself result in an evolution of the international consensus and, as noted above, it is the Committee's suggestion that no legislative measures be introduced before the outcome of that process is known.

Approaches identified by the OECD

The concept of "conduit" companies, and the extent to which otherwise available treaty benefits might be denied, is discussed in some detail in the OECD Commentary to Article 1, specifically at paragraphs 13-20. Canada has not provided any "observations" on this Commentary. Accordingly, it seems to the Committee that this Commentary is a logical starting point for evaluating any sort of rule that would address the same general point.

(a) Look-Through Approach

This approach would deny treaty benefits to any company that is a resident of a Contracting State if it is owned or controlled by persons who are not residents of one of the Contracting States. According to the OECD Commentary, this kind of rule is appropriate only for treaties with States that "have no or very low taxation and where little substantive business activities would normally be carried on". Moreover, the OECD states, even in these cases, the provision may have to be altered to "safeguard *bona fide* business activities".

An example of this approach is set out in paragraph 13 of the OECD Commentary:

> A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.

This approach is quite blunt. It ignores the tax treatment of the entity as well as any other factors that may be considered relevant to an "abuse" analysis.[5]

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[5] A somewhat less broad approach is set out in paragraph 21.2 of the OECD Commentary, and is aimed specifically at entities that benefit from preferential regimes. This type of approach has been adopted in several of Canada's existing treaties. For example, Article 27(3) of the Canada-Korea Treaty provides:

> 3. The Convention shall not apply to any company, trust or other entity that is a resident of a Contracting State and is beneficially owned or controlled, directly or indirectly, by one or more persons who are not residents of that State, if the amount of the tax imposed on the income or capital of the company, trust or other entity by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust, or other entity or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or other entity, as the case may be, were beneficially owned by one or more individuals who were residents of that State. However, this paragraph shall not apply if 90 per cent or more of the income on which the lower amount of tax is imposed is derived exclusively from the active conduct of a trade or business carried on by it other than an investment business.

Canada has included these types of "preferential regime" provisions in over 40 tax treaties. One feature these provisions have in common is that they apply only to entities that benefit from preferential tax treatment under the laws of the treaty partner by reason of being owned or controlled by third-country residents. Given the seemingly conscious decision to include this approach in some – but not all -- treaties, it does not seem to be a good starting point for a legislative measure affecting all treaties.

Essentially, this type of rule denies treaty benefits to certain entities that are not considered to be sufficiently owned or controlled by domestic persons, but then provides an exception for situations involving a trade or business (other than an investment business).

Although these approaches may appear to be straightforward and objective, there may be ambiguity in applying the control test under domestic rules. More troubling is the fact that these approaches impose a seemingly inflexible ownership rule that may deny treaty benefits in non-abusive situations. Investors form holding companies for a variety of reasons. In many cases, investors choose a single corporate vehicle for reasons having much more to do with administrative convenience than treaty shopping. There are numerous instances where corporate groups consolidate their investment or financing functions in jurisdictions such as Luxembourg or the Netherlands for commercial reasons (e.g., access to EU markets).

It is also common to form an entity in a jurisdiction such as Luxembourg where an investment fund is making an investment and wishes to keep matters simple for the investee and other shareholders by obviating the need for them to identify and test the treaty status of every investor. Fund investors may also wish to avoid the requirement to file returns in the source State, and thus the Fund may form the intermediary entity purely as a reporting “blocker” rather than to achieve incremental tax savings. It is natural to select as the jurisdiction of residence of such a company a jurisdiction in which incremental tax leakage is not significant. More often than not, the intermediary adds no incremental treaty protection for the majority of investors, but merely provides administrative convenience. Of course, such a plan, to be effective, must result in the creation of a company that has submitted itself to worldwide taxation in the relevant State such that it qualifies as a “resident” of that State. The Committee suggests that one cannot necessarily infer a treaty shopping motive from the absence of material tax being paid in the holding jurisdiction. Yet, the look-through approach would deny treaty benefits even where creation of the Luxembourg company had nothing to do with treaty shopping.

The look-through approach has not been widely adopted and, for the reasons discussed above, we suggest that it should not be considered without the addition of extensive exceptions to limit its application to situations that involve true treaty shopping.

(b) Subject to Tax Approach

This approach grants treaty benefits only for income that is actually subject to tax in the Residence State. However, the OECD “does not recommend” such a provision as a general matter, though a specific anti-conduit rule could be negotiated with a Contracting State if it has a sufficiently robust “safeguarding provision”. Clearly, this approach is likely to be extremely over-inclusive. Furthermore, the application of this type of rule is inherently uncertain and raises numerous questions. For instance, if the resident of the other State has losses or other deductions, would that, on its own, disqualify an item of income from treaty protection? Also, if such a rule were to be reciprocally applied, would Canadian corporations be denied treaty benefits on dividends received out of a foreign affiliate’s exempt surplus?

Overall, this approach seems like a highly inappropriate starting point for any Canadian measure. Indeed, the OECD’s stated view is that this approach is generally not recommended.

(c) Channel (Base Erosion) Approach

A third approach is the “channel” or “stepping-stone” approach discussed at paragraphs 17-18 of the OECD Commentary to Article 1. It focuses directly on the “conduit” arrangement. The rule applies only to a particular item of income received by a company resident in State A (the Residence State) from State B (the Source State) where one or more persons who are not residents of the Residence State (a) have a “substantial interest” in the company, or (b) exercise “management or control” over the company. The effect of the rule is to deny a treaty exemption or treaty-reduced rate on a particular item of income if more than 50% of that particular income "is used to satisfy claims by such persons". One problem with such a rule – as acknowledged by the OECD – is that "it may cover normal business transactions". Indeed, it appears from the Commentary that this approach is found only in certain bilateral treaties, many apparently involving Switzerland.

Given the potential over-breadth of such a rule, the Committee believes that it is not the proper starting point for a general anti-treaty shopping rule law (although it may have a place in specific bilateral treaties).

(d) Comprehensive LOB

A final--and more general–approach is an LOB clause of the sort normally found in treaties negotiated by the US. LOB clauses change fundamentally the core bargain negotiated between Contracting States by imposing a series of objective rules relating to, among other things, ownership and base erosion that apply in addition to the normal "residence" test of being "liable to tax". Even the US, which generally has little hesitation in super-imposing its own domestic laws and doctrines onto negotiated treaties, recognizes that LOB clauses should be added to a treaty only through negotiation with the other State. While the US has insisted on the inclusion of LOB clauses for the last 20 years or more, it did not impose this rule unilaterally by means of domestic legislation, but rather methodically re-negotiated its treaties to add LOB provisions on a mutually acceptable basis.

Accordingly, while an LOB provision may make sense in the context of some specific treaties, we suggest that it is not an appropriate starting point for a new domestic measure in Canadian law.

Other Approaches

(e) Main Purpose Test

A "main purpose" test exists in several of Canada's treaties. It is generally limited to the Articles dealing with interest, dividends and royalties. Thus, to the extent treaty shopping concerns include other items of income, or capital gains, the "main purpose" test as it currently exists would not be of assistance. Our detailed comments on a "main purpose" test are set out below under Question 4.

(f) Notify known conduit jurisdictions that Canada wishes to Negotiate a Protocol

As noted above, a potentially effective approach would be for Canada to notify formally the handful of countries known to be commonly used for treaty shopping that it wishes to negotiate a Protocol to address this practice.

The mere notification may curb some treaty shopping activities, as noted above. Ultimately, it would then be necessary to negotiate and ratify a Protocol (or new treaty, depending on the outcome of negotiations) that specifically limits treaty benefits in a way that both countries find acceptable. While this would take longer than enacting a domestic measure, this approach would have the advantage of achieving a more certain–and thus effective–outcome. We acknowledge that new "conduit" jurisdictions could become fashionable, but we believe there are only a limited number of potentially appropriate jurisdictions, and that similar steps could be taken to address issues involving other countries if and when they arise.

This approach obviously requires some cooperation from Canada's treaty partners. In an extreme case, where the relevant treaty country refuses to negotiate, Canada could terminate the treaty.

(g) Impose additional administrative requirements

As an example of this approach, India appears to have targeted Cyprus because the former has been unable to get co-operation under the Exchange of Information Article. As a result, it has imposed additional withholding tax and information reporting requirements that penalise transactions with Cyprus, presumably to pressure Cyprus into being more co-operative. Approaches of this nature could be considered on a case-by-case basis where information exchange is not working.

Concluding Comments

Different types of anti-treaty shopping rules may be appropriate in different settings. For example, a negotiated "look-through" rule might make sense in a treaty with a country that imposes low or no taxation but is not generally a sensible starting point for an all-encompassing domestic rule. If Canada proceeds to enact a domestic general anti-treaty shopping rule, a "one-size-fits-all" rule that does not give rise to inappropriate results is extraordinarily difficult, if not impossible, to formulate.

Complex and all-encompassing rules, such as LOB rules, alter the basic bargain between Contracting States and should not be enacted unilaterally. An overly-broad approach would be unprecedented and inconsistent with international norms. Even those jurisdictions that impose domestic laws to override treaties, such as the US, have implicitly acknowledged that LOB rules need to be specifically negotiated on a bilateral basis.

Any domestic anti-treaty shopping rule must include safeguards to avoid catching structures that are benign, such as intermediate companies owned to a sufficient degree by third party residents whose home countries provide equivalent treaty benefits, entities established mainly for non-tax reasons, and other *bona fide* business transactions. Cross-border trade and investment, not to mention Canada's relationships with its many treaty partners, could be affected materially and detrimentally by the enactment of an overly-broad rule.

International norms, as articulated in the OECD Commentary, suggest that while domestic anti-treaty shopping rules rooted in the concept of "abuse" are considered acceptable by many countries, other rules should be reserved for bilateral negotiation where the appropriate trade-offs will occur and where the rules will reflect the specific factual backdrop of the countries' bilateral relationship and the respective tax systems. The BEPS Initiative may well result in a new multilateral approach. The Committee suggests that any unilateral enactment by Canada – outside of the BEPS Initiative or the recognized concept of "abuse" – would risk upsetting any potential future international consensus.

While there are a number of possible approaches to combatting treaty shopping, each suffers from the same main defects: they depend on precise drafting or leave a great deal of uncertainty; they require numerous exceptions to ensure that intended benefits are not eliminated unintentionally and they do not permit a comprehensive review of the policy of the treaty to determine if the benefits being eliminated are within or without the Contracting States' intended benefits.

Question 3 – The Government invites stakeholders' views on whether a general approach is preferred over a relatively more specific and objective approach.

The main advantage of a general approach is that it can be applied in a nuanced way to the specific facts of a transaction, but that is also its main disadvantage. While a general approach should be tailored to ensure it is neither over-inclusive nor under-inclusive, such an approach is inevitably less certain and predictable than a more specific and objective approach, at least until enough judicial guidance has emerged with respect to its application. Moreover, it may take many years for such jurisprudence to emerge, leaving the true meaning of the rule in doubt for even longer than it would take to renegotiate key tax treaties. A more general approach may also contribute to unfairness arising from inconsistent application by relevant decision-makers, be they tax administrators or the judiciary.

As our comments elsewhere in this submission indicate, the Committee believes that a more specific and objective approach is preferable because it would strike the best balance among the objectives of effectiveness, certainty, predictability and fairness.

Question 4: Whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.

As noted in the Paper, some of Canada's tax treaties contain provisions that deny the benefits of particular Articles where a "main purpose" or "one of the main purposes" test is met.

As an example, Article 10(7) of the Canada-Hong Kong Treaty provides that the reduced rates of withholding tax on dividends otherwise provided in Article 10 do not apply in certain circumstances. Specifically, Article 10(7) provides:

> A resident of a Party shall not be entitled to any benefits provided under this Article in respect of a dividend if one of the main purposes of any person concerned with an assignment or transfer of the dividend, or with the creation, assignment, acquisition or transfer of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the dividend, is for that resident to obtain the benefits of this Article.

As another example, Article 11(9) of the Canada-Hong Kong Treaty provides that the reduced rates of withholding tax on interest otherwise provided in Article 11 do not apply in certain circumstances. Specifically, Article 11(9) provides:

> A resident of a Party shall not be entitled to any benefits provided under this Article in respect of interest if one of the main purposes of any person concerned with an assignment or transfer of the interest, or with the creation, assignment, acquisition or transfer of the debt-claim or other rights in respect of which the interest is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the interest, is for that resident to obtain the benefits of this Article.

Unlike GAAR, this test may apply in the absence of any finding of "abuse".

In the context of Article 10(7) of the Canada-Hong Kong Treaty, it seems the inquiry would be, essentially, whether one of the main purposes of the existence of the Hong Kong resident or of its acquisition of the shares was to obtain a treaty-reduced rate of withholding tax. Tests of this nature exist elsewhere in Canadian law, such as in subsection 55(2) and paragraph 95(6)(b) of the *Income Tax Act*. As the experience with those provisions demonstrates, a "main purpose" test is highly fact-sensitive and thus inevitably there will be disagreements between tax authorities and taxpayers, and ultimately litigation. For example, in the context of Article 10(7), CRA may assert that shares were acquired for the main purpose of realizing treaty benefits, while the taxpayer may contend that the only material purpose was to earn dividend income or appreciation. Until the Courts are able to rule, there will be uncertainty as to its scope.

The application of paragraph 95(6)(b) has been uncertain and controversial for many years. Most tax advisers have advocated a contextual and purposive interpretation that limits its application to situations where foreign affiliate or controlled foreign affiliate status has been manipulated. The CRA has, at times, sought to apply the rule in much broader circumstances, relying on the broad general wording of the provision. Under this approach, the CRA could apply the provision in many situations where a foreign affiliate is incorporated and a tax benefit is obtained. Lengthy discussions between the Committee and the CRA preceded the issuance of the CRA's Income Tax Technical News No. 36 in 2007; these discussions resulted in the CRA eliminating a number of examples to which the provision was expected initially to apply.

However, the general problems with the provision remain: if the provision applies broadly, it poses significant uncertainty for taxpayers and CRA alike, and may deny tax benefits that are otherwise contemplated by the foreign affiliate rules, such as non-recognition treatment for various types of reorganization transactions. In effect, the provision is similar to GAAR but without a misuse or abuse exception. Taxpayers would be dependent on the CRA's goodwill to choose not to apply the provision where there is no abuse; as the Federal Court of Appeal held recently in *JP Morgan*, the law may not even grant any such discretion to the CRA. Taxpayers will be reluctant to undertake a transaction that is not identical to one blessed by the CRA. A recent decision, *Lehigh Cement Ltd.*, has compounded the interpretive uncertainty relating to the "principal purpose" test in paragraph 95(6)(b).

The Committee is concerned that a domestic anti-treaty shopping provision that denies a treaty benefit if the obtaining of the benefit is a main or principal purpose of a transaction, with no exception for situations that are not abusive, would pose the same interpretive difficulties and uncertainty experienced by taxpayers and the CRA in the context of subsection 95(6).

In any event, consistent with the inclusion of a "main purpose" test in some – but not all – of Canada's tax treaties, the Committee would suggest that a rule of this nature is more appropriately dealt with in the context of a treaty-based approach, rather than as part of a domestic legislative measure. Otherwise, both taxpayers and Contracting States may argue that the denial of benefits based on a "main purpose" test found nowhere in the treaty effectively amounts to taxation in a manner not consistent with the treaty.

Question 5 – The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration—para. 7.2.

Paragraph 7.2 of the Paper considers the possibility that a "main purpose" test may not be appropriate and suggests "an anti-treaty shopping rule that is more specific". The rule purports to focus on "conduit" companies.

The Committee's comments on the specific "conduit" company rule described in the Paper are noted below.

International Consensus on Scope of Unilateral Domestic Treaty Rules

The discussion of conduit companies in the OECD Commentary on Article 1 follows a more general discussion about the "improper use of conventions". It is noted that, in general, States may impose domestic anti-abuse provisions (whether targeted or specific) that are generally seen not to conflict with treaties. The determination of "abuse" is, according to the OECD, rooted in "the object and purpose" of the treaty as well as the obligation to interpret treaties in good faith, in accordance with the principles mandated by Article 31 of the Vienna Convention on the Law of Treaties. So, while abuse "should not be lightly assumed", the Committee suggests that the Canadian concept of "abusive tax avoidance", which is at the heart of GAAR, aligns comfortably with the internationally accepted approach to tax treaty interpretation and in particular is viewed as an acceptable method to be employed to address abuses. It is also noted that the "beneficial owner" concept addresses "some forms of tax avoidance". The Committee is aware of the Government's skepticism regarding the effectiveness of these existing tools, but believes it is important to recognize that they generally conform to international standards.

The OECD Commentary regarding treaty shopping does not mention the possibility of States enacting unilateral domestic anti-treaty shopping rules of general application that are not rooted in the "abuse" concept. It is true that a multilaterally agreed rule to "prevent treaty abuse" is one of the specific items being pursued as part of the BEPS Initiative. As this project proceeds, an international consensus may develop on a new set of rules. However, as of now, the focus of the Commentary is on the "abuse" of a treaty.

The Committee acknowledges that some governments may consider any form of tax planning involving treaties to be abusive. However, the Committee believes that the international consensus is that domestic anti-treaty shopping measures should include some element of "abuse" to avoid being overly broad. Thus, while the Committee acknowledges the Department's stated desire to proceed with a new rule, we are concerned that a rule that is neither based on a multilaterally agreed approach, such as the recommendations flowing from the BEPS Initiative, nor rooted in the "abuse" concept, may be inconsistent with internationally accepted norms.

Conduit Rule Described in Consultation Paper

Paragraph 7.2 of the Paper describes a conduit rule as follows:

> For example, such a rule could deny tax treaty benefits to an entity (a conduit) where:
>
> 1) the entity is owned or controlled, directly or indirectly, by residents of one or more third countries;
>
> 2) the entity pays, in the country in which it is resident, no or low taxes 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);
>
> 3) the entity is not engaged in substantive business operations in its country of residence (other than managing investment income); and
>
> 4) the third country residents referred to in (1) or (2) are not all resident in a country with which Canada has a tax treaty, and that treaty provides at least as much tax relief on the particular item of income as the particular tax treaty.

One key feature that is missing from this rule is any concept of the otherwise available treaty benefits being unintended. In other words, the rule is too broad, because it purports to deny treaty benefits even in non-abusive situations. Such a rule cannot be reconciled with internationally accepted norms.

It follows that an essential addition is a requirement that it be reasonable to consider that the relevant arrangement results in an "abuse", having regard to the purpose of the treaty provisions under which benefits are claimed. The Committee cannot find any support in the OECD Commentary for the imposition unilaterally of a rule to deny negotiated treaty benefits unless that rule is rooted in the concept of "abuse".

The Committee acknowledges that paragraph 7.2(3) above articulates a form of "activity" exception. However, the "activity" exception recommended by the OECD at paragraph 18(b) of the Commentary on Article 1, unlike that described in the Paper, does not exclude the activity of "managing investment income". In our view, there is no merit to the exclusion. Indeed, the management of investment income is precisely the core activity undertaken by CIVs that are dealt with at paragraphs 6.8 to 6.34 of the Commentary to Article 1. There is no suggestion in this detailed Commentary that the activity of managing investments is somehow an activity that should be disregarded. Accordingly, if the Department were to proceed with a conduit rule as described in the Paper, the parenthetical at paragraph 7.2(3) should be deleted. While some elements of "substance" may appropriately be required in order to qualify for an "activity" exception, the wholesale exclusion of investment activities seems inappropriate.

Paragraph 7.2(4) acknowledges the concept of "derivative benefits" or "equivalent beneficiaries", but does so in a highly arbitrary and far too narrow way. The rule as articulated limits the exception to situations where 100% of the shareholders are entitled to at least as much tax relief as the intermediary.

If a very high proportion of the shareholders are entitled to at least as low a rate on the item of income in question, then that fact is a strong indicator of the absence of treaty shopping as a motivating purpose of the arrangement. As noted above, in many cases, investors choose a single corporate vehicle for reasons having much more to do with administrative convenience than treaty shopping.

In situations where there is a relatively small percentage ownership by persons whose treaty status would not provide at least as much relief, it is inappropriate and unfair to provide a 100% denial for the other investors, as would be the case under the conduit rule in paragraph 7.2. A sensible approach would be to provide a "derivative benefits" exception under which treaty benefits would be available to the intermediary entity where more than a pre-determined threshold (perhaps 50%, although a higher percentage may also be appropriate) of the equity is held by (and deductible payments are made to) investors who would have been entitled to at least as much relief as the entity. In cases where this ownership test (or base erosion test) is not met, treaty benefits should still be available on a look-through basis to those investors who are entitled to treaty-reduced rates under the treaty between Canada and their country of residence, including to those who would be entitled to inferior treaty benefits but nevertheless entitled to some benefits. If the inter-position of an intermediary is to be disregarded for some purposes, it is only fair that look-through benefits be provided for those investors who would have been entitled to benefits had they invested directly.

The rule as articulated in the Paper is incomplete in several other respects. As noted above, CIVs are now dealt with specifically in the Commentary. CIVs are defined for this purpose as investment funds that are "widely held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established". The OECD Commentary recommends that countries consider specific bilaterally negotiated approaches to CIVs. This process should not be circumvented by a new, unilaterally-imposed, Canadian rule. Moreover, CIVs by their nature do not have the attributes of a "conduit" entity, as that term is used in the Commentary. For all of these reasons, CIVs, as defined in the Commentary, should be expressly excluded from any new anti-treaty shopping rule. To avoid undue uncertainty and any inappropriate disruption of cross-border portfolio investment flows, there should be a *per se* exclusion for CIVs. For similar reasons, there should be a *per se* exception for pension funds, charities, and similar entities that are exempt from tax in their country of residence and for their subsidiaries.

Similarly, public companies and their subsidiaries ought to be excluded on a *per se* basis. This would be consistent with comprehensive negotiated bilateral LOBs, which grant treaty benefits to public companies, regardless of any other factors. The Committee acknowledges that an appropriate definition of a public company would have to be developed. The OECD Commentary recommends an exception for companies whose principal class of shares is listed on an approved exchange; this seems like a reasonable starting point for a public company exception.

Conclusion

The Committee suggests that the conduit rule suggested in the Paper is far too broad. It lacks the fundamental element of requiring a finding of abuse as a condition to its application. It would deny otherwise available treaty benefits to investors resident in treaty countries, thus amounting to taxation on a basis not contemplated by our treaties. Such a rule could also, inappropriately in the Committee's view, deny treaty benefits to entities formed as CIVs, and to public companies, pension funds, charities and their respective subsidiaries.

Question 6 – For stakeholders who favour a more specific approach over a main purpose approach, the Government invites input on the design of the conditions and the exceptions (e.g. the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach with a view to ensuring that the measure is effective and applies in a relatively straightforward manner with predictable outcomes.

Question 6 arises in the Paper at paragraph 7.2 in conjunction with Question 5 and as such there is substantial overlap with our comments on the preceding question. Consistent with our approach to Question 5, we have assumed that the reference to a "more specific" approach connotes a rule that focuses on companies which are described in the Paper as "conduit" companies.

Conditions for Application – Requirement for Treaty Abuse

As noted above, the Committee cannot find any support in the relevant OECD Commentary for the unilateral imposition of a domestic rule to deny negotiated treaty benefits unless that rule is rooted expressly in the concept of "abuse". This is the key feature that is missing from the rule suggested in paragraph 7.2 of the Paper. Fundamentally, a rule that purports to deny treaty benefits even in circumstances which are not abusive is too broad and cannot be reconciled with internationally accepted norms.

Exceptions to Application

The Paper acknowledges what is also highlighted in the OECD Commentary on conduit companies, namely, that any rule will need to include specific exceptions to ensure that treaty benefits will be granted "in *bona fide* cases".

(a) CIVs

As noted in the response to Question 5, CIV's are a prime example of entities that are motivated by "sound business reasons" and that fall within the intended scope and purpose of tax treaties. To avoid undue uncertainty and any inappropriate disruption of cross-border portfolio investment flows, there should be a *per se* exclusion from any new anti-treaty-shopping rule for CIVs.

(b) Tax Exempt Investors

Consistent with the logic for a CIV exception, there should be a *per se* exception for pension funds, charities, and similar entities that are exempt from tax in their country of residence (and for their subsidiaries), regardless of whether the company meets the OECD description of a CIV.

(c) Public Entity Exception

The Committee suggests adopting the OECD Commentary's recommendation for an exception for companies whose principal class of shares is listed on an approved exchange and for their subsidiaries. Other publicly traded vehicles, including trusts and their subsidiaries, should also be included in the exception particularly in light of the administrative burden for both taxpayers and the CRA of establishing derivative benefits in the context of widely held and publicly traded entities.

(d) Derivative Benefits Exception

In situations where there is a relatively small percentage ownership by persons whose treaty status would not provide substantially similar relief, it is inappropriate to deny treaty benefits to the other investors, as would be the case under paragraph 7.2 of the Paper. The specific threshold exception discussed in Question 5 would be similar to the approach already applied by the CRA in the case of partnerships, which do not themselves enjoy the benefits of treaty protection. Similar to partnerships, if an intermediary is to be disregarded for treaty purposes, it would be appropriate to provide look-through benefits to those investors who would have been entitled to benefits had they invested directly. As noted above, any other approach is internally inconsistent. We also note that providing look-through benefits should not result in materially greater administrative or compliance costs in the context of any rule that would otherwise deny benefits after testing whether equivalent benefits would otherwise be available. In other words, if the test under the rule is based on a determination of the benefits that would have been obtained in the absence of the intermediary entity, then it should not add material administrative or compliance costs to base the effect of the rule on the same data.

(e) Substantive Business Exception

The OECD Commentary, and most bilaterally negotiated comprehensive LOB provisions, contain some form of business activity exception where the company is “engaged in substantive business operations” in its state of residence. As discussed in Question 5, paragraph 7.2(3) of the Paper articulates a narrow form of “activity” exception. For the reasons set out in Question 5, there is no merit to the exclusion for the activity of “managing investment income”, which is not excluded by OECD commentary. The Committee recommends that the parenthetical at paragraph 7.2(3) should be deleted, if the Government were to proceed with a rule such as that described in the Paper.

(f) Non-Abusive Situations

The Committee also believes that any measure that may be adopted should include a feature that permits the CRA to dis-apply it in appropriate circumstances, such as under paragraph 6 of the US LOB.

(g) US LOB

While we are not convinced that there is really any need for or net benefit to Canada to be derived from the introduction of any new anti-treaty shopping measure, we do believe that the best balance between the various considerations that are relevant in this context could be achieved by a treaty-based comprehensive LOB such as the US LOB. Such a measure would be more sensitive to the matters discussed above, as well as to other important factors, if properly and carefully crafted. However, our experience with the US LOB since it became bilateral under the Fifth Protocol indicates that this particular example is not ideal (as detailed by numerous papers on the subject that have been published by the Canadian Tax Foundation and other organizations). This is not surprising because it is one of the earlier ones developed by the US and was not modernized at the time of the Fifth Protocol. Thus, while we believe that the LOB approach would be preferable in general, it would be important in developing a Canadian Model LOB to consider carefully its specific parameters and technical wording.

Prospective Application

The Committee recommends that the application of any new statutory rule that may operate to limit the benefits provided under Canada’s treaties should be prospective in its application, should be neither retroactive nor retrospective, and should generally apply only to claims for treaty relief in structures put into place after the date on which the details of the rule are first announced. The Committee acknowledges that the crafting of an effective and fair phase-in rule would require considerable and careful thought. Legitimate expectations of investors will have to be balanced against effectiveness. Insofar as a new rule has the effect of changing the “rules of the road” in a way that could not have been anticipated when prior investments were made, we would suggest that it is only fair that already-existing structures not be caught. Perhaps some form of reasonable “normal growth” concept could be used. Needless to say, existing structures are in no way immunized from attack under existing rules and doctrines, including GAAR.

Question 7: The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.

The Committee is of the view that this question may be the one that highlights most directly the difficulties and perils of any unilateral, domestic, "one-size-fits-all" approach to treaty shopping. The various reasons for this view are outlined below.

Canada's only "comprehensive anti-treaty shopping rule" in a treaty is the US LOB. Accordingly, it seems that any discussion of whether a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule necessarily must be conducted against the backdrop of the US LOB. Furthermore, regardless of whether a domestic anti-treaty shopping rule is general or specific, it would give rise to all the issues discussed below. Accordingly, except in the limited and specific circumstances below, we will not distinguish between a general and a specific anti-treaty shopping rule.

The Committee believes that any domestic anti-treaty shopping rule would have to contain a specific exception for benefits claimed under a treaty that has a comprehensive anti-treaty shopping rule. Given the nature of a comprehensive anti-treaty shopping rule, such a rule can arise only after extensive negotiations between the Contracting States. To apply a domestic anti-treaty shopping rule that denies treaty benefits that would be allowed under a negotiated comprehensive anti-treaty shopping rule would, in the Committee's view, be completely inappropriate and in serious conflict with the treaty (as noted, the only comprehensive anti-treaty shopping rule that exists currently in any Canadian tax treaty is the US LOB, so it is the only rule that would be exempted currently under our suggestion).

The Committee acknowledges that the current global environment in respect of international tax planning, including the BEPS Initiative, is likely as favourable as any environment has been recently for a more aggressive domestic approach to treaty shopping. Nonetheless, the Committee suggests that the implementation of a domestic anti-treaty shopping rule could be subject to strong criticism from some of Canada's treaty partners. Indeed, one of the stated objectives of the BEPS Initiative is to eliminate the incentive for countries to take unilateral action. This criticism would be even stronger if Canada adopted a unilateral rule that exempted only the US Treaty, and yet it must exempt it, as discussed above.

The Committee also notes that Canada's treaty partners would not have a voice or an opportunity, under the mutual agreement procedures ("MAP") in their specific treaties, to negotiate the merits of a case where their residents are being denied treaty benefits by reason of Canada's new rule. Yet US residents have this opportunity under the US LOB rule.

Apart from concerns relating to the defense of the interests of its residents, a treaty partner will have an interest in the application of a domestic anti-treaty shopping rule to one of its residents because it will lose tax base to Canada (in other words, the treaty partner likely will have to give its resident a greater foreign tax credit to recognize Canada's increased tax). Consequently, the Committee suggests that perhaps one of the most controversial, but least obvious, issues raised by the introduction of a domestic anti-treaty shopping rule is the loss of the bilateral nature of dispute resolution options to taxpayers and tax administrators. This means that not only should there be an exception from the application of a domestic anti-treaty shopping rule if a tax treaty contains a comprehensive anti-treaty shopping rule, but there should also be some form of exception – possibly dependent on the MAP procedure – for treaties that contain one or more general or specific anti-treaty shopping rules. That includes a very large number of Canada's tax treaties.

The Committee recognizes that this is an existing issue to the extent that GAAR can be applied to deny treaty benefits. In particular, the Committee notes the position outlined in IC 71-17R5 at paragraph 27, which states that "in general, the Canadian Competent Authority will not negotiate cases where the (re)assessment relies on section 245 of the Act or other specific anti-avoidance provisions of the Act including the Income Tax Act Regulations." However, the Committee suggests that Canada should not exacerbate this unfortunate situation by introducing further domestic anti-avoidance rules that cannot be resolved through MAP.

Conclusion

The Committee suggests that any domestic anti-treaty shopping rule, whether comprehensive or general in nature, should provide a clear and comprehensive exemption from its application for any comprehensive anti-treaty shopping rule contained in a treaty. The US LOB is such a comprehensive rule and therefore should be exempted from any domestic anti-treaty shopping rule – in other words the domestic rule should give way to the comprehensive rule in the treaty.

It is more difficult to make as strong a statement in the case of the many less-than-comprehensive anti-treaty shopping rules in other treaties if Canada were to adopt a domestic rule of general or less-than-comprehensive nature.

Summary and Recommendations

As noted above, the Committee is grateful for the opportunity to comment on the Paper. It is clear to the Committee that this is a complex and difficult area, and we hope that our comments are useful to the Department.

The Committee's overall recommendations may be summarized as follows:

(a) The term "treaty shopping" should be understood to mean the use of treaties to obtain unintended benefits. While the absence of material tax leakage in an intermediary company may in some cases be an indicator of treaty shopping, it is not a reliable indicator, as holding companies are often established for reasons other than to obtain otherwise unavailable treaty benefits.

(b) It is premature for the Government to enact a new legislative measure aimed at treaty shopping. Any such measure should await the outcome of the BEPS Initiative. It should also be preceded by a rigorous cost/benefit analysis that takes into account the potential adverse effects of such a measure on inbound investment and the cost of capital to Canadian businesses.

(c) Despite the Government's lack of success in some recent treaty shopping cases, GAAR remains a powerful tool. GAAR deters some types of aggressive tax planning, including planning that relies on treaty benefits. The Committee acknowledges the Department's view that existing tools, including GAAR are inadequate, but is not persuaded that these tools, if deployed judiciously and coupled with a treaty-based approach, cannot effectively protect the Canadian tax base from erosion through treaty shopping.

(d) The treaty-based approach is preferable to a domestic law approach. While it is true that such an approach may take longer to complete, the Government could implement a risk-based assessment to determine which countries to target first. If the Government were to notify the handful of countries most commonly used that it wishes to negotiate a Protocol to limit treaty benefits, the announcement itself is likely to deter the more aggressive forms of treaty shopping. The treaty-based approach can be tailored to the specific treaty in question, thereby minimizing the potentially inappropriate results arising from a "one-size-fits-all" approach.

(e) If a domestic measure is contemplated, it should be rooted in the accepted concept of "abuse". Mechanical rules, such as LOBs, that apply without reference to "abuse" are normally understood to be appropriate only in the context of bilaterally negotiated provisions, and even there it would be appropriate to provide an exception for non-abusive situations, such as that contemplated by paragraph 6 of the US LOB.

(f) Any domestic measure should have clear *per se* exceptions for CIVs, and for public companies, pension funds, charities, other tax exempt entities and their respective subsidiaries. This would be consistent with LOBs such as the US LOB. There should also be exceptions for derivative benefits and substantial business activities.

(g) Any new rule should be prospective only. Arrangements currently in place at the date of announcement should be grandfathered subject to reasonable "normal growth" limitations.

(h) If the Government determines that a domestic legislative measure is essential, a possible approach may be to amend the *Income Tax Conventions Interpretation Act* ("**ITCIA**") to provide Courts with specific guidance regarding the factors to be taken into account in determining whether a benefit obtained under a treaty should be denied on the basis that the relevant transaction involves abusive tax avoidance. ITCIA was previously amended in 2004 to extend GAAR's reach to treaty benefits, so this may be a logical place to specify such factors. Of course, considerable thought would be required to determine the appropriate factors to be enumerated to ensure that they target only those transactions that are truly abusive. The Committee does not recommend this approach, as we believe the treaty-based approach remains preferable.

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The Committee would be pleased to engage in further discussions with the Department on this important issue.