September 12, 2019

Alta Energy Luxembourg S.A.R.L. v. The Queen, [1] Case Study

On August 29, 2019, Canada ratified the *Multilateral Convention To Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "**Convention**"). It is intended that the Convention will operate alongside Canada's bilateral tax treaties,[2] but will only apply to a particular bilateral tax treaty if both parties agree and instruments of ratification are deposited with the OECD.

Canada has agreed to modify the preamble to its tax treaties to include the following:

> *"Intending to eliminate double taxation with respect to taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance (including treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).*[3]

The most controversial provision contains a specific anti-abuse rule as follows:

> *"Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude: having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement."* [4]

Presumably, the hope of the Canadian government is that the courts will apply these principles when examining a tax plan, rather than concluding the opposite, such as has been the case in Canada, for example in the recent *Alta Energy* case. [5]

In 2011, the Blackstone Group LP, a major private equity fund, and Alta Resources LLC, an industry leader in shale oil and gas exploitation, formed a US LLC to develop a shale property in Northwest Canada. They incorporated a Canadian subsidiary of the LLC, Alta Energy Partners Ltd. ("**Alta Canada**"), to carry on the Canadian business. When it was determined that this structure was not favourable from a U.S. tax perspective, a reorganization was undertaken in 2012 (the "**Reorganization**") to transfer the shares of Alta Canada from the LLC to a Luxembourg holding company (the "**Taxpayer**").

During 2012 and 2013, Alta Canada acquired several drilling and exploration licenses and engaged in limited activities to find and develop productive shale oil deposits. However, in late 2013 the Taxpayer sold the shares of Alta Canada for proceeds of CAD$679,712,251, giving rise to a capital gain of nearly CAD$400 million.

---

1 2018 DTC 1120 (Tax Court of Canada). Under appeal to Federal Court of Appeal.

2 Of Canada's current list of 93 tax treaties in force, up to 75 are intended to be modified (**"Covered Tax Agreements**").

3 Article 6, paragraph 1 of the Schedule.

4 This provision denies the treaty benefit where the following three criteria are satisfied:
- the benefit would otherwise result "directly or indirectly" from "any arrangement or transaction" [the **result criterion**]
- "it is reasonable to conclude, having regard to all relevant facts and circumstances" that obtaining the benefit was "one of the principal purposes" of the arrangement or transaction [the **principal purpose criterion**]
- it is not established that granting the benefit in these circumstances is in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement [the **object and purpose criterion**].

5 In an earlier case, *The Queen v. MIL Investments S.A.*, 2007 DTC 5437 (Federal Court of Appeal), the court rejected the proposition that there was a general policy against treaty-shopping.

The Taxpayer claimed an exemption from Canadian tax under Article 13(5) of the Canada-Luxembourg tax treaty (the "**Treaty**"). The Canada Revenue Agency (the "**CRA**") denied the exemption both on a technical treaty basis and under the general anti-avoidance rule ("**GAAR**").

Gains from the disposition of taxable Canadian property that is not treaty-protected property are included in a non-resident's taxable income in Canada under the Income Tax Act (Canada)(the "**ITA**"). Taxable Canadian property includes Canadian resource properties and shares of a private company that derive their principal value from Canadian resource properties. Treaty-protected property is property that is exempt from Canadian tax because of an exemption under a tax treaty entered into between Canada and another country.

Under the Treaty, Canada has the right to tax the capital gain realized by a Luxembourg resident if the shares sold are taxable Canadian property and not treaty-protected property. In this case, the share would be treaty-protected property for a resource property if the business of the Canadian corporation was carried on in that resource property.

The Tax Court of Canada interpreted the Treaty liberally, with a view to implementing the true intention of the parties, Canada and Luxembourg, who intended to exclude property developed in accordance with the industry's best practices. In this case, the oil and gas industry practice was to undertake preliminary drilling and testing of a reserve to establish its economic value before exploiting all of the property. The Court found this is what Alta Canada in fact did, and it rejected the more narrow view pressed upon it by the government's lawyers to the effect that if Alta Canada did not work to exploit each and every resource property under license to the maximum, the exclusion from taxation did not apply.

In doing so, the Court also took judicial notice of a publication by the CRA acknowledging that reserves are developed in Canada through active exploitation or kept for future exploitation. The government's lawyers were now unjustifiably contradicting that position, and taxpayers should be able to rely on stated positions of the CRA that take into account how reserves are developed in Canada.

The Court also ruled in favour of the Taxpayer on the GAAR assessment. While the Taxpayer conceded that the Reorganization was a tax benefit (to obtain the Treaty exemption), and that that it was not arranged primarily for a *bona fide* purpose other than to obtain the tax benefit, nevertheless, the parties disagreed on whether the avoidance transaction was abusive.

The government argued that the purpose of the Treaty was to prevent double taxation not to permit double non-taxation (capital gains in this case were not taxed in Luxembourg) . It also argued that the Taxpayer was a mere conduit for the Blackstone and other investors, as the proceeds of sale were immediately distributed to the Taxpayer's shareholders and the Taxpayer wound up after the sale. Finally, the government argued that the Reorganization amounted to prohibited "treaty shopping" and, therefore, it was abusive.

The Court held against the government on the first argument, finding that the wording of the Treaty did not contemplate a prohibition against double non-taxation. It also ruled in the Taxpayer's favour on the second argument, finding that the term *conduit* is meaningless in the absence of an agency or nominee relationship. Finally, the Court rejected the application of a rule against *treaty shopping* in the absence of a specific anti-treaty shopping rule in the Treaty.

In light of Canada's recent ratification of the Convention, some commentators have speculated on what the outcome of a case similar to *Alta Energy* would be in the future. Arguably some guidance can be gleaned from this Court's finding that the purpose of the exemption from capital gains tax in the Treaty is to attract capital investments to Canada in a high-risk industry, which is exactly what happened in this case. Moreover, the purpose of entering into the Treaty was also to attract capital to Canada. As noted earlier, the notion in the principal purpose test of the Convention is that a tax benefit can be saved if *it is established that granting the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement*.

We are left with the question whether, in light of the Convention, the Canadian courts will remain suspicious of broad claims of *treaty shopping*.

Lorne Saltman
Partner
lsaltman@grllp.com