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FATCA in Canada: The Restriction on the Class of Entities Subject to FATCA

Roy A. Berg and Paul M. Barba*

PRÉCIS

Le présent article constitue pour les Canadiens une introduction à la Foreign Account Tax Compliance Act (FATCA) et analyse la loi de mise en vigueur du Canada concernant la FATCA. La loi de mise en vigueur classifie de façon unique les entités assujetties à la FATCA, se démarquant ainsi de la classification dans les règlements du Trésor américain, dans l’accord intergouvernemental entre le Canada et les États-Unis sur la FATCA (l’IGA canadien), et dans la loi de mise en vigueur adoptée ou proposée par d’autres administrations fiscales qui ont signé des IGA avec les États-Unis. Ainsi positionnée, la loi de mise en vigueur place le Canada soit à l’avant-garde en matière de rédaction législative concernant la FATCA soit en porte-à-faux avec les États-Unis et ces autres administrations fiscales. Le présent article analyse la position et le raisonnement du Canada relativement à sa classification restrictive des entités assujetties à la FATCA en vertu de la loi de mise en vigueur, et conclut que l’interprétation de la loi est vraisemblablement discordante.

La FATCA est problématique pour toutes les parties concernées, autant dans le secteur privé que public. Malheureusement, la loi de mise en vigueur du Canada semble aggraver la situation. La loi limite la définition de l’IGA canadien d’« institution financière » à une liste exclusive de 13 types d’entités. Il reste à voir si cette restriction du Canada est appropriée. La loi de mise en vigueur classifie toutes les fiducies personnelles canadiennes, ou les fiducies familiales et autres fiducies privées qui sont des résidents du Canada, comme entités exonérées des exigences de l’IGA canadien, alors que ces fiducies seraient classifiées comme entités assujetties à l’IGA canadien en vertu des règlements du Trésor, de l’IGA lui-même, et de la loi de mise en vigueur d’autres administrations fiscales qui ont signé des IGA. En conséquence, le Canada embrouille l’application de la FATCA avec son IGA canadien et pourrait avoir unilatéralement annulé une entente internationale. En particulier, la loi pourrait produire une retenue excédentaire sur certains paiements aux entités canadiennes assujetties avec raison à la FATCA en vertu de l’IGA canadien — en particulier les fiducies personnelles canadiennes — ou pourrait empêcher l’IGA canadien d’entrer en vigueur. La retenue excédentaire augmenterait le fardeau de la FATCA pour les entités canadiennes visées en exigeant qu’elles récupèrent les retenues d’impôt autrement inutiles auprès de l’agent de retenue ou, plus probablement, de l’Internal Revenue Service.

* Of Moodys Gartner Tax Law LLP, Calgary (e-mail: rberg@moodysgartner.com; pharba@moodysgartner.com). We would like to thank Kim G.C. Moody of Moodys Gartner Tax Law LLP, Calgary, for his significant contributions and helpful suggestions. This article is based on our firm’s submission to the Department of Finance in March 2014; see infra note 18.
Naturellement, les négociations entre le département du Trésor américain et le ministère des Finances canadien concernant la FATCA se sont déroulées derrière des portes closes et on ne connaît pas les sujets de discussion des parties, leur nature et les ententes tacites qui auraient pu survenir. En conséquence, nous ne donnons pas notre avis sur l’exactitude de la loi de mise en vigueur canadienne, mais nous analysons plutôt la loi pertinente dans l’espoir que notre analyse serve de cadre à l’évolution de la loi de mise en vigueur étrangère concernant la FATCA au Canada et au-delà.

En particulier, le présent article analyse 1) la FATCA en général et l’IGA canadien en particulier; 2) les raisons pour lesquelles certaines fiducies personnelles canadiennes devraient être classifiées comme des entités assujetties à la FATCA en vertu de l’IGA canadien à titre d’entités de placement, d’établissements de garde de valeurs, ou les deux, et pourquoi le renvoi au Groupe d’action financière dans la définition d’entité de placement ne change pas cette classification; 3) la loi de mise en vigueur en vertu de l’IGA canadien, en particulier sa classification unique des fiducies personnelles canadiennes comme entités exonérées de l’IGA canadien, et un historique de la loi; et 4) les conséquences potentielles de limiter la catégorie d’entités assujetties à la FATCA en vertu de l’IGA canadien, notamment la retenue excédentaire et l’invalidation de l’IGA.

**ABSTRACT**

This article provides an introduction to the Foreign Account Tax Compliance Act (FATCA) for Canadians and analyzes Canada’s implementing legislation regarding FATCA. The implementing legislation uniquely classifies entities subject to FATCA, in that it departs from the classification in the US Treasury regulations, the Canada-US intergovernmental agreement regarding FATCA (the Canadian IGA), and the implementing legislation adopted or proposed by other jurisdictions with signed IGAs with the United States. Thus positioned, the implementing legislation places Canada either in the vanguard of legislative drafting regarding FATCA or as discrepant with both the United States and these other jurisdictions. This article analyzes Canada’s position and rationale for its restrictive classification of entities subject to FATCA under the implementing legislation, and concludes that the legislation is likely discrepant in its interpretation.

FATCA is problematic for all parties involved, in both the private and the public sectors. Unfortunately, Canada’s implementing legislation appears to exacerbate the situation. The legislation restricts the Canadian IGA’s definition of “financial institution” to an exclusive list of 13 types of entities. Whether Canada’s restriction on that term is proper remains to be seen. The implementing legislation classifies all personal Canadian trusts, or family trusts and other private trusts that are Canadian residents, as entities exempt from the Canadian IGA’s requirements, while these trusts would be classified as entities subject to the Canadian IGA under the Treasury regulations, the IGA itself, and the implementing legislation of other jurisdictions with signed IGAs. Consequently, Canada has obscured the application of FATCA through the Canadian IGA and may have unilaterally overridden an international agreement. Specifically, the legislation could cause overwithholding on certain payments to Canadian entities properly subject to FATCA under the Canadian IGA—particularly personal Canadian trusts—or may prevent the Canadian IGA from entering into force. Overwithholding would increase FATCA’s burden on the affected Canadian entities by requiring them to recover the otherwise unnecessary withholding taxes from the withholding agent or, most likely, the Internal Revenue Service.

Of course, negotiations between the US Department of the Treasury and the Canadian Department of Finance regarding FATCA occurred behind closed doors, and it is uncertain what the parties discussed, the nature of any possible debate, and the tacit agreements.
that may have been reached. Accordingly, we do not opine on the correctness of the Canadian implementing legislation, but instead simply analyze the relevant law in the hope that our analysis will serve as a framework for the evolution of foreign implementing legislation regarding FATCA in Canada and beyond.

Specifically, this article analyzes (1) FATCA generally and the Canadian IGA in particular; (2) why some personal Canadian trusts should be classified as entities subject to FATCA under the Canadian IGA as investment entities, custodial institutions, or both, and why the Financial Action Task Force reference in the definition of an investment entity does not alter this classification; (3) the implementing legislation under the Canadian IGA, particularly its unique classification of personal Canadian trusts as entities exempt from the Canadian IGA, and a history of the legislation; and (4) the potential consequences of restricting the class of entities subject to FATCA under the Canadian IGA, including overwithholding and invalidation of the IGA.

KEYWORDS: TRUSTS ■ FATCA ■ US-CANADA ■ CROSS-BORDER ■ INTERGOVERNMENTAL AGREEMENT ■ TAX LEGISLATION

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INTRODUCTION

On February 5, 2014, Canada and the United States signed an intergovernmental agreement (“the Canadian IGA”) regarding the application of the US Foreign Account Tax Compliance Act (FATCA) to Canadian entities.1 The Canadian IGA relieves Canadian entities subject to FATCA from many of the onerous obligations that they would otherwise have faced under FATCA’s default regime. On the same day that the agreement was signed, the Department of Finance issued draft legislation, as required under Canadian law, to implement the Canadian IGA. A slightly modified version of the draft legislation was tabled in the House of Commons on February 11, 2014,2 and on June 19, 2014, the Canadian implementing legislation received royal assent.3

FATCA classifies every “entity”4 (including trusts) as falling within one of two mutually exclusive groups: “foreign financial institution” (FFI) or “non-financial foreign entity” (NFFE).5 Generally, entities must comply with FATCA’s requirements,

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1 Agreement Between the Government of the United States of America and the Government of Canada To Improve International Tax Compliance Through Enhanced Exchange of Information Under the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital, signed on February 5, 2014 (www.fin.gc.ca/treaties-conventions/pdf/FATCA-eng.pdf). The Foreign Account Tax Compliance Act was enacted on March 18, 2010, as subtitle A of title V of the Hiring Incentives To Restore Employment Act of 2010, Pub. L. no. 111-147, as amended (herein referred to as “the HIRE Act”). The name “Foreign Account Tax Compliance Act” is, strictly speaking, an incorrect reference to the law that was enacted as part of the HIRE Act in 2010, but is a holdover from the original iteration of the 2009 legislation that did not become law. Foreign Account Tax Compliance Act of 2009, House Report 3933 (October 27, 2009). Title V, Subtitle A of the HIRE Act is headed “Foreign Account Tax Compliance,” omitting the word “Act.” But since this is the name that remains in widespread use by government officials, entities, and non-government commentators, we have adopted it here.

2 Bill C-31, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on February 11, 2014 and Other Measures, first reading March 28, 2014 (herein referred to as either “the Canadian implementing legislation” or “the implementing legislation”). The relevant provisions of Bill C-31 are substantially similar to the draft legislation initially released by the Department of Finance: Canada, Department of Finance, Legislative Proposals Relating to the Canada-United States Enhanced Tax Information Exchange Agreement Implementation Act (Ottawa: Department of Finance, February 2014) (www.fin.gc.ca/drleg-apl/2014/can-us-eu-0214l-eng.aspx) (herein referred to as “the draft legislation”). When the House of Commons Standing Committee on Finance commenced its review of Bill C-31 in the spring of 2014, one of the authors of this article (Roy Berg) was called to testify on the proposed implementation legislation.

3 SC 2014, c. 20, enacting part XVIII, sections 263 through 269, of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the ITA”).

4 Defined in Treas. reg. section 1.1471-1(b)(35).

5 Sections 1471(a) and 1472(a) of the Internal Revenue Code of 1986, as amended (herein referred to as “the Code” or “IRC”). “Foreign financial institution” is defined in IRC section 1471(d)(4); “non-financial foreign entity” is defined in IRC section 1472(d). Unless otherwise noted, the word “foreign” is used in this article to refer to a person that is not a “United States person” under the definition in IRC section 7701(a)(30). See also IRC section 1473(5).
which differ depending on the entity’s classification as an FFI or an NFFE, or face a 30 percent withholding tax on certain US-source payments received.\textsuperscript{6} FFIs are generally required to enter into an “FFI agreement” with the US Internal Revenue Service (IRS) under FATCA to prevent this withholding,\textsuperscript{7} while NFFEs are not.\textsuperscript{8}

The IGAs with various foreign jurisdictions are surrogates for the default FATCA regime in the Code and the Treasury regulations, which generally make FATCA more palatable for those jurisdictions and their residents.\textsuperscript{9} The IGAs largely override this default regime; they are meant to facilitate the implementation of FATCA and to avoid any legal impediments under foreign law that would otherwise limit an entity’s ability to comply with its FATCA obligations, particularly in jurisdictions with stringent privacy laws.\textsuperscript{10} Nonetheless, an IGA is an incomplete surrogate since it operates in accordance with foreign law. Entities subject to FATCA under an IGA may satisfy their FATCA reporting obligations by reporting to the designated authority in their country of residence under that country’s laws, and that authority then reports to the IRS (Model 1 IGA); or the country of residence must enable such entities to report directly to the IRS (Model 2 IGA).\textsuperscript{11} Accordingly, the implementing legislation of the foreign jurisdiction will initially govern whether an entity is subject to FATCA under a Model 1 IGA.\textsuperscript{12} Under the IGAs, only financial institutions are subject to FATCA’s requirements, including reporting, withholding, and due diligence, while non-financial institutions are not.\textsuperscript{13} The Canadian IGA is a Model 1 IGA; consequently, the Canadian implementing legislation will initially govern whether an entity is

\textsuperscript{6} IRC sections 1471(a) and 1472(a).
\textsuperscript{7} IRC sections 1471(a) and (b)(1); Treas. reg. section 1.1471-4.
\textsuperscript{8} IRC sections 1472(b).
\textsuperscript{9} For a list of jurisdictions that have signed an IGA, see United States, Department of the Treasury, “FATCA—Archive” (www.treasury.gov/resource-center/tax-policy/treaties/pages/fatca-archive.aspx) (herein referred to as “the FATCA archive”).
\textsuperscript{11} There are three versions of the Model 1 IGA and two versions of the Model 2 IGA (see infra note 13), and each model has its own pair of annexes. All US model IGAs can be found on the Treasury’s FATCA page: www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.
\textsuperscript{12} Model 1A IGA, supra note 10, article 2; Canadian IGA, supra note 1, article 2.
\textsuperscript{13} For example, the Canadian IGA, supra note 1, articles 1(1) and 4(1), and annex I(I) and (VI)(B)(2); Model 1A IGA, supra note 10, articles 1(1) and 4(1), and annex I(I) and VI(B)(2). United States, Department of the Treasury, “Model 2 IGA, Preexisting TIEA or DTC,”
subject to FATCA under the IGA. Notably, the IGAs replace the FFI agreements and only modify the default rules for FFIs—and not the rules for NFFEs—under the Code and the Treasury regulations. Thus, entities properly classified as NFFEs will not be governed by the Canadian IGA or the Canadian implementing legislation to determine whether they are subject to FATCA; instead, they will be governed by the default rules in the Code and the Treasury regulations.

Personal trusts resident in Canada that are not regulated by Canadian law are directly affected by the definition of “financial institution” in the implementing legislation. These trusts are typically family trusts used frequently in Canada for a variety of legitimate and even statutorily sanctioned endeavours, including holding closely held businesses or other investments, income splitting, intergenerational wealth transfer, and post mortem planning. We refer to these types of trusts, which are both residents of Canada and properly classified as trusts under US tax law, as “personal Canadian trusts.”

The Canadian implementing legislation alters the definition of “financial institution”—one of the most important terms defined in the Canadian IGA—in a manner that appears to be inconsistent with the IGA, and is more restrictive than the Treasury regulations and the implementing legislation regarding FATCA that has been adopted or proposed in every other jurisdiction with a signed IGA. The implementing legislation explicitly provides that it governs in the event of any inconsistency between it and the Canadian IGA, and this restriction seemingly creates an inconsistency. Thus, the implementing legislation’s restrictive alteration of the Canadian IGA’s definition of a financial institution will exempt from the IGA, and perhaps even from FATCA entirely, entities that would otherwise be subject to FATCA under the

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14 Model 1A IGA, supra note 10, articles 2 through 4 and 4(1); Canadian IGA, supra note 1, articles 2 through 4 and 4(1).
15 IRC section 7701(a)(30)(E); Treas. reg. section 301.7701-4; and article IV of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007. A trust must fail either the court test or the control test in IRC section 7701(a)(30)(E) to constitute a foreign trust. IRC section 7701(a)(31)(B).
16 Canadian IGA, supra note 1, article 1(1)(g).
17 ITA subsection 263(5). See also ITA subsection 91(4).
provisions of the IGA, the Code and Treasury regulations, and the implementing legislation of other jurisdictions with IGAs.

In this article, we provide an introduction to FATCA in Canada and discuss the implementing legislation’s apparent limitation on Canadian entities subject to FATCA under Canadian law, particularly personal Canadian trusts.\(^\text{18}\) To understand how FATCA will work in Canada, it is important to recognize that there are three sources of substantive law that—at least in theory—are supposed to function in harmony (though practical impediments may cause some dissonance): the Code and the Treasury regulations, the Canadian IGA, and the Canadian implementing legislation. The Canadian implementing legislation is augmented by administrative guidance notes issued by the Canada Revenue Agency (CRA).\(^\text{19}\) The analysis that follows is based on these sources and is divided into five parts. First, we will discuss the purpose of FATCA in the context of the US system of worldwide income taxation. Second, we will provide a brief introduction to FATCA under both the default rules in the Code and the Treasury regulations and the IGAs. Third, we will address how personal Canadian trusts are classified under FATCA in the Code and Treasury regulations and in the Canadian IGA. Specifically, we will examine why personal Canadian trusts are properly classified as financial institutions subject to FATCA under the Code and the Canadian IGA as investment entities, custodial institutions, or both, and how the IGA’s reference to the recommendations of the Financial Action Task Force (FATF)\(^\text{20}\) does not alter this classification. Fourth, we will outline how personal Canadian


\(^\text{20}\) The Financial Action Task Force is an independent intergovernmental body that develops and promotes policies to protect the global financial system. According to the FATF, the International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation—FATF Recommendations (Paris: Financial Action Task Force, February 2012) are recognized as the global standard: Financial Action Task Force, “Who We Are” (www.fatf-gafi.org/pages/aboutus/). The document (referred to herein as “the FATF recommendations” and discussed later in this article) can be found at www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf.
trusts are improperly classified under the Canadian implementing legislation as entities exempt from the IGA, and perhaps even from FATCA entirely, and we will review the history of the legislation. Fifth, we will analyze the consequences to Canadians of excluding personal Canadian trusts from FATCA under the implementing legislation. Notably, the legislation could cause overwithholding on certain US-source payments to Canadian financial institutions—as defined by the Canadian IGA or US domestic law—particularly payments to personal Canadian trusts, or it could even prevent the Canadian IGA from entering into force.

FATCA—A CONTEXTUAL OVERVIEW

FATCA's Purpose and Worldwide US Taxation

As background to our analysis, we will begin by identifying the purpose of FATCA, since it is important to keep that purpose in mind in considering the various provisions discussed below. FATCA is designed to detect and deter offshore tax evasion by persons subject to US taxation. FATCA fulfills its purpose by imposing reporting, withholding, and due diligence requirements on certain financial entities regarding those entities’ US account holders and owners.

To understand the harm that FATCA was designed to prevent, a brief overview of the US income tax system is in order. The United States is unique in that it taxes “United States persons” on their worldwide income. Worldwide US income taxation follows from the lack of limiting language on the taxation of persons. The Code is written broadly to potentially apply to any person in existence, regardless of whether that person resides in the United States. The Code begins by generally providing that “every individual” and “every corporation” may be subject to US tax on income “from whatever source derived.” This means that an individual or a corporation may be subject to US tax on any item of income earned or received, regardless of that person’s country of residence. But other provisions of the Code generally limit worldwide income taxation to United States persons. A “United States person” is generally defined as a US citizen or resident, a US corporation or partnership, a US-resident estate, or a US trust. Notably, US citizenship for tax purposes is determined

22 IRC sections 1, 11, 641, 701, and 7701(b)(1); Treas. reg. section 1.1-1(b). The term “United States person” is defined in IRC section 7701(a)(30); see the text below at note 25.
23 IRC sections 1(a), 11(a), 61(a), and 63.
24 IRC sections 2(d), 11(d), and 7701(a)(5), (a)(30), and (b)(1).
25 IRC section 7701(a)(30).
by reference to US immigration law,26 which provides that individuals born in the United States and subject to its jurisdiction are US citizens.27 This is important to remember while rummaging through FATCA’s specific rules because FATCA was largely designed to identify US citizens, in order to fulfill its purpose of detecting and deterring tax evasion, particularly pertaining to its due diligence and payee identification requirements.28 In light of FATCA’s purpose, we will begin our journey into its labyrinth by discussing its antecedents and inception.

**FATCA’s Antecedents and Inception**

After the terrorist attacks on September 11, 2001, the United States realized that its position in the global economy, coupled with pressure on the global banking system, could prove to be a powerful weapon to fight money laundering and terrorism, and began implementing strategies to leverage its position to that end.29 In 2010, the US Congress enacted FATCA, which utilizes similar strategies to a different end—namely, as noted above, to detect and deter US persons30 that seek to avoid US tax by hiding income and assets in foreign jurisdictions.

FATCA is one of the most ambitious and controversial bodies of legislation in the recent history of taxation. It was born from the ashes of the UBS tax scandal, and seeks to combat offshore tax evasion by US persons through the use of non-US financial entities and investment structures.31 Historically, US persons seeking to evade US taxation have favoured this strategy because of the robust bank secrecy laws in many jurisdictions (notably, Switzerland).32 FATCA attempts to eliminate this type of tax evasion by imposing an innovative withholding tax on certain US-source payments to specified foreign entities if the entities fail to report information regarding their US owners and account holders to the IRS, perform due diligence to discover these owners and account holders, and make any required withholdings.33

Information reported under FATCA can have grim consequences for US persons who have undisclosed funds offshore or are not compliant with their US tax-filing obligations.

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26 Treas. reg. section 1.1-1(c).
27 8 USC section 1401(a).
28 See the text accompanying notes 74-76 and 132-163, infra.
30 In this article, unless otherwise noted, references to a “US person” or “US persons” mean persons falling within the definition of “United States person” in IRC section 7701(a)(30).
31 See the Senate report, supra note 21, at 2; and Congressional Record, supra note 21, at S10785.
33 IRC sections 1471(a), 1472(a), 1473(1)(A), and 1474.
obligations. Non-compliant taxpayers who are reported to the IRS under FATCA may not be eligible to use the recently amended streamlined filing compliance procedures to catch up on their US filing obligations without incurring substantial penalties, since the information gleaned would presumably trigger an IRS audit and investigation; under the amended rules, the initiation of a civil or criminal investigation by the IRS will preclude taxpayers from using the streamlined filing procedures. Accordingly, non-compliant taxpayers should take action to remedy their non-compliance sooner rather than later.

The primary criticisms of FATCA appear to be that (1) it is unilateral, (2) it is extraterritorial, and (3) it improperly passes on the costs of detecting tax evasion—traditionally borne by government—to private parties. Canada’s former finance minister Jim Flaherty was one of FATCA’s most outspoken critics. He said, for example, that FATCA would “turn Canadian banks into extensions of the IRS” and ultimately fail to achieve anything “except waste resources on all sides.” FATCA has also been criticized, using a cost-benefit analysis, for placing an unjustifiably high financial burden on the world’s financial entities to deter and detect US tax evasion; indeed, it has been suggested that the implementation costs for entities subject to FATCA will exceed the US tax revenues raised.

Some believe that FATCA will not withstand the test of time because it is overly broad and overreaching, and others question the validity of the IGAs under either US or foreign law. Notably, before the Canadian IGA was signed, the pre-eminent Canadian constitutional law scholar Peter W. Hogg argued that an IGA based on one
of the US model IGAs—which is precisely what the Canadian IGA is—would violate the Canadian constitution. But his view is not shared by all. We will not take a side in this debate, but assume that FATCA is valid under both US and Canadian law.

Whether by rueful concession or enlightened embrace, jurisdictions and financial entities have begun to accept FATCA and the changes that FATCA has wrought to their internal processes as a means of combatting tax evasion and money laundering. In fact, numerous jurisdictions have introduced or imposed their own versions of FATCA, and even the new common reporting standard (CRS) adopted by the Organisation for Economic Co-operation and Development (OECD) for the automatic exchange of information between tax authorities worldwide is built on the foundation laid by the IGAs.

To be implemented effectively, FATCA and FATCA-like legislation require standard definitions. The OECD CRS emphasizes that the standardized automatic exchange of financial account information is key to its success, the benefits of which include process simplification, higher effectiveness, and lower costs for all parties involved. “A proliferation of different and inconsistent models would potentially impose significant costs on both government and business to collect the necessary information and operate the different models.” This is critical, because the costs of complying with FATCA and FATCA-like legislation are expected to be in the billions (US) for banks and other affected entities, and these costs will be borne by the account holders and owners of those entities. Furthermore, because tax evasion is a global issue, the standard used must have a global reach to actually solve the problem rather than merely reallocate it to other jurisdictions with lower reporting thresholds.

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44 Ibid., at 7.

45 Ibid.

46 Wood, supra note 37.

FATCA BASICS UNDER THE CODE AND THE IGAS

FATCA is a dauntingly complex body of law. Although the Code provisions span fewer than 10 pages,48 the Treasury regulations (final, temporary, and proposed) and their preambles recently surpassed the 700-page mark,49 not to mention the five model IGAs and their annexes,50 numerous IRS guidance materials,51 43 signed IGAs with various jurisdictions (as of October 1, 2014),52 and 58 IGAs in substance that are treated as in effect (as of October 1, 2014).53 Although originally scheduled to take effect after 2013,54 FATCA withholding has been delayed and now applies to “withholdable payments”55 made starting July 1, 2014.56 In Notice 2013-43, the IRS agreed that certain jurisdictions will be treated as having an IGA in effect even though the particular jurisdiction has signed an IGA but has not yet brought it into force.57 Notice 2014-33 announced that 2014 and 2015 will be transition periods for IRS enforcement and administration of FATCA’s reporting, withholding, and due diligence requirements, including a good-faith efforts standard under the Treasury regulations.58

48 IRC sections 1471 through 1474.
50 See the FATCA page on the Treasury’s website, supra note 11.
52 See the FATCA archive, supra note 9.
53 IRS Announcement 2014-17, 2014-17 IRB 1; FATCA archive, supra note 9.
54 HIRE Act, supra note 1, section 501(d).
55 Defined in IRC section 1473(1)(A); Treas. reg. sections 1.1471-1(b)(145) and 1.1473-1(a).
56 IRS Notice 2013-43, supra note 51.
57 Ibid. This was later confirmed by IRS Announcement 2014-17, supra note 53. This announcement also provided that certain countries that have reached an agreement in substance with the United States on the terms of their IGAs will be treated as having an agreement in effect until the end of 2014. The Treasury website lists these jurisdictions in the FATCA archive, supra note 9. For entry into force, see the Canadian IGA, supra note 1, article 10(1), and the Model 1A IGA, supra note 10, article 10(1).
58 IRS Notice 2014-33, 2014-21 IRB 1. Generally, Notice 2014-33 announces the IRS’s intent to amend the Treasury regulations and portions of future IGAs to include the following: (1) a provision allowing withholding agents or entities subject to FATCA to treat certain entity obligations (including accounts) as pre-existing accounts for FATCAs reporting, withholding, and due diligence requirements; (2) additional guidance regarding FFIs that are members of expanded affiliated groups; (3) modification of the standards of knowledge under Treas. reg. section 1.1441-7(b) for withholding agents regarding accounts documented before July 1, 2014; and (4) revision of the definition of a “reasonable explanation supporting a claim of foreign status” in Treas. reg. section 1.1471-3(e)(4)(viii). Interestingly, this notice does not mention good-faith efforts under the IGAs, although countries are permitted to allow their residents to opt into the due diligence requirements in the Treasury regulations. See, for example, the Canadian IGA, supra note 1, annex I(i)(C). Perhaps the revised Treasury regulations reflecting Notice 2014-33 will address this inconsistency.
When boiled down to its essence, FATCA forces certain foreign entities to serve as information gatherers and couriers for the IRS by imposing various reporting, withholding, and due diligence obligations on entities with US account holders or owners. As we have noted, FATCA was designed to combat offshore tax evasion by US persons, and it does so indirectly by imposing an expansive and powerful withholding tax on certain payments of US-source income to specified foreign entities that fail to comply with the FATCA regime. Practically, this means that foreign entities such as banks will report information regarding their US owners and account holders to the IRS, and the IRS will presumably use this information to pursue these persons if they are not compliant with their US tax-filing obligations or have undisclosed funds offshore.

Under both the Code and the Canadian IGA, a “specified United States person” is subject to FATCA reporting and withholding. A “specified United States person” is a “United States person” other than certain publicly traded corporations, tax-exempt organizations, individual retirement plans, US government entities, US banks, real estate investment trusts, regulated investment companies, common trust funds, and charitable remainder trusts. As discussed above, the Code defines a “United States person” to mean a US citizen or resident, a US corporation or partnership, a US-resident estate, or a US trust. The definition in the Canadian IGA is essentially the same, with some variation in wording.

FATCA introduces over 150 defined terms, which can have different meanings depending on where the entity resides. If an entity is resident in a country with an IGA, the IGA will generally govern. An entity resident in a country without an IGA is governed by the default rules in the Code and the Treasury regulations. We will cover the analysis under the Code and regulations before analyzing the IGAs in general and the Canadian IGA in particular. As will become apparent, compared to the Code and regulations, the IGAs generally provide a more favourable regime for all parties subject to FATCA.

60 IRC sections 1471(b)(1)(A) and (D), (c)(1), and (d)(1); Canadian IGA, supra note 1, articles 4(1), 1(1)(cc), and 1(1)(ff).
61 IRC section 1473(3); Canadian IGA, supra note 1, article 1(1)(ff).
62 See generally IRC section 7701(b). A US resident includes an individual who has obtained a lawful permanent resident card (green card), whether or not that individual continues to reside in the United States. T reas. reg. section 301.7701(b)-1(b).
63 Compare IRC section 7701(a)(30), temp. T reas. reg. section 1.1471-1T(b)(141), and the Canadian IGA, supra note 1, article 1(1)(ee).
64 See, for example, T reas. reg. section 1.1471-1(b), temp. T reas. reg. section 1.1471-1T(b), and the Canadian IGA, supra note 1, article 1.
FATCA Under the Code and the Treasury Regulations

As we have noted, FATCA classifies every entity into one of two mutually exclusive groups, as an FFI or an NFFE. Certain FFIs and NFFEs must report information regarding the accounts and other ownership interests of US persons or face a 30 percent withholding tax on “withholdable payments”—that is, US-source payments of interest, dividends, royalties, and gross proceeds from sales of assets that can produce US-source interest or dividends. An FFI is a financial institution that is a “foreign entity,” defined as an entity that is not a “United States person.” A “financial institution” is generally defined as an entity that accepts deposits in the ordinary course of a banking or similar business; holds financial assets for the account of others as a substantial portion of its business; or engages primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or an interest in any of the immediately preceding items. The Treasury regulations further divide financial institutions into the following categories:

1. depository institution,
2. custodial institution,
3. investment entity,
4. “insurance company or holding company,” and
5. “holding company or treasury center.”

An FFI must enter into an FFI agreement with the IRS and obtain a “global intermediary identification number” (G.I.N) in order to avoid FATCA withholding, unless the FFI qualifies for an exclusion. An FFI agreement obligates the FFI to perform

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66 IRC sections 1471(a) and 1472(a).

67 IRC section 1473(1)(A).

68 IRC section 1471(d)(4); Treas. reg. section 1.1471-1(b)(42).

69 IRC sections 1473(1)(A) and 7701(a)(30); Treas. reg. section 1.1473-1(e); temp. Treas. reg. section 1.1471-1T(b)(141).

70 IRC section 1471(d)(5).

71 Treas. reg. section 1.1471-5(e)(1). Note that certain entities are excluded from the FFI definition, including excepted non-financial group entities, excepted non-financial startup companies, excepted non-financial entities in liquidation or bankruptcy, excepted interaffiliate FFIs, IRC section 501(c) entities, and non-profit organizations. Treas. reg. section 1.1471-5(e)(5).

72 IRC section 1471(b); Treas. reg. section 1.1471-4(e)(1). “Global intermediary identification number” is defined in Treas. reg. section 1.1471-1(b)(57). As will be elaborated below, there are exclusions from FATCA reporting for certain entities.
due diligence regarding its account holders and payees, make information reports to the IRS, withhold on certain withholdable payments, and even close the accounts of a US account holder where foreign law prevents FATCA reporting and the FFI cannot obtain a waiver from the holder to fulfill the reporting requirement. Different due diligence requirements apply depending on whether the account holder is an individual or an entity and when the account was opened. An FFI that cannot determine whether an account holder is a US person within the time period prescribed in the Treasury regulations (which is generally 90 days for new accounts and up to two years for “preexisting accounts”) must treat the holder as a “recalcitrant account holder.” An FFI is generally required to withhold on payments to a recalcitrant account holder, report the account holder to the IRS, and possibly close the holder’s accounts. Since the due diligence requirements in the Treasury regulations are generally similar to those in the Canadian IGA, we will cover them in detail below.

NFFEs are defined in the negative as entities that are not FFIs. An NFFE is not required to report as much information as an FFI, and generally must either certify that it does not have a “substantial United States owner” or report its US owner to the relevant withholding agent in order to escape FATCA withholding. A “withholding agent” is defined in the Code as any person that controls, receives, has custody or disposal of, or pays a withholdable payment. Prior to making a withholdable payment, the withholding agent must submit the information provided by the NFFE to the IRS, or it will be liable for the withholding that would otherwise be due. Unlike FFIs, NFFEs are not required to enter into an agreement with the IRS to comply with their FATCA obligations.

73 IRC section 1471(b)(1); Treas. reg. section 1.1471-4.
74 Treas. reg. sections 1.1471-4(c)(3) through (5).
75 Treas. reg. sections 1.1471-4(c)(4)(i) and (5)(i). The relevant time period is determined by Treas. reg. section 1.1471-5(g)(3)(i) or (ii).
76 Treas. reg. section 1.1471-4(a)(1); temp. Treas. reg. section 1.1471-4T(a)(3).
77 IRC section 1472(d); Treas. reg. section 1.1471-1(b)(80). Note that certain NFFEs are excepted from FATCA withholding, including publicly traded corporations, certain affiliated entities related to a publicly traded corporation, certain territory entities, active NFFEs, excepted non-financial entities, direct reporting NFFEs, and sponsored direct reporting NFFEs. Treas. reg. section 1.1472-1(c)(1); temp. Treas. reg. section 1.1472-1T(c)(1).
78 IRS form W-8BEN-E, “Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities),” is used for this purpose.
79 Defined in IRC section 1473(2).
80 IRC section 1472(b).
81 IRC section 1473(4).
82 IRC section 1472(b)(3). Note that the withholding agent must not know or have reason to know that the information provided is incorrect. IRC section 1472(b)(2).
83 IRC section 1474(a).
84 IRC section 1472(b)(3).
FATCA withholding cannot be reduced or eliminated by tax treaty; the only way to avoid it is by providing the information required by FATCA or qualifying for an exclusion. The information that FFI s and NFFE s report is generally limited for use in determining US tax obligations, although the identity of FFIs may be disclosed and is required by withholding agents in order to discharge their due diligence obligations. FATCA withholding is generally treated as withholding under IRC sections 1441 through 1446; however, no credit or refund is allowed unless the beneficial owner of the payment triggering the withholding provides the IRS with the information needed to determine (1) whether the owner is a “United States owned foreign entity” and (2) the identity of any substantial US owners of that entity.

FFIs may obtain a credit or refund on FATCA withholding if they are entitled to a reduced rate under a tax treaty, and if so, the credit or refund is limited to the extent of the treaty reduction and no interest is allowed thereon. If more than one person qualifies as a withholding agent regarding a single withholdable payment, only one FATCA withholding must be collected. Generally, the withholding agent will be the person that last controlled the withholdable payment. Withholding agents are personally liable for FATCA withholding. The withholding agent must ascertain the identity and status of the payee under FATCA before making a withholdable payment. The payee generally must establish its FATCA status by providing documentation, including form W-8BEN-E.

The withholding rules under the IGAs are similar to those under the Code and the Treasury regulations, albeit a much more benign (or less draconian, depending on your point of view) regime applies. For example, only a “nonparticipating financial institution” is subject to FATCA withholding under the Canadian IGA.

85 IRC sections 1471(a), 1472(a), 1473(1)(A), and 1474(a); temp. Treas. reg. section 1.1471-2T(a)(1); Treas. reg. section 1.1472-1(a).
86 IRC sections 1474(c)(1), 3406(f), and 6103; TD 9658, supra note 49.
87 IRC section 1474(c)(2); Treas. reg. section 1.1471-3.
88 IRC section 1474(b)(1).
89 Defined in IRC section 1471(d)(3).
90 IRC section 1474(b)(3).
91 IRC section 1474(b)(2)(A).
92 Treas. reg. section 1.1474-1(a)(1).
93 Treas. reg. section 1.1473-1(d).
94 IRC section 1474(a).
95 Treas. reg. section 1.1471-3.
96 Form W-8BEN-E, supra note 78; Treas. reg. section 1.1471-3(b)(2). FATCA status is referred to as “chapter 4 status” under the regulations. Treas. reg. sections 1.1471-3(b) and 1(b)(82).
97 Canadian IGA, supra note 1, article 4(1), postamble, and article 5(2).
The IGAs Generally

The IGAs provide a different set of rules for residents of the relevant IGA jurisdiction, which largely trump the FATCA rules under the Code and the Treasury regulations.98 The US Department of the Treasury, the department responsible for drafting and negotiating the IGAs, entered into these agreements to ease the burden of exchanging information under foreign law and make compliance with FATCA feasible, particularly in jurisdictions where entities may not be able to comply with FATCA owing to local legal impediments.99 Consequently, the IGAs rely on cooperation between the foreign country and the United States to facilitate the exchange of information under FATCA.

As discussed earlier, there are two basic model IGAs, Model 1 and Model 2. The Model 1 IGA allows financial institutions resident in countries with IGAs to satisfy their FATCA obligations by reporting the relevant information regarding their US owners and account holders directly to the designated authority in their country of residence, which then reports to the IRS. These financial institutions are not required to enter into an FFI agreement.100 There are two subtypes of the Model 1 IGA: a reciprocal Model 1A IGA, and a non-reciprocal Model 1B IGA. The Model 1B IGA is further divided into two versions: one for countries with an existing tax information exchange agreement (TIEA) or double tax convention (DTC), and one for those without.101

The Model 2 IGA differs from the Model 1 in that it is non-reciprocal and provides that financial institutions must report directly to and enter into an FFI agreement with the IRS; in addition, the resident country must enable financial institutions to collect and exchange the FATCA information required and to register with the IRS.102 Like the Model 1 IGA, there are two subtypes of the Model 2 IGA: one for countries with an existing TIEA or DTC, and one for those without.103 The model IGAs also include two annexes, which are generally similar regardless of the IGAs type.104

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98 Preamble to Treas. reg. section 1.1471-0, TD 9610, 2013-15 IRB 765; Model 1A IGA, supra note 10, article 4(1); Canadian IGA, supra note 1, article 4(1). Note, however, that countries with Model 1A IGAs (including Canada) may permit financial institutions to use the definitions in the Treasury regulations instead of the definitions in the IGA if this use would not “frustrate the purposes of” the IGA. See the Model 1A IGA, supra note 10, article 4(7); and the Canadian IGA, supra note 1, article 4(7). See also the Model 1A IGA, supra note 10, annex I(I)(C); and the Canadian IGA, supra note 1, annex I(I)(C). In addition, when it comes to defining an entity as an FFI, the Treasury regulations explicitly bend to the IGAs. Treas. reg. section 1.1471-5(d).

99 See, for example, the Model 1A IGA, supra note 10, paragraph 5 of the preamble; and the Canadian IGA, supra note 1, paragraph 5 of the preamble.

100 Model 1A IGA, supra note 10, article 4(1).

101 FATCA archive, supra note 9.

102 “Model 2 IGA, Preexisting TIEA or DTC,” supra note 13, articles 2 and 3(1); “Model 2 IGA, No TIEA or DTC,” supra note 13, articles 2 and 3(1).

103 FATCA archive, supra note 9.

104 Ibid.
The IGAs have their own set of definitions, which generally follow the definitions in the Code and the Treasury regulations.\textsuperscript{105} The IGAs still classify entities\textsuperscript{106} into one of two mutually exclusive groups, as a financial institution or a non-financial institution. But a financial institution is defined somewhat differently in the IGAs as compared with an FFI under the Code and regulations, and the IGAs do not include a definition of a non-financial institution (apart from the definition of the term “NFFE” for due diligence purposes).\textsuperscript{107} An entity that is not a financial institution is by implication a non-financial institution exempt from the requirements under the IGAs, though it would still be subject to FATCA under the default rules in the Code and regulations as an NFFE.\textsuperscript{108} The Treasury regulations expressly provide that an entity resident in a country with an IGA in effect is an FFI if it is a financial institution under that IGA.\textsuperscript{109} Accordingly, the IGAs’ classification rules regarding whether an entity is a financial institution subject to FATCA trump the Treasury regulations. Specifically, the IGAs split financial institutions into four categories:\textsuperscript{110}

1. custodial institution,
2. depository institution,
3. investment entity, and
4. specified insurance company.

As described above, the Model 1\textsuperscript{a} IGA provides that financial institutions may satisfy their FATCA obligations by reporting the relevant information directly to the designated authority in their country of residence, and that authority then reports to the IRS.\textsuperscript{111} All Model 1 IGAs depend heavily on foreign law to work. The IGAs generally provide that financial institutions will be treated as FATCA-compliant if they fulfill their obligations under foreign law to identify certain US account holders and owners, and if their country of residence complies with its requirements under the relevant IGA.\textsuperscript{112} The country of residence generally must implement its own laws to obtain and exchange the requisite information regarding reportable accounts in the time and manner prescribed by its IGA.\textsuperscript{113} Accordingly, the role of Canada’s

\textsuperscript{105} See, for example, the Model 1\textsuperscript{a} IGA, supra note 10, article 1; and the Canadian IGA, supra note 1, article 1.

\textsuperscript{106} The term “entity” is defined in the Model 1\textsuperscript{a} IGA, supra note 10, article 1(1)(gg); see also the Canadian IGA, supra note 1, article 1(1)(gg).

\textsuperscript{107} Model 1\textsuperscript{a} IGA, supra note 10, annex I(VI)(B)(2); Canadian IGA, supra note 1, annex I(VI)(B)(2).

\textsuperscript{108} Model 1\textsuperscript{a} IGA, supra note 10, articles 1(1), 4(1), and annex I(VI)(B)(2); Canadian IGA, supra note 1, articles 1(1), 4(1), and annex I(VI)(B)(2); IRC sections 1471(a) and (d).

\textsuperscript{109} Treas. reg. sections 1.1471-1(b)(47) and 5(d).

\textsuperscript{110} Model 1\textsuperscript{a} IGA, supra note 10, article 1(1)(g); Canadian IGA, supra note 1, article 1(1)(g).

\textsuperscript{111} Model 1\textsuperscript{a} IGA, supra note 10, article 4(1); Canadian IGA, supra note 1, article 4(1).

\textsuperscript{112} Ibid.

\textsuperscript{113} Model 1\textsuperscript{a} IGA, supra note 10, articles 2 and 3; Canadian IGA, supra note 1, articles 2 and 3.
implementing legislation is to ensure that Canada’s responsibilities under the Canadian IGA can be properly discharged to facilitate FATCA’s execution in Canada through the IGA. While countries with Model 1 IGAs require foreign law for implementation, a Treasury official has indicated that foreign law must be substantially similar to the Code and the Treasury regulations in classifying financial institutions subject to FATCA. Ronald Dabrowski, IRS deputy associate chief counsel (international), stated, “[K]eep in mind that the IGAs will be under foreign law and will develop on their own, but the scope is meant to be the same.”

The Canadian IGA

The Canadian IGA is nearly identical to the current Model 1a IGA, excepting certain defined terms; therefore, we will limit our discussion accordingly.

All Canadian financial institutions are classified into one of three types: a reporting Canadian financial institution, a non-reporting Canadian financial institution, or a non-participating financial institution. A “reporting Canadian financial institution” is defined in the negative as a Canadian financial institution that is not a non-reporting Canadian financial institution. A “non-reporting Canadian financial institution” is defined as a Canadian financial institution or other Canadian-resident entity that is identified as such in annex II or that otherwise qualifies as a deemed-compliant FFI or an exempt beneficial owner (EBO) under the Treasury regulations. Furthermore, a reporting Canadian financial institution will be treated as compliant with FATCA and not subject to withholding under article 4(1) of the Canadian IGA if the following conditions are met:

1. Canada complies with its obligations under the Canadian IGA regarding that institution; and
2. the institution registers with the IRS, obtains a GIIN, reports certain information to the Canadian competent authority (that is, the CRA), and withholds on certain withholdable payments.

The Treasury regulations provide that a reporting Canadian financial institution that complies with the registration requirements in the Canadian IGA is a registered deemed-compliant FFI. Reporting Canadian financial institutions for which Canada meets its obligations and that meet their own obligations under the Canadian

115 Canadian IGA, supra note 1, article 1(1)(o).
116 Defined in article 1(1)(gg), ibid. See also ibid., annex II.
117 Ibid., article 1(1)(q). Deemed-compliant FFIs and EBOs are discussed in a separate section below.
118 Ibid., article 4(1).
119 Treas. reg. sections 1.1471-1(b)(111) and 5(f)(1).
IGA, though not subject to FATCA withholding themselves, must still withhold on withholdable payments not specified in article 4(1) or will face personal liability for that withholding. In other words, reporting Canadian financial institutions that otherwise comply with FATCA are not required to withhold to maintain their own exemptions from withholding under article 4(1), but must follow the default withholding rules in the Code and Treasury regulations nonetheless, since the Canadian IGA does not preclude the application of those rules. As noted, the penalty for failure to withhold is personal liability for the non-withheld amount.

Reporting Canadian financial institutions are not required to enter into FFI agreements, though their responsibilities under the Canadian IGA are generally similar to those under an FFI agreement. The information reported must include the reporting Canadian financial institution’s “US reportable accounts” and the name of any non-participating financial institution to which it has made payments. Importantly, US reportable accounts do not include certain tax-saving accounts and other products, listed in annex II of the Canadian IGA, such as tax-free savings accounts (TFSAs) and various registered savings plans. Generally, under the IGA, the Canadian government (in practice, the CRA) must provide the IRS with specific information regarding each US reportable account of each reporting Canadian financial institution.

As noted above, a non-reporting Canadian financial institution is a Canadian financial institution or other Canadian-resident entity that qualifies as an EBO or a deemed-compliant FFI under either the Canadian IGA or the Treasury regulations in effect when the IGA was signed. Non-reporting Canadian financial institutions are essentially exempt from FATCA’s requirements. Notably, non-reporting Canadian financial institutions will be treated as certified deemed-compliant FFIs, which are not required to register with the IRS.

A “nonparticipating financial institution” is generally a reporting financial institution whose significant non-compliance with its FATCA obligations exceeds 18 months

120 IRC section 1474(a); Treas. reg. section 1.1474-1; temp. Treas. reg. section 1.1471-3T(f)(9).
121 Ibid. Compare with Treas. reg. section 1.1471-4.
122 Defined in article 1(1)(cc) of the Canadian IGA, supra note 1.
123 Ibid., articles 4(1)(a) and (b). Note that the latter requirement applies only for 2015 and 2016.
124 Canadian IGA, supra note 1, annex II(IV). The Treasury regulations provide similar exceptions. Treas. reg. section 1.1471-5(b)(2).
125 Canadian IGA, supra note 1, article 2(2)(a). The CRA will also report certain information regarding the Canadian reportable accounts of each US financial institution. Ibid., article 2(2)(b). Discussion of this reporting is outside the scope of this article.
126 IRC section 1471(b)(4); Treas. reg. sections 1.1471-5(e)(5) and 1.1471-6.
127 Treas. reg. section 1.1471-1(b)(14); temp. Treas. reg. section 1.1471-5T(f)(2).
after the first notification of significant non-compliance was provided.\footnote{Canadian IGA, supra note 1, articles 1(1)(r) and 5(2)(b); Treas. reg. section 1.1471-1(b)(82). Each country has an affirmative duty to notify the other of significant non-compliance with the requirements under the Canadian IGA by a reporting financial institution in the other country. Canadian IGA, supra note 1, article 5(2)(a). For example, if the CRA knows that a reporting Canadian financial institution is significantly non-compliant with its obligations under the Canadian IGA, it must report that institution to the IRS.} Classification as a non-participating financial institution is disastrous because that is the only way that a reporting Canadian financial institution is subject to FATCA withholding under the Canadian IGA. Specifically, a reporting Canadian financial institution that does not comply with its obligations under article 4(1) of the Canadian IGA is not subject to FATCA withholding unless the IRS treats it as a non-participating financial institution under article 5(2)(b).\footnote{Canadian IGA, supra note 1, article 4(1), postamble.} It would be quite the feat for an institution to fall under article 5(2)(b), given the requirement of continued significant non-compliance for a period exceeding 18 months. To purge its classification as a non-participating financial institution, a reporting Canadian financial institution must remedy its significant non-compliance.\footnote{Ibid., articles 4(1) and 5(2).} A reporting Canadian financial institution that makes a payment to a non-participating financial institution must report that payee to the CRA (but note that this requirement applies only for 2015 and 2016).\footnote{Ibid., article 4(1)(b).}

The Canadian IGA imposes due diligence requirements on reporting Canadian financial institutions that generally follow the requirements imposed by FFI agreements under the Treasury regulations. Different requirements apply depending on whether the account holder is an individual or an entity.\footnote{Ibid., annex I(II) through (V).} For present purposes, we will limit our discussion to individuals. (The due diligence requirements are generally the same for entity account holders, except that entities are allowed higher monetary exemption amounts.)\footnote{See, for example, ibid., annex I(IV)(A).} Similar to the due diligence requirements in the Treasury regulations, the requirements in the Canadian IGA distinguish between pre-existing accounts and new accounts. A pre-existing account is an account existing before July 1, 2014, and a new account is an account opened on or after that date.\footnote{Ibid., annex I(II), (III), and (VI)(B)(5).} Certain account balance aggregation and currency translation rules apply for determining the various monetary thresholds under the due diligence requirements.\footnote{Ibid., annex I(VI)(C).} Moreover, a reporting Canadian financial institution cannot rely on self-certifications or documentary evidence obtained under the due diligence requirements if it knows or has reason to know that the certification or documentation is incorrect.
The due diligence requirements for pre-existing accounts differ depending on the value of the account as follows:

1. Accounts not exceeding US$50,000, cash value insurance or annuity contracts not exceeding US$250,000 on June 30, 2014, and cash value insurance or annuity contracts that cannot be effectively sold to US residents under Canadian or US law are not required to be reviewed, identified, or reported as US reportable accounts. The exemption of these accounts from the due diligence procedures does not, however, prevent reporting Canadian financial institutions from actually reviewing, identifying, or reporting them. Indeed, many such institutions may well choose to do so, since it is probably cheaper to send out the requisite IRS forms (W-8 and W-9) to account holders in bulk, as opposed to sifting through all of the institution’s accounts. These exemptions from the due diligence requirements are consistent with the Treasury regulations.

2. Lower-value accounts—those exceeding US$50,000 (US$250,000 for a cash value insurance contract or annuity contract) but not exceeding US$1 million—must be reviewed by an electronic record search for certain listed US indicia—facts indicating that the account holder is a US citizen or resident, such as a US place of birth or mailing address—by June 30, 2016, so that the reporting Canadian financial institution can ascertain whether the account holder is indeed a US person subject to FATCA (in which case, the institution must identify and report the holder’s US reportable accounts to the IRS). Notably, the electronic search is not required to identify all of the listed US indicia. If US indicia are not discovered, nothing further is required until there is a change in circumstances that results in the discovery of US indicia or the account becomes a high-value account. If any US indicia are discovered, the reporting Canadian financial institution must treat the account as a US reportable account unless it elects otherwise and one of four specific exceptions applies. The most troubling of the exceptions is the first one, which allows

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136 Ibid., annex I(VI)(A). The IRS will consider good-faith efforts to comply with the Treasury regulations regarding FATCA’s reporting, withholding, and due diligence requirements for 2014 and 2015. See IRS Notice 2014-33, supra note 58, at III, and our additional comments in that note regarding opting-in provisions.

137 Canadian IGA, supra note 1, annex I(II)(A). Additionally, note the modifications in notice 2014-33 regarding pre-existing entity accounts. IRS Notice 2014-33, supra note 58, at IV.

138 Treas. reg. section 1.1471-4(c)(5)(iii); IRS Notice 2014-33, supra note 58, at IV.

139 Canadian IGA, supra note 1, annex I(II)(B)(1) and (II)(C)(1); Treas. reg. section 1.1471-4(c)(5)(iv)(B).

140 Canadian IGA, supra note 1, annex I(II)(B)(1).

141 Ibid., annex I(II)(B)(2).

142 Ibid., annex I(II)(B)(3). The exceptions are contained in annex I(II)(B)(4).

143 Ibid., annex I(II)(B)(4)(a).
an account holder to rebut unambiguous information indicating a US place of birth by

a. self-certifying that the holder is not a US citizen or resident for tax purposes;

b. providing a non-US passport or other government-issued identification showing foreign citizenship or nationality; and

c. providing either a certificate of loss of US nationality (CLN) or a “reasonable explanation” of why the holder does not have a CLN despite relinquishing US citizenship, or why the holder did not obtain US citizenship at birth.\footnote{144}

Account holders without a CLN who opt to provide a reasonable explanation of why they are not US citizens will certainly invite additional IRS scrutiny; and, in any event, it is unclear what constitutes a reasonable explanation. Moreover, account holders who wish to rebut by obtaining a CLN may be in for a reckoning if a CLN is actually issued and the exit tax in IRC section 877A would apply on the date of issuance.\footnote{145} Critically, the issuance of a CLN triggers notice to the IRS even though it is obtained from a different US government agency, so that the IRS can ensure that taxpayers cannot escape the exit tax (if applicable).\footnote{146} The above due diligence requirements are consistent with the Treasury regulations.\footnote{147}

3. High-value accounts—those exceeding US$1 million—must be reviewed by an electronic record search for US indicia (the same indicia listed for lower-value accounts). In addition, certain paper records must be searched to the extent that the electronic search is insufficient to collect other specified information.\footnote{148} These searches must be completed by June 30, 2015, and reporting Canadian financial institutions must identify and report such high-value US reportable accounts to the IRS.\footnote{149} Additionally, reporting Canadian financial institutions must question a high-value account holder’s “relationship manager,” or investment adviser,\footnote{150} to determine whether the manager actually knows that the holder is a specified US person.\footnote{151} The relationship manager inquiry must be repeated annually, and the reporting Canadian financial institution must implement procedures to ensure that the manager identifies any

\footnote{144}{Recall that, generally, an individual who is born in the United States becomes a US citizen at that time. 8 USC section 1401(a). See also IRS Notice 2014-33, supra note 58, at IV.}

\footnote{145}{IRC section 877A(g)(4)(C). See also IRC section 7701(a)(50)(A).}

\footnote{146}{IRC section 6039G(d)(2).}

\footnote{147}{Treas. reg. section 1.1471-1(c)(5)(iv).}

\footnote{148}{Canadian IGA, supra note 1, annex I(II)(D)(1) through (3).}

\footnote{149}{Ibid., annex I(II)(E)(1).}

\footnote{150}{Treas. reg. section 1.1471-1(b)(112). Since this term is not otherwise defined in either the Canadian IGA or the implementing legislation, presumably, the definition in the Treasury regulations applies. Canadian IGA, supra note 1, article 1(2).}

\footnote{151}{Canadian IGA, supra note 1, annex I(II)(D)(4).}
change in circumstances regarding each high-value account. The remaining due diligence requirements are similar to those for lower-value accounts. These due diligence requirements are also consistent with the Treasury regulations.

4. Finally, if a reporting Canadian financial institution previously obtained documentation from an account holder establishing that the holder is not a US citizen or resident, in order to meet the institution’s obligations for certain other US tax purposes, it is not required to complete the due diligence requirements for lower-value accounts or the requirements for high-value accounts except the relationship manager inquiry. The Treasury regulations provide a similar exemption.

The due diligence requirements for new accounts also differ depending on the value of the account:

1. Depository accounts and cash value insurance contracts not exceeding US$50,000 at the end of any calendar year or other appropriate reporting period are not required to be reviewed, identified, or reported as US reportable accounts. Similar to the exemptions for pre-existing accounts, reporting Canadian financial institutions are allowed to review, identify, and report these accounts as US reportable accounts despite these exemptions. These due diligence requirements are consistent with the Treasury regulations.

2. For all other new accounts, the reporting Canadian financial institution must obtain self-certification from the account holder that allows the institution to determine whether the holder is a US resident for tax purposes, and to confirm the reasonableness of the certification when the account is opened or within 90 days after the account ceases to be an exempt account as described above. If the self-certification establishes that the account holder is a US resident for tax purposes, the reporting Canadian financial institution must treat the account as a US reportable account and obtain the holder’s taxpayer identifying number. If there is a change in circumstances regarding an account giving the reporting Canadian financial institution knowledge or reason to

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152 Ibid., annex I(II)(E)(3) and (5).
153 Treas. reg. section 1.1471-4(c)(5)(iv)(D).
154 Canadian IGA, supra note 1, annex I(II)(F). See also IRS Notice 2014-33, supra note 58, at V.
155 Treas. reg. section 1.1471-4(c)(5)(ii).
156 Canadian IGA, supra note 1, annex I(III)(A); ITA subparagraph 264(1)(b).
157 Treas. reg. section 1.1471-4(c)(4).
158 Canadian IGA, supra note 1, annex I(III)(B)(1).
159 Ibid., annex I(III)(B)(2).
know that the account holder’s original self-certification is incorrect or unreliable, the financial institution must obtain a valid self-certification establishing whether the holder is a US citizen or resident for tax purposes; if it cannot do so, it must treat the account as a US reportable account. These due diligence requirements are also consistent with the Treasury regulations.

The Canadian IGA is reciprocal; however, the United States is not required to provide Canada with the same information that Canada must provide. Under the Canadian IGA, the United States only “acknowledges the need to achieve equivalent levels of reciprocal automatic information exchange with Canada,” declaring that it is committed to further improve transparency and enhance the exchange relationship with Canada by pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic information exchange.

**EBOs and Deemed-Compliant FFIs**

EBOs and deemed-compliant FFIs occupy a special seat at the FATCA table. Under the Code and the IGAs, payments to EBOs are generally exempt from FATCA withholding, and deemed-compliant FFIs are excluded from FATCA withholding and reporting. Under the Treasury regulations, if a certain type of EBO receives a withholdable payment connected with a commercial financing activity, it will not be treated as an EBO for that payment and FATCA withholding will apply. It is unclear whether this commercial financing activity exception applies under the IGAs.

The Canadian IGA seemingly provides three opportunities for an entity to qualify as an EBO or a deemed-compliant FFI. First, an entity will be treated as an EBO or a deemed-compliant FFI if it is a non-reporting Canadian financial institution and otherwise qualifies as an EBO or a deemed-compliant FFI under either the

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160 Ibid., annex I(III)(B)(3).
161 Treas. reg. section 1.1471-4(c)(4).
162 Ibid., article 6(1).
163 Ibid., article 6(1). See also article 6(4) and paragraph 6 of the preamble. Similar language is included in the Model 1A IGAs with other countries. Model 1A IGA, supra note 10, articles 6(1) and (4), and paragraph 6 of the preamble.
164 These terms are defined in the Treasury regulations, but not in the Canadian IGA. See Treas. reg. sections 1.1471-1(b)(27) and (42).
165 IRC section 1471(f); Treas. reg. section 1.1471-6; Canadian IGA, supra note 1, article 4(3) and annex II(II); Model 1A IGA, supra note 10, article 4(3) and annex II(II).
166 IRC section 1472(b)(2); Treas. reg. section 1.1471-5(f); Canadian IGA, supra note 1, article 4(3) and annex II(II); Model 1A IGA, supra note 10, article 4(3) and annex II(III) and (IV).
167 Treas. reg. section 1.1471-6(h).
Code and Treasury regulations or the Canadian IGA.\textsuperscript{168} Second, an entity may qualify as an EBO or a deemed-compliant FFI under the Canadian IGA.\textsuperscript{169} Third, an entity may qualify as an EBO or a deemed-compliant FFI if it is a Canadian retirement plan identified in annex II of the Canadian IGA and otherwise qualifies as an EBO or a deemed-compliant FFI.\textsuperscript{170}

Generally, EBOs are foreign governments, including any political subdivisions or wholly owned agencies thereof, foreign central banks, governments of US territories, certain foreign retirement funds, and certain entities owned by EBOs.\textsuperscript{171} Deemed-compliant FFIs fall into three major categories under the Treasury regulations:\textsuperscript{172}

1. registered deemed-compliant FFI,
2. certified deemed-compliant FFI, and
3. owner-documented FFI.

An entity does not automatically qualify as a deemed-compliant FFI under the Code and Treasury regulations; it must take some affirmative action to obtain this status.\textsuperscript{173} Yet entities that qualify as EBOs or deemed-compliant FFIs under the Canadian IGA receive more favourable treatment than those qualifying under the Code and regulations, since they are not required to take affirmative action to so qualify.\textsuperscript{174} Generally, the rules under the Canadian IGA for EBOs and deemed-compliant FFIs are similar to the rules in the Treasury regulations.\textsuperscript{175}

As indicated above, there are special rules in the Canadian IGA for Canadian retirement plans. Although the Canadian IGA provides that the United States must treat the Canadian retirement plans in annex II as EBOs or deemed-compliant FFIs under IRC sections 1471 and 1472, this provision is an “as appropriate” clause. Consequently, Canadian retirement plans will qualify as EBOs or deemed-compliant FFIs under article 4(3) of the IGA if they would otherwise meet those definitions.\textsuperscript{176} Since the terms “exempt beneficial owner” and “deemed-compliant FFI” are used in article 4(3) without initial capitals and neither of these terms is defined in the IGA, presumably the definitions in the Code and regulations apply.

\textsuperscript{168} Canadian IGA, supra note 1, articles 1(1)(q) and 4(4). This opportunity follows from the definition of non-reporting Canadian financial institution.
\textsuperscript{169} Ibid., annex II(II) and (III).
\textsuperscript{170} Ibid., article 4(3). See also article 1(1)(q).
\textsuperscript{171} IRC section 1471(f); Treas. reg. section 1.1471-6; Canadian IGA, supra note 1, annex II(II) and article 1(1)(q).
\textsuperscript{172} IRC section 1471(b)(2); Treas. reg. section 1.1471-5(f).
\textsuperscript{173} Treas. reg. sections 1.1471-5(f)(1) through (3) and (f)(1)(ii); Canadian IGA, supra note 1, article 4(1).
\textsuperscript{174} Canadian IGA, supra note 1, annex II(II) and (III).
\textsuperscript{175} Ibid., annex I(II) and (III).
\textsuperscript{176} Ibid., article 4(3); see also article 4(4).
PERSONAL CANADIAN TRUSTS SHOULD BE CLASSIFIED AS FINANCIAL INSTITUTIONS UNDER THE CANADIAN IGA

As we have noted, the Canadian IGA defines “financial institution” to mean a custodial institution, a depository institution, an investment entity, or a specified insurance company. Before delving into the definitions of the latter terms, it is necessary to read the Canadian IGA holistically for perspective. When read holistically, the text of the Canadian IGA supports the conclusion that certain personal trusts are financial institutions.

In defining the term “equity interest,” the Canadian IGA explicitly refers to “a trust that is a financial institution.” This language is broad, such that the definition applies to determine the equity interests for any trust, and not just trusts that are widely held or offered to the public, as the implementing legislation provides. Furthermore, the Canadian IGA defines “entity” to mean “a legal person or a legal arrangement such as a trust.” Why would trusts be directly referred to in these definitions if they were not subject to FATCA under the Canadian IGA? If the US Treasury had intended to exclude trusts from the definition of “financial institution,” it could have easily done so by omitting the references to trusts in the definitions of “equity interest” and “entity.” Statutory construction principles provide that interpretations that would render unnecessary other provisions or text of a statute or that would defeat the statute’s policy must be avoided. The Canadian implementing legislation accomplishes precisely that by reading all personal trusts out of the Canadian IGA through its restriction on the definition of a financial institution.

Also note the omission of annex II(IV)(a) of the Model 1A IGA from the Canadian IGA. That provision creates an exclusion from FATCA for trustee-documented trusts, or trusts with certain financial institutions as trustees that report the information required under an IGA on their behalf. This omission suggests that the United States intends to treat certain Canadian trusts as financial institutions subject to FATCA under the Canadian IGA.

The intent of the US Congress and the Treasury department—the primary drafter of the Canadian IGA—should also be examined to determine the classification of

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177 ibid., article 1(1)(g).
178 ibid., article 1(1)(v).
179 See ITA paragraphs 263(1)(j) and (k). See also Treas. reg. section 1.1473-1(b)(3)(ii) for the elaborate rules applicable for determining a person’s beneficial interest in a trust, which even include references to the tables in IRC section 7520. Notably, the types of public trusts covered by the implementing legislation probably would not qualify as trusts under US tax law, as explored further below. See the text accompanying notes 194 and 239, infra.
180 Canadian IGA, supra note 1, article 1(1)(gg).
182 Model 1A IGA, supra note 10, annex II(IV)(A).
personal trusts under FATCA. It is unclear whether the US Congress intended to classify trusts as financial institutions subject to FATCA when the law was originally introduced in 2009 and enacted in 2010.\(^{183}\) A US Senate subcommittee has previously described trusts as “enablers” of tax evasion and abuse, suggesting that trusts are properly subject to FATCA.\(^{184}\) The term “trust” is used only six times in the relevant sections of the Code, and never in the context of a financial institution.\(^{185}\) The Treasury regulations, however, are replete with references to trusts, and two examples explicitly provide that trusts can be financial institutions.\(^{186}\) Other jurisdictions with Model 1A IGAs have also classified trusts as financial institutions subject to FATCA. The United Kingdom’s guidance notes specifically contemplate that certain trusts will be classified as financial institutions,\(^{187}\) and Ireland’s guidance notes echo this conclusion.\(^{188}\)

The OECD CRS confirms that an effective reporting regime should “limit the opportunities for taxpayers to circumvent reporting by using interposed legal entities or arrangements,” by requiring financial institutions to look through “shell companies, trusts or similar arrangements” to determine who the individual behind the account or ownership interest actually is.\(^{189}\) Accordingly, although Congress's intent is unclear, the US Treasury and other jurisdictions with IGAs treat certain personal trusts as financial institutions subject to FATCA. That treatment is inconsistent with the treatment of personal trusts under the Canadian implementing legislation.

In this section, first we will address the classification of certain personal trusts as investment entities subject to FATCA under the Canadian IGA. Second, we will analyze the FATF reference in the definition of “investment entity” and explain why it should not be used to restrict that definition under the Canadian IGA, and cannot be used to restrict the more general term “financial institution.” Third, we will examine the classification of certain personal trusts as custodial institutions subject to FATCA under the Canadian IGA.

\(^{183}\) See Congressional Record, supra note 21, at S10785.


\(^{185}\) See IRC sections 1471 through 1474.

\(^{186}\) Treas. reg. section 1.1471-5(e)(4)(v), examples 5 and 6.


\(^{188}\) Irish Revenue, Guidance Notes on the Implementation of FATCA in Ireland (Dublin: Irish Revenue, January 17, 2014), at chapter 2(2)(C) (herein referred to as “the Irish guidance notes”).

\(^{189}\) OECD CRS, supra note 43, at 7-8.
Certain Personal Canadian Trusts Should Be Classified as Investment Entities Under the Canadian IGA

An investment entity is defined under the Canadian IGA as follows:

The term “Investment Entity” means any Entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:

1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
2) individual and collective portfolio management; or
3) otherwise investing, administering, or managing funds or money on behalf of other persons.

This subparagraph 1(j) shall be interpreted in a manner consistent with similar language set forth in the definition of “financial institution” in the Financial Action Task Force Recommendations.190

This definition is not meant to be read lightly; it employs dense, technical language that is easier to understand when digested one piece at a time.

First, note that only an “entity” can be an “investment entity.” In Canada and most common-law jurisdictions, trusts are “legal relationships,” not entities. Trusts are entities, however, under FATCA. As noted above, the Canadian IGA defines “entity” as “a legal person or a legal arrangement such as a trust.”191 Furthermore, under the Treasury regulations, an “entity” is “any person other than an individual,”192 and a “person” is “an individual, a trust, estate, partnership, association, company or corporation.”193

Second, ignoring the parenthetical phrase “managed by . . .” in the first sentence and the FATF reference in the postamble (which we address separately below), it is relatively clear that trusts do not fall under the definition of an investment entity.

191 Canadian IGA, supra note 1, article 1(1)(gg).
192 Treas. reg. section 1.1471-1(b)(39).
193 Temp. Treas. reg. section 1.1471-1T(b)(100); IRC section 7701(a)(1).
Trusts do not have “customers,” if that word is given its traditional meaning; they have beneficiaries.\textsuperscript{194} Furthermore, a trust generally cannot be engaged in a business to qualify as such under US tax law.\textsuperscript{195} Accordingly, the parenthetical phrase is necessary to ensure that a trust will qualify as an investment entity for US tax purposes.

Third, the “managed by” relaxes the customer requirement by providing that trusts are investment entities if they are managed by an entity that is in the business of providing the three enumerated services to customers.

Fourth, the Canadian IGA does not explain what is meant by “managed by.” The Treasury regulations, however, add some clarity by providing two examples showing that the threshold is not very high.\textsuperscript{196} The management component is satisfied—and the trust is an investment entity under the Treasury regulations—if the trustee manages the trust itself or the investment assets of the trust.\textsuperscript{197} Mere advice, however, may not constitute management.\textsuperscript{198}

In summary, if we ignore the reference to FATF, a personal Canadian trust will be classified as an investment entity—and therefore as a financial institution subject to FATCA—if

1. either
   a. the trust has a professional trustee or
   b. the assets of the trust are managed by a professional manager;
   and
2. the professional trustee or manager is not an individual person.\textsuperscript{199}

This conclusion is consistent with the guidance notes issued by the United Kingdom and Ireland regarding FATCA. The UK guidance notes specifically state that trusts are investment entities if they are managed by a financial institution.\textsuperscript{200} The Irish guidance notes echo the United Kingdom’s position.\textsuperscript{201} The Treasury regulations

\textsuperscript{194} See Treas. reg. section 301.7701-4(a). The term “customer” is not defined in either the Canadian IGA or the Treasury regulations.

\textsuperscript{195} Treas. reg. section 301.7701-4(b). Business trusts may be reclassified as corporations or partnerships for US tax purposes. See also\textit{ Morrissey v. Commissioner}, 296 US 344 (1935).

\textsuperscript{196} Treas. reg. section 1.1471-5(e)(4)(v), examples 5 and 6.

\textsuperscript{197} ibid., example 6.


\textsuperscript{200} UK guidance notes, supra note 187, at sections 2.28 and 2.36.

\textsuperscript{201} Irish guidance notes, supra note 188, at chapter 2(2)(C).
state, and IRS and Treasury officials believe, that a personal trust will be an FFI subject to FATCA if an entity performs management functions on behalf of the trust, regardless of the assets it holds.202

Thus, certain personal Canadian trusts will qualify as investment entities—and therefore as financial institutions subject to FATCA under the Canadian IGA—unless the FATF reference alters this treatment. The FATF reference, however, cannot be accorded that much weight, as we shall see below.

The Reference to the FATF Recommendations

As we have noted, the postamble of the definition of “investment entity” explicitly states that the definition is to be interpreted “in a manner consistent with similar language” in the FATF’s definition of a financial institution.203 The wording of this instruction does not invite interpretations consistent with dissimilar language in the FATF definition, nor does it invite a reading of the FATF reference into the IGA’s more general definition of a financial institution. The FATF reference is present in the definition of “investment entity” in all the model IGAs, including those signed with the United Kingdom and Ireland.204 Public statements made by Canada’s Department of Finance show that it believes that the FATF reference in the definition of “investment entity” excludes personal trusts from that definition.205 This interpretation would exclude such trusts from FATCA if the FATF reference is understood to alter the analysis above and is read into the more general definition of “financial institution” in the Canadian IGA.

Close examination of the FATF definition of “financial institution”206 does little to clarify the definition of “investment entity” in the Canadian IGA; yet the FATF definition is explicitly, clearly, and unambiguously referenced. How, then, should this reference be incorporated? Fundamental tenets of statutory construction dictate that reliance on the FATF reference should not result in an interpretation of the

202 Treas. reg. section 1.1471-5(e)(4)(v), examples 5 and 6; Coder and Sheppard, supra note 114 (statements by Ronald Dabrowski, IRS deputy associate chief counsel, and Steven Musher, IRS associate chief counsel (international)); and Sheppard, supra note 198, at 1165 (statement by Jesse Eggert, former Treasury associate international tax counsel).

203 A similar requirement of consistency with the FATF recommendations is included in the IGAs definition of “controlling persons.” Canadian IGA, supra note 1, article 1(1)(mm).

204 See United States, Department of the Treasury, Resource Center, “Foreign Account Tax Compliance—Model Intergovernmental Agreements” (www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx); and supra note 190, UK IGA, article 1(1)(j), and Irish IGA, article 1(1)(j).

205 Dean DiSpalatro, “Finance Bites Back at FATCA Criticism,” advisor.ca, April 2, 2014 (www.advisor.ca/tax/tax-news/finance-bites-back-at- FATCA-criticism-148790). The Department of Finance presumably reads the FATF reference into the definition of “financial institution” in article 1(1)(g) of the Canadian IGA.

206 FATF recommendations, supra note 20, at 116-17.
Canadian IGA that is inconsistent with any other provisions of the agreement. 207 Reliance on the FATF definition of “financial institution” is probably unwarranted because (as we explain in more detail below), first, it is contrary to the text of the Canadian IGA and the “managed by” parenthetical phrase; second, it is overinclusive and would render other definitions superfluous; and third, it is inconsistent with the type of persons that can be classified as entities subject to FATCA under the IGA. Moreover, the Finance department’s interpretation improperly reads the FATF reference out of the definition of “investment entity” into the more general definition of “financial institution” and is contrary to comments made by a Treasury official. 208 Consequently, the reference to the FATF recommendations does little to advance a clear understanding of the term “financial institution” and should not be relied upon—particularly not as support for a more restrictive interpretation of “investment entity” under the Canadian IGA or any permutation of the meaning of “financial institution” under the implementing legislation. 209 With these inconsistencies, it is difficult to obtain meaningful clarification of the term “investment entity” by reference to the FATF recommendations. It is even more difficult to interpret investment entity “in a manner consistent with similar language” in the FATF definition of “financial institution,” as the Canadian IGA instructs.

First, the FATF definition does not contain language similar to the “managed by” parenthetical phrase in the Canadian IGA’s definition of “investment entity.” According to the FATF recommendations, trusts may be financial institutions if they trade in certain financial instruments; engage in portfolio management; administer cash or liquid securities on behalf of others; or otherwise invest, administer, or manage funds or money on behalf of others. 210 Moreover, to qualify as a financial institution under the recommendations, a personal trust must conduct its business “for or on behalf of a customer.” 211 The latter requirement would preclude many trusts from qualifying as a financial institution under the recommendations (since trusts have beneficiaries, not “customers”), but no such requirement is present in the definition of “investment entity” under the Canadian IGA. An investment entity does not have to conduct business for or on behalf of a customer under the Canadian IGA if it is managed by an entity that does so. 212

Second, the FATF definition of “financial institution” is overinclusive and renders other provisions of the Canadian IGA superfluous. Numerous entities classified as

207 Eskridge and Frickey, supra note 181, at 98.
208 See Sheppard, supra note 198, at 1165.
209 See ITA subsection 263(2).
210 FATF recommendations, supra note 20, at 116-17.
211 Ibid. “Customer” is not defined. Note that certain trusts may be “designated non-financial businesses and professions”—and thus not financial institutions—under the FATF recommendations (see ibid., at 113-14), although including trusts in this category is certainly debatable. Ibid., at 113-14. See Cotorceanu, The First Nibble, supra note 199, at 418.
212 Canadian IGA, supra note 1, article 1(1)(j), preamble (parenthetical phrase).
financial institutions under the FATF definition fall outside the definition of “investment entity” under the Canadian IGA, including depository institutions, custodial institutions, and specified insurance companies. Using the FATF’s definition of “financial institution” to interpret the definition of “investment entity” under the Canadian IGA would be inconsistent with the language of the agreement and would result in classifying virtually every type of banking entity as an investment entity, thereby rendering the other subcategories of financial institution in the Canadian IGA superfluous.

Third, financial institutions under the FATF recommendations can be individual persons, whereas it is generally understood that financial institutions under FATCA and the IGAs must be entities. As noted above, an “entity” is defined by the Canadian IGA as “a legal person or a legal arrangement such as a trust.” A “legal person” is not defined in the Canadian IGA (or the Treasury regulations), but since the term “natural person” is used elsewhere in article 1, it is reasonable to conclude that an investment entity under the IGA cannot be an individual person.

Furthermore, the Treasury regulations define the term “entity” to mean “any person other than an individual.”

Fourth, as regards the meaning of “financial institution” under the Canadian IGA, the FATF recommendations are mentioned only in the definition of “investment entity,” and do not otherwise modify the definition of “financial institution” or its offspring, including “custodial institution.” Yet the implementing legislation modifies the meaning of “financial institution,” and the modified definition applies to all four subcategories of financial institution referred to in the Canadian IGA.
The Department of Finance presumably reads the FATF reference out of the definition of “investment entity” into the definition of “financial institution.”223 The FATF reference cannot be used to support the proposition that a personal trust is not a custodial institution. Consequently, the legislation is unsound (at least in this regard) and should be limited to investment entities.

Finally, a former Treasury official responsible for answering questions regarding FATCA disagrees with Canada’s interpretation of the FATF reference. Jesse Eggert, former Treasury associate international tax counsel, stated that managed trusts will be financial institutions subject to FATCA to the extent that they are managed by an FFI even if they would not be a financial institution under the FATF recommendations.224 Therefore, the FATF reference should not be used to support a more restrictive reading of “financial institution” under the Canadian implementing legislation.

**Certain Personal Canadian Trusts Should Be Classified as Custodial Institutions Under the Canadian IGA**

In addition to being classified as investment entities, personal Canadian trusts could be classified as custodial institutions and thus financial institutions. A “custodial institution” is defined as any entity

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\text{that holds, as a substantial portion of its business, financial assets for the account of others. An entity holds financial assets for the account of others as a substantial portion of its business if the entity’s gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 percent of the entity’s gross income}^{225}
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during a certain time period. Notably, the IRS initially took the position that foreign trusts are custodial institutions—and thus financial institutions—although the Treasury regulations subsequently precluded this position by significantly restricting the types of income constituting “income attributable to holding financial assets and related financial services,”226 which is a prerequisite for the trust to qualify as a custodial institution.227

The Canadian IGA, however, does not contain the limitation in the Treasury regulations, and the Canadian implementing legislation does not provide an explicit option to apply the definitions in the regulations if they are more favourable under article 4(7) of the Canadian IGA. It is unclear whether the implementing legislation “permits Canadian financial institutions” to use a definition in the Treasury regulations

223 Compare articles 1(1)(g) and (j) of the Canadian IGA, supra note 1.
224 Sheppard, supra note 198, at 1165.
225 Canadian IGA, supra note 1, article 1(1)(h).
226 Treas. reg. section 1.1471-5(e)(3)(ii); temp. Treas. reg. section 1.1471-5T(e)(3)(ii).
227 Canadian IGA, supra note 1, article 1(1)(h); IRS Notice 2010-60, supra note 51.
in lieu of a definition in the Canadian IGA.\textsuperscript{228} The preamble to the implementing legislation merely enacts the Canadian IGA to the extent that the legislation does not override the IGA, and the legislation is silent regarding the opportunity in article 4(7).\textsuperscript{229} Accordingly, unless Canada allows Canadian financial institutions this opportunity to opt out, many personal trusts should be classified as custodial institutions under the Canadian IGA, since trustees hold financial assets for others as a substantial portion of their business and the 20 percent threshold should be met for trusts holding primarily financial assets.\textsuperscript{230} Perhaps the CRA could further clarify the applicability of article 4(7) in its guidance notes on FATCA.\textsuperscript{231}

\textbf{THE CANADIAN IMPLEMENTING LEGISLATION EXCLUDES PERSONAL CANADIAN TRUSTS FROM FATCA UNDER THE CANADIAN IGA}

The Department of Finance excluded personal Canadian trusts from FATCA under the implementing legislation by restricting the Canadian IGA's definition of “financial institution.”\textsuperscript{232} In a public comment, Finance indicated that it excluded personal trusts from FATCA under the Canadian IGA for administrative ease and was justified in doing so because of the FATF reference.\textsuperscript{233} Finance has a valid point: subjecting personal trusts to FATCA under the Canadian IGA would be administratively difficult, costly, and time-consuming for financial institutions.\textsuperscript{234} Moreover, if Finance feels justified in its position because of the FATF reference, it presumably believes that other jurisdictions that have concluded that personal trusts are subject to FATCA under their respective IGAs, such as the United Kingdom and Ireland, have unnecessarily expanded FATCA’s scope. As discussed above, Finance’s reliance on the FATF reference is misplaced.\textsuperscript{235}

From a practical perspective, by excluding personal Canadian trusts properly classified as financial institutions from the definition of “financial institution,” Finance

\begin{footnotesize}
\begin{enumerate}
\item[228] Canadian IGA, supra note 1, article 4(7).
\item[229] Canadian implementing legislation, supra note 2, paragraph 4 of the preamble.
\item[230] See Cotorceanu, \textit{The First Nibble}, supra note 199, at 417. “Financial asset” is not defined in the Canadian IGA; however, the Treasury regulations define the term to mean a security, partnership interest, commodity, insurance contract, annuity contract, or an interest in any of the foregoing. Treas. reg. section 1.1471-5(e)(4)(ii).
\item[231] The CRAs guidance notes, supra note 19, at 2.3 and 2.4, mention this possibility but do not allow the opt-out unless the CRA permits it. It is unclear why the guidance notes contain this restriction. Also note that the guidance notes take a static view of the Treasury regulations, at least in part. See ibid., at 3.31 and 3.35.
\item[232] See DiSpalatro, supra note 205, quote from an unnamed Department of Finance official.
\item[233] Ibid.
\item[234] Ibid.
\item[235] See supra, the text accompanying notes 206-224.
\end{enumerate}
\end{footnotesize}
has reduced, but not eliminated, their FATCA compliance burden. These personal Canadian trusts would probably still be classified as NFFEs subject to lower reporting thresholds, due diligence requirements, and withholding requirements under the Code and the Treasury regulations, even though they would not technically fall under the definition of an NFFE. That is, technically these trusts could not qualify as NFFEs since, by definition, an NFFE is a foreign entity that is not a financial institution. This definitional nicety would likely be overlooked by the IRS in practice, on the basis that these misclassified personal Canadian trusts are NFFEs if they are not financial institutions under the Canadian implementing legislation. After all, a trust resident in Canada is a foreign entity, and a foreign entity is subject to FATCA as either an FFI or an NFFE.

Although Finance’s intentions are understandable, its position that personal Canadian trusts should not be subject to FATCA under the Canadian IGA comes with serious consequences. This position also seems to discount the type of activity that FATCA seeks to prevent—tax evasion through offshore investments—and shows that Finance may not have fully understood FATCA’s unique withholding regime. Moreover, Finance may have underestimated the administrative burdens that its position imposes on non-Canadian financial institutions making withholdable payments to personal Canadian trusts and the transactional costs to these trusts from obtaining refunds on unnecessary FATCA withholdings.

Subsection 263(2) of the ITA narrows the definition of financial institution found in the Canadian IGA by restricting the definition to listed financial institutions. A listed financial institution does not include a personal Canadian trust that would otherwise be included as a financial institution under the Canadian IGA, as examined above. The 13 entities specified as listed financial institutions are generally banks, quasi-public entities regulated by Canadian law, and other entities (including trusts) represented or promoted to the public; personal Canadian trusts are not one of these entities. Notably, the implementing legislation applies to trusts that probably would not be classified as “trusts” under US tax law. These Canadian trusts, while taxed as trusts under Canadian law, would probably be business trusts or investment trusts and reclassified as corporations or partnerships for US tax purposes.

Negotiations between the Department of Finance and the US Treasury are not on public record, and what was discussed is currently unknown. It is entirely possible that Finance and Treasury discussed and agreed to the restrictive definition of “financial institution” reflected in the implementing legislation. Assuming, however, that

236 IRC section 1472(d); Treas. reg. section 1.1471-1(b)(80).
237 Supra note 3.
238 See supra, the text accompanying notes 177-231.
239 See ITA subsection 263(1), the definition of “listed financial institution.”
240 Treas. reg. section 301.7701-4(b). See also Morrissey v. Commissioner, supra note 195.
there was no off-the-record agreement, Finance would be precluded from departure from the definition found in the Canadian IGA for the following reasons.

First, the Canadian IGA provides that any term not defined in it will, unless modified by the competent authorities, be determined under local law. Yet “financial institution” is already defined in the Canadian IGA. Second, the Canadian IGA provides that, notwithstanding the definitions in the IGA, Canada may elect to use the definitions found in the Treasury regulations provided that this use does not frustrate the purposes of the IGA. The restrictive interpretation of “financial institution” in ITA subsection 263(2) is not present in the Treasury regulations. Furthermore, when explaining the interaction between foreign law and the IGAs, an IRS official stated that although the IGAs will develop under foreign law, they are meant to be consistent with the Treasury regulations. Third, the Canadian IGA’s “most-favoured-nation” clause grants Canada the benefit of any more favourable terms under article 4 or annex I afforded to another jurisdiction with a similar IGA regarding the application of FATCA to its financial institutions. At the time of completion of this article, no other country with a signed IGA has restricted the definition of “financial institution” to specifically exempt personal trusts from FATCA under that IGA, as Canada has done in its implementing legislation. Notably, Canadian residents should be able to benefit from the most-favoured-nation clause since Canada has not explicitly elected out of it. Consequently, the implementing legislation initially appears to be incongruent with the Canadian IGA.

History of the Legislation—The Punctuation Error in the Draft Legislation and the CRA’s Guidance Notes

There was originally a punctuation error in draft subsection 263(2) that materially changed the meaning of the draft legislation, and probably would have prevented the inconsistent treatment of financial institutions under Canadian law. Subsection 263(2) corrected the punctuation error by adding a critical comma before the last clause:

(2) For the purposes of this Part, “Canadian financial institution” and “reporting Canadian financial institution” each have the meaning that would be assigned by the [Canadian IGA], and the definition “non-reporting Canadian financial institution” in

241 Canadian IGA, supra note 1, article 1(2).
242 Ibid., article 1(1)(g).
243 Ibid., article 4(7).
244 Coder and Sheppard, supra note 114.
245 Canadian IGA, supra note 1, article 7(1).
246 See the FATCA archive, supra note 9.
247 IRS Notice 2014-33, supra note 58, at IV(B).
248 See supra note 18, the articles by Johnston and Melnitzer.
subsection (1) has the meaning that would be assigned by that subsection, if the definition “Financial Institution” in subparagraph 1(g) of Article 1 of the [IGA] were read as follows . . . .

Before the critical comma was added, the last clause modified only the definition of “non-reporting Canadian financial institution.” The definitions outlined in the preceding clause arguably should not be limited by the latter. After that critical comma, the last clause modifies every definition in the sentence, significantly restricting the class of financial institutions subject to FATCA under the legislation, and thus indirectly restricts the Canadian IGA’s definition of “financial institution” under Canadian law. The legislation also contains a new definition—“listed financial institution.” Although the new definition expands the list of entities subject to FATCA under Canadian law by 2 (bringing the total from 11 to 13), it will still exclude personal Canadian trusts from FATCA under the Canadian IGA. Also note that the enacted legislation omits the criminal penalty included in the draft version for reporting financial institutions that fail to collect and keep information required for Canada to comply with its obligations under the Canadian IGA.250

The CRA’s recently released guidance notes on FATCA also demonstrate (among other things) Canada’s intent to restrict the Canadian IGA’s definition of “financial institution.”251 Example C states:

Peter establishes a Canadian resident trust as a vehicle to hold financial assets for family estate planning purposes in Canada. The trust is settled with capital provided by Peter and it is not represented or promoted to the public. The trust is not described in the definition of the term “listed financial institution” in subsection 263(1) of the ITA and is not a Canadian financial institution with due diligence and reporting obligations under Part XVIII.252

249 Compare ITA subsections 263(1) and (2) with subsection 263(2) of the draft legislation, supra note 2. These two new entities are entities “represented or promoted to the public” as various types of investment funds (such as hedge funds and venture capital funds) and clearing houses or clearing agencies: see subsection 263(1), the definition of “listed financial institution,” paragraphs (k) and (l). The legislation also adds the words “fund administration, or fund management” to paragraph (j) of the definition; this change is insignificant. Simultaneously, the legislation slightly decreases the scope of the legislation by limiting paragraph (j) to “an entity” (the draft legislation referred to “a person or an entity”). This change is also insignificant, given that FATCA applies only to entities, and not individuals. Treas. reg. section 1.1471-1(b)(39); Canadian IGA, supra note 1, articles 1(1)(g) through (k) and (gg).

250 Subsection 238(1) of the draft legislation, supra note 2.

251 See supra note 19, and the articles by Johnston and Melnitzer, supra note 18. The CRA is authorized to make regulations under the implementing legislation. Canadian implementing legislation, supra note 2, at paragraph 5 of the preamble.

252 CRA guidance notes, supra note 19, at chapter 3.27, example C.
This example is contrary to the Treasury regulations directly on point and the definition of financial institution under the Canadian IGA. Furthermore, the CRA’s guidance notes contain a questionable rule regarding an unambiguous US place of birth, which states that the United States must be identified as the country of birth to be considered unambiguous. For example, if a US citizen presents a birth certificate showing Boston, Massachusetts as his or her place of birth when opening a new savings account at a reporting Canadian financial institution, the birth certificate is not an indicium of an unambiguous US place of birth and the institution is not required to report it under the guidance notes. This is truly problematic, since no birth certificate that we have seen identifies the United States as the country of birth. The infamous Holmesian “bad man” would have a field day with this rule, easily bypassing the Canadian legislation in direct contravention of the Canadian IGA’s purpose by providing a birth certificate rather than a US passport (which specifically identifies the bearer’s place of birth as, for example, “MASSACHUSETTS, U.S.A.” or simply “U.S.A.” if the passport was issued in Canada). The CRA’s guidance notes should not provide this escape hatch, and should be amended accordingly.

CONSEQUENCES OF RESTRICTING THE CLASS OF ENTITIES SUBJECT TO FATCA UNDER THE CANADIAN IMPLEMENTING LEGISLATION

FATCA belongs to a unique body of law, the enforcement of which does not rely on the action of any sovereign but rather on rational economic decisions made by market participants. The Code and Treasury regulations generally provide that before an entity subject to FATCA (“the payee”) transfers withholdable payments to the withholding agent (“the payer”), the payer must ascertain the status of the payee and determine whether FATCA withholding is required. The result is a definition of “financial institution” that is different in Canada, the United States, and other jurisdictions. This type of incongruity is what the OECD CRS warns against and seeks to prevent through its standardized reporting requirements.

Where both the payer and the payee are Canadian residents, there is a lower chance of confusion or unnecessary withholding because they are both subject to the Canadian implementing legislation. However, where the payer is not a Canadian resident, its decision to withhold becomes more complicated. Needless to say,

253 Treas. reg. section 1.1471-5(e)(4)(v), examples 5 and 6; Canadian IGA, supra note 1, article 1(1)(g). See supra, the text accompanying notes 177-231.
254 CRA guidance notes, supra note 19, at 8.28.
256 See Canadian IGA, supra note 1, annex I(II)(B)(4).
257 IRC sections 1471(a), 1472(a), and 1473(1)(A); Treas. reg. section 1.1471-3. See also Treas. reg. sections 1.1471-1(b)(96) and (140), and 3(a); temp. Treas. reg. section 1.1471-1T(b)(98).
258 OECD CRS, supra note 43, at 7-8.
entities that are not Canadian residents are not bound by Canada’s implementing legislation regarding FATCA. Under the general rules, if a payer does not withhold when required, it is personally liable for the withholding and any applicable interest and penalties.\footnote{IRC section 1474(a); Treas. reg. section 1.1474-1; temp. Treas. reg. section 1.1471-3T(f)(9)(i).} Accordingly, a payer that is uncertain of the FATCA status\footnote{Or “chapter 4 status,” as the Treasury regulations christen it. Treas. reg. section 1.1471-3(b).} of an entity such as a personal Canadian trust—because, for example, Canadian law limits the class of entities subject to FATCA—will likely withhold (absent explicit IRS guidance to the contrary) because to do otherwise would expose the payer to liability for the non-withheld amount.\footnote{IRC sections 1471(a) and 1474(a); Treas. reg. sections 1.1471-3(d) and (d)(12).} In such cases, the payer may prefer to deal with a disgruntled customer than an IRS agent asking for FATCA withholding that the payer failed to collect. However, such withholding would be undesirable for Canadian cross-border investors, who would be subject to unnecessary compliance burdens and costs from obtaining the refunds of the excess withholdings.

Additionally, the implementing legislation may have much more dire consequences for Canadians by jeopardizing the Canadian IGA’s status. The United States may see the legislation as an invalid implementation of the agreement, potentially precluding it from entering into force.

**Restricting the Definition of Financial Institution Could Lead to Unnecessary Overwithholding**

Before making a payment subject to FATCA, a payer must determine the identity and status of the payee under FATCA, and the payee must establish its status by providing substantiating documentation.\footnote{Canadian IGA, supra note 1, annex I(IV)(D)(4), (V)(B), and (VI)(B)(2); Treas. reg. sections 1.1471-3(d) and (d)(12); IRC sections 1472(a) and (b); Treas. reg. section 1.1472-1(a).} Personal Canadian trusts would presumably take the position that they are either (1) non-financial institutions exempt from FATCA under the Canadian implementing legislation or (2) NFFEs, and must provide a certificate to the payer to that effect,\footnote{Supra note 78.} using IRS form W-8BEN-E.\footnote{Canadian IGA, supra note 1, annex I(IV)(D)(4); Treas. reg. section 1471-3(b).} We will discuss these possible reporting positions below, after summarizing some general rules. For the purposes of the discussion immediately below, personal Canadian trusts analyzed under the withholding rules are assumed to be entities properly classified as financial institutions under the Canadian IGA but misclassified as non-financial institutions under the Canadian implementing legislation.

**General Rules for Determining a Payee’s FATCA Status**

The payer can rely on documentation provided by a payee to establish the payee’s FATCA status unless the payer knows or has reason to know that the information
provided is incorrect or receives notice from the IRS that the payee’s claim of status is incorrect. In the case of a personal Canadian trust, the problem is that under the Code, the Treasury regulations, and the Canadian IGA, the trust is probably not an NFFE, but an FFI subject to FATCA under the IGA. That is, many personal Canadian trusts are properly classified as financial institutions under the Canadian IGA, but misclassified as non-financial institutions under the Canadian implementing legislation.

Under the Treasury regulations, if a payee’s claimed FATCA status conflicts with the payer’s documentation, the payer must presume that the payee is a non-participating FFI and withhold. For example, if a personal Canadian trust’s claim of status conflicts with any information in the payer’s files, including documentation collected by its anti-money-laundering due diligence procedures, the payer will be considered to have reason to know that the trust’s claim is unreliable, and must withhold or be held personally liable for the withholding. Moreover, under the Canadian IGA, reporting Canadian financial institutions—which include personal Canadian trusts properly classified as financial institutions—cannot rely on self-certifications or documentary evidence if they know or have reason to know that the certification or evidence is incorrect or unreliable, and they must withhold, absent an exception to the contrary.

Furthermore, the Code makes the decision to withhold in this situation easier since it explicitly indemnifies the payer against claims and demands of any person for required FATCA withholding. Where a payer withholds on the basis of a reasonable belief that withholding is required, the payer is treated as if withholding were required for indemnification purposes. There are no penalties under FATCA for overwithholding, and the payer may—but is not required to—reimburse the payee for amounts that were overwithheld, or use these amounts to set off taxes otherwise required to be paid.

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265 Canadian IGA, supra note 1, annex I(VI)(A); Treas. reg. sections 1471-3(d) and (e); temp. Treas. reg. section 1.1471-3T(e)(4) (which provides the standards for “reason to know”).

266 Temp. Treas. reg. sections 1.1471-3T(f)(4) and (9).

267 Temp. Treas. reg. section 1.1471-3T(e)(4); Treas. reg. section 1.1471-3(e)(1).

268 Canadian IGA, supra note 1, annex I(VI)(A); Treas. reg. section 1.1474-1; temp. Treas. reg. section 1.1471-3T(f)(9)(i).


270 Treas. reg. section 1.1474-1(f).

271 However, the payer may be subject to suit by the payee if its decision to withhold was unreasonable. Ibid. It is questionable, however, whether a payee would actually sue the payer when it can claim a refund from the IRS instead. See Dale, supra note 269, at 95-100.

The combination of these rules—personal liability for FATCA withholding, indemnification, lack of penalties for overwithholding, and the absence of a requirement to reimburse or set off overwithheld amounts—makes withholding the safest (and thus the default) choice whenever the payer is in doubt. The only check on this behaviour would be the economic consequences of a payer’s policy to overwithhold. When the dust settles, payees that are subject to overwithholding will most likely be left in the unenviable position of applying directly to the IRS for a refund of the overwithheld amount.273

Eventually, these misclassified Canadian payees will be reported to the IRS under the Treasury regulations or another IGA,274 and the IRS may apply the procedures in article 5 or 8 of the IGA—or, worse, terminate the IGA.275 Interestingly, Canada would be required to apply its domestic law, including applicable penalties, to address any significant non-compliance identified.276

While a discordance of entity classification on form W-8BEN-E would result in the unnecessary withholding described above, the IRS could craft a solution to mitigate this result. Unnecessary withholding occurs when a payee’s claimed status is different from what the payer knows or has reason to know it should be. It might be possible for the IRS to clarify form W-8BEN-E to acknowledge that the entity’s status may be different under its domestic legislation than it would be under FATCA proper. That is, such an entity would effectively be reclassified as an NFFE under the applicable domestic implementing legislation. As a result, there would be no difference in classification on the form itself, and withholding would presumably be unnecessary. If the IRS allowed this result, it would be confirmation that IGA partner jurisdictions will truly be able to enact legislation that works domestically, in accordance with the spirit of the IGAs. Otherwise, arguably all IGA partner implementing legislation must, in essence, be US law packaged with a foreign-law label. Yet, these possible revisions to form W-8BEN-E may also signal to IGA partner jurisdictions that they may unilaterally change important definitions to effectively exempt certain entities from the more onerous FATCA obligations as financial institutions, by reclassifying them as NFFEs under their domestic law. Notably, without these possible revisions to form W-8BEN-E, payees that improperly certify that they are entities other than financial institutions may face criminal prosecution, since that form is signed under penalties of perjury.277

273 Treas. reg. sections 1.1471-4(h)(4) and 1.1474-5.
274 Treas. reg. section 1.1471-4(c); Model 1A IGA, supra note 10, article 4(1).
275 Canadian IGA, supra note 1, article 10(2).
276 Ibid., article 5(2)(b).
277 See, for example, IRC section 7206(1); 18 USC section 1001.
Non-Financial Institutions Exempt from FATCA Under the Canadian Implementing Legislation: Delayed or Immediate Withholding

Where a personal Canadian trust is properly classified as a financial institution under the Canadian IGA but misclassified as a non-financial institution under the Canadian implementing legislation, and the trust fails to register with the IRS as required under article 4(1), it will face FATCA withholding; the only question is when that withholding will occur. Generally, we assume that the trust would provide withholding certificates or other documentation stating that it is a non-financial institution not subject to FATCA—though this is a hard position to defend, given that a personal Canadian trust is an entity and, as such, must be either an FFI or an NFFE.278 There are three ways to analyze this issue for such trusts: first, under the Canadian IGA in isolation; second, under the Treasury regulations in isolation; and third, under the Canadian IGA together with the Treasury regulations.

Recall that article 4(1) of the Canadian IGA provides, in the postamble, that reporting Canadian financial institutions that do not comply with the requirements of articles 4(1)(a) through (e) are exempt from FATCA withholding unless the IRS treats them as a non-participating financial institution under article 5(2)(b). Consequently, a reporting Canadian financial institution’s non-compliance must be substantial, and must exceed 18 months before withholding can be imposed under the Canadian IGA.279 There are no similar provisions in either the Code or the relevant Treasury regulations.280

The Treasury regulations suggest that any reporting Canadian financial institution (or any reporting Model 1 FFI) that fails to obtain a GIIN is disallowed the benefit of article 4(1)’s protection from FATCA withholding.281 Specifically, the temporary Treasury regulations provide282 that the payer must withhold on withholdable payments to FFIs unless either

1. the payment is made under a grandfathered obligation in Treas. reg. section 1.1471-2(b) or is proceeds from the disposition of a grandfathered obligation; or
2. the payer can reliably associate the payment with permissible documentation to treat the payment as exempt from FATCA withholding under Treas. reg. section 1.1471-2(a)(4).

278 IRC sections 1471(a) and 1472(d).
279 Canadian IGA, supra note 1, article 5(2)(b).
280 See Treas. reg. sections 1.1471-2(a)(1) and (4); temp. Treas. reg. sections 1.1471-2T(a)(1) and (4).
281 Treas. reg. section 1.1471-5(f)(1).
282 Temp. Treas. reg. section 1.1471-2T(a)(1).
For the purposes of this analysis, we will assume that withholdable payments are not made under a grandfathered obligation, which is generally an obligation outstanding on July 1, 2014. Withholdable payments are exempt from FATCA withholding under various circumstances in Treas. reg. section 1.1471-2(a)(4), the most relevant of which are the following:

- withholding on payments made before July 1, 2016 for pre-existing obligations of a non-prima facie FFI;
- payments to participating FFIs; and
- payments to deemed-compliant FFIs.

We will also assume that withholdable payments are not made on a pre-existing obligation, which is generally an account, instrument, contract, debt, or equity interest outstanding on June 30, 2014. Personal Canadian trusts that are financial institutions under the Canadian IGA are not participating FFIs. A participating FFI is an FFI that agreed to an FFI agreement (including an FFI described in a Model 2 IGA) and a qualified intermediate branch of a US financial institution unless the branch is a Model 1 FFI. Personal Canadian trusts do not fall under this definition because they will not have FFI agreements under the IGA and are not US financial institutions, but are Canadian financial institutions.

For payments made after January 1, 2015, personal Canadian trusts that do not properly register with the IRS and obtain a GIIN should not qualify as deemed-compliant FFIs because of how that term is defined. Reporting Canadian financial institutions cannot qualify as deemed-compliant FFIs unless they have a GIIN. Yet a personal trust will be exempted from withholding for payments made before January 1, 2015—whether or not it has a GIIN—if it provides a certificate (that is, form W-8BEN-E) to the payer indicating that the trust is a reporting Canadian financial institution under the Canadian IGA. Accordingly, a personal Canadian trust that is a financial institution under the Canadian IGA could delay the inevitable withholding and IRS registration requirement until January 1, 2015 merely by indicating on a withholding certificate that it is a reporting Canadian financial institution.

Thus, the discordance between the Canadian IGA and the Treasury regulations creates uncertainty regarding the applicability of the postamble of article 4(1) for reporting Canadian financial institutions that fail to comply with the listed requirements in that article, particularly the requirement to register with the IRS and obtain

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283 Treas. reg. section 1.1471-2(b)(2)(i); temp. Treas. reg. section 1.1471-2T(b)(2)(i)(A)(1).
284 Treas. reg. sections 1.1471-2(a)(4)(ii) through (iv); temp. Treas. reg. section 1.1471-2T(a)(4)(ii).
285 Temp. Treas. reg. section 1.1471-1T(b)(104)(i).
286 Temp. Treas. reg. section 1.1471-1T(b)(91).
287 Treas. reg. sections 1.1471-1(b)(109) and (136).
288 Treas. reg. section 1.1471-5(f)(1).
a GIIN. This uncertainty means that it is unclear when FATCA withholding will begin: starting 18 months after July 1, 2014; on January 1, 2015; or immediately. Specifically, personal Canadian trusts that are financial institutions under the Canadian IGA but misclassified as non-financial institutions under the Canadian implementing legislation, and that do not comply with their FATCA requirements, will face withholding; it is merely a question of when that withholding must occur under the applicable rules, and which rule the withholding agent (the payer) decides to follow. If the payer examines the Canadian IGA in isolation, it must wait over 18 months before withholding is required under article 5(2)(b). If the payer examines the Treasury regulations in isolation, it must withhold on withholdable payments made starting either on July 1, 2014 (FATCA’s effective date)\(^{290}\) or on January 1, 2015 if (contrary to our assumption above) the personal Canadian trust certifies that it is a financial institution. Finally, if the payer examines the Canadian IGA together with the Treasury regulations, it is unclear when withholding must occur, and the payer may choose to withhold in order to avoid personal liability for withholding otherwise required.\(^{291}\) Whether payers are aware of this quandary or not, many will likely withhold immediately rather than face personal liability for the FATCA withholding that may be required.

**NFFEs: Immediate Withholding Unless an Exception Applies**

Although personal Canadian trusts properly classified as financial institutions under the Canadian IGA but misclassified as non-financial institutions under the implementing legislation cannot qualify as NFFEs because, by definition, they are FFIs, when asked about their FATCA status, some may choose to certify that they are NFFEs on form W-8BEN-E rather than claim that they are non-financial institutions not subject to FATCA. Regardless of definitional niceties, these trusts remain entities under FATCA, and entities are either FFIs or NFFEs. Claiming status as a non-financial institution not subject to FATCA under the implementing legislation is currently not an option on form W-8BEN-E. Moreover, if a dispute arose, the IRS would certainly argue that these misclassified trusts are NFFEs as its secondary position (that is, if it lost the argument that they were FFIs).

Misclassified personal Canadian trusts certifying that they are NFFEs will be subject to FATCA withholding on withholdable payments unless they report information regarding the accounts and other ownership interests of US persons.\(^{292}\) This general withholding rule will require withholding on payments to misclassified personal Canadian trusts, unless they fulfill their truncated FATCA obligations as NFFEs (as compared with the more robust FATCA obligations for FFIs). There are two potential notable exceptions to the general rule. First, there is a transitory exception

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\(^{290}\) IRS Notice 2013-43, supra note 51.

\(^{291}\) IRC section 1474(a); Treas. reg. section 1.1474-1; temp. Treas. reg. section 1.1471-3T(f)(9)(i).

\(^{292}\) IRC section 1473(1)(A); Treas. reg. section 1.1472-1(a).
to the general rule for withholdable payments made before January 1, 2016 in the Treasury regulations if 293

1. the payment is on pre-existing obligations of a non-prima facie FFI payee; and
2. the documentation required to determine FATCA status does not indicate that the payee is a passive NFFE when the payee has not provided the required owner certification.

If both of these requirements are met, the payer is not required to withhold or report on payments to NFFEs. 294 Second, FATCA withholding is not required for withholdable payments made to excepted NFFEs, the most relevant of which includes active NFFEs. 295 An active NFFE must meet both of the following tests: 296

1. **Passive income test:** Less than 50 percent of the gross income from the past tax year is passive income.
2. **Passive assets test:** Less than 50 percent of the weighted average of its assets held during the past tax year are assets held for the production of passive income.

Thus, misclassified personal Canadian trusts that are NFFEs will be subject to FATCA withholding on withholdable payments made starting July 1, 2014 unless they fulfill their FATCA requirements or fall under one of the exceptions listed above.

**Restricting the Definition of Financial Institution May Invalidate the Canadian IGA**

Alternatively, in the worst-case scenario, the United States may view the legislation as an invalid implementation of the Canadian IGA under article 10(1), thereby precluding the Canadian IGA from entering into force. If so, Canadians would be subject to the more stringent default rules under the Code and the Treasury regulations, where the withholding regime is much less forgiving and FFIs must enter into FFI agreements to report directly to the IRS. 297 Canadian financial institutions would then be faced with the dilemma of choosing between following Canadian law, and

293 Temp. Treas. reg. section 1.1472-1T(b)(2).
294 Ibid.
295 Temp. Treas. reg. section 1.1472-1T(c)(1).
297 Compare Canadian IGA, supra note 1, articles 4(1) and 5(2) with Treas. reg. sections 1.1471-4 and 1.1472-1.
suffering the consequences under FATCA, or following the default rules under the Code and Treasury regulations, and suffering the consequences under Canadian law. This is an unlikely alternative, since the United States or Canada could invoke article 8 of the Canadian IGA and request a consultation to resolve the differences between the Canadian legislation and the IGA.

Finally, the United States may treat the legislation as Canada’s abrogation of its obligations under articles 2 and 3 of the Canadian IGA, thereby precluding all entities with inconsistent FATCA classifications under the legislation—such as personal trusts—from being treated as FATCA-compliant and subjecting them to withholding.298 Reporting Canadian financial institutions would then again be subject to the default rules under the Code and the Treasury regulations.

CONCLUSION
The Canadian implementing legislation places Canada either in the vanguard of legislative drafting regarding FATCA or as discrepant with the United States and other jurisdictions with IGAs. As shown above, we believe the latter is true.

FATCA is an ambitious, complex, and dynamic regime for eliminating tax evasion and perceived abuses through offshore investments and entities. As demonstrated by the OECD CRS, FATCA is quickly becoming the new global standard for the automatic exchange of information to combat these evils.299 FATCA does not have to be a one-sided affair. Canada and the rest of the world can benefit from standardized information exchange and changes to the international financial community to combat their own offshore tax evaders. Yet, to function effectively, the benefits of standardization that FATCA provides must be permitted to work without the possible impediments that the Canadian implementing legislation embodies. Simply, FATCA’s definitions and application will lack symmetry and consistency under the Canadian implementing legislation, which appears to demonstrate the antithesis of standardization regarding the classification of entities subject to its regime. Without the benefits of standardization, tax evaders will seek out and exploit jurisdictional inconsistencies to avoid FATCA. Therefore, we believe that the implementing legislation should be amended to facilitate FATCA’s effective implementation in Canada, ease FATCA’s burden on Canadians, and mitigate the negative consequences identified above.

298 Canadian IGA, supra note 1, article 4(1).
299 OECD CRS, supra note 43. See Blank and Mason, supra note 32.
User Fee Design by Canadian Municipalities: Considerations Arising from the Case Law

Kelly I.E. Farish and Lindsay M. Tedds*

Abstract
Municipal governments in Canada have come to rely increasingly on user fees to fund local services, as they struggle to deal with the combined pressures of federal and provincial devolution of responsibility for such services and the political costs of raising property taxes. While there is a substantial body of literature regarding the rationale for user fees, little information exists about how to design and implement a user fee so as to ensure that it satisfies the legal requirements for imposing this type of levy. The authors provide a detailed review of the existing Canadian case law to highlight key legal, technical, and administrative issues facing municipalities in designing and implementing user fees. The discussion focuses in particular on the principal legal tests for user fees and the application of those tests in specific cases. Through their analysis, the authors

* Kelly Farish is an associate at Lawson Lundell LLP, Vancouver (e-mail: kfarish@lawsonlundell.com). Lindsay Tedds is of the School of Public Administration, University of Victoria (e-mail: ltedds@uvic.ca).
draw attention to several unresolved issues and inconsistencies in the application and interpretation of the tests, which need to be navigated and addressed by the courts.

**KEYWORDS:** FEES ■ USER CHARGES ■ MUNICIPAL FINANCE ■ TAX LAW

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### INTRODUCTION

A growing concern for Canadian municipalities is their ability to generate sufficient revenue to fund activities, using the most appropriate policy instrument, while balancing complex policy challenges. As “creatures of the provinces,” Canadian municipalities may raise revenue only through means authorized by the provinces.1 As a result, fewer revenue-generating instruments are available to municipalities as compared with those available to the provincial and federal governments. These concerns have led Canadian municipalities to turn increasingly to user fees as an alternative to property taxes.2

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1 The expression “creatures of the provinces” is often used in reference to, and is derived from, the constitutional status of municipal governments in Canada, discussed in the next section of the article. Throughout the article, the term “provinces” is used in a broad or general sense and may include one or more of Canada’s three territories.

While the rationale for user fees is well established in the literature, little information exists on how to satisfy the Canadian legal requirements for the imposition of user fees, despite the presence of significant relevant case law. In fact, the legal requirements for user fees do not appear to be well understood, if they are even considered, in the existing literature. There is evidence suggesting that municipalities have experienced legal difficulties in implementing user fees. Not only have municipal user fees in a number of forms faced legal challenges across Canada (examples include campground fees, volumetric gravel removal fees, and waste disposal fees), but they have also been the subject of negative internal audit reviews.

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4 We note, in particular, one Canadian study and three US studies on the legal criteria applicable to user fees: Catherine Althaus, Lindsay M. Tedds, and Allen McAvoy, “The Feasibility of Implementing a Congestion Charge on the Halifax Peninsula: Filling the ‘Missing Link’ of Implementation” (2011) 37:4 Canadian Public Policy 541-61, briefly summarize the key Canadian case law on the legal criteria for a user fee in Canada, to evaluate whether a congestion charge could be designed to satisfy the legal requirements for a user fee; Wisconsin, Legislative Audit Bureau, Joint Legislative Audit Committee, Best Practices Report: Local Government User Fees (Madison, WI: Legislative Audit Bureau, April 2004) (http://legis.wisconsin.gov/lab/reports/04-0UserFeesFull.pdf), provides a brief overview of the statutory and case law that governs the distinction between a tax and a user fee in Wisconsin; Leslie A. Powell, “User Fee or Tax: Does Diplomatic Immunity from Taxation Extend to New York City’s Proposed Congestion Charge?” (2009) 23:1 Emory International Law Review 231-71, uses statutes and case law to determine whether the city of New York’s proposed congestion charge meets the legal criteria to be considered a user fee and therefore not subject to the Vienna Convention on Diplomatic Relations; and Hugh D. Spitzer, “Taxes vs Fees: A Curious Confusion” (2003) 38:2 Gonzaga Law Review 335-65, considers the case law for distinguishing a tax and a user fee in the state of Washington.


6 Allard Contractors Ltd. v. Coquitlam (District), [1993] 4 SCR 371.

7 Antigonish (Town) Waste Disposal Charges Bylaw, Re (1999), 7 MPLR (3d) 165 (NSSC).

8 For example, City of Ottawa, Office of the Auditor General, 2010 Audit Report (Ottawa: Office of the Auditor General, 2011) (www.ottawa.ca/city_hall/mayor_council/auditor_general/audit_reports/2011/annual_report_2010_en.pdf), where the auditor general wrote, first, that there was no comparison of planned amounts and actual costs and volumes to validate the user fees charged by the city of Ottawa; second, that city council was not provided with the details of the costing used to justify the user fees; and finally, that some user fee calculations included costs that were in no way attributable to the service being provided.
The primary purpose of this article is to assess the current state of the law on user fees in Canada and to highlight key issues that present challenges to Canadian municipalities in ensuring that user fees are legally permissible and appropriate. By carrying out a detailed review and critique of the existing case law, we aim to provide clarity with respect to the principles developed in the jurisprudence on the topic of user fees, particularly from a municipal implementation perspective. Our main focus is on the legal tests and criteria that are relevant for municipal public administrators. While these tests may address some questions regarding the legitimacy of user fees, the law in this area is complex and not definitive. As a result, many legal questions remain unresolved, creating uncertainty with respect to the specific requirements that must be met in designing municipal user fees. Our intention in highlighting these grey areas of the law is to illuminate the inconsistencies between the existing legal tests, not only to ensure that municipalities are aware of potential vulnerabilities but also to guide courts toward resolving these inconsistencies. An important caveat of our work is that, because municipalities derive their authority to charge user fees from their enabling legislation, the analysis presented here cannot and should not supplant careful review of such legislation by any municipality contemplating the introduction of user fees.

The discussion that follows is divided into six sections. In section one, we outline the constitutional authority for municipalities to charge user fees. Then, in section two, we explain the legal tests for user fees and review the leading cases establishing these tests and their respective criteria. Our discussion focuses on those cases in which the legal criteria have been elaborated or clarified; by no means do we attempt to cover all municipal user fee cases. However, we do include user fee cases outside municipal law where the judgment would apply in the municipal context. Drawing on this case-law review, in section three we identify and explain a number of unresolved issues related to the existing legal tests, and make recommendations for clarification of the test. Then, in section four, we address an important complication that arises in the jurisprudence—the difference between a user fee and a regulatory charge. Again, our review of the case law highlights several unresolved questions related to the distinction between a user fee and a regulatory charge, and these are discussed in section five. Section six presents a few brief concluding comments.

9 While our work focuses on issues related to municipal user fee design, many of the lessons that we expound can also be applied to user fees designed by other levels of government. Municipalities, however, operate within a constrained fiscal environment that serves as a backdrop for the application of these legal principles. Other levels of government are not so constrained, and some of the considerations that we outline would not apply beyond municipal governments. This is not to suggest that there are no restrictions on the fiscal powers accorded to the federal and provincial governments. Governments at both levels are constrained not only constitutionally but also procedurally. In particular, the Constitution Act, 1867 stipulates that before a tax can be enacted, it must be approved by Parliament or a provincial legislature, as the case may be. See sections 91 and 92 of the Constitution Act, 1867 (UK), 30 & 31 Vict., c. 3. Failure to meet this procedural requirement would result in “taxation without representation.”
CONSTITUTIONAL AUTHORITY FOR MUNICIPALITIES TO CHARGE USER FEES

As noted in the introduction, municipalities have only limited revenue-raising powers. These powers are derived from the allocation of jurisdiction among the three levels of government—federal, provincial, and municipal—under Canada’s constitution. The Constitution Act, 1867\(^\text{10}\) sets out, in sections 91 and 92, the division of powers between the federal and provincial governments, respectively. The federal and provincial governments are able to pass laws only on the matters for which they are given specific authority. Thus, if a law is outside the jurisdiction of a government—that is, the government is not authorized, by the constitution, to govern in that area—the law is said to be “ultra vires” (beyond the powers or legal authority); conversely, if a law is within the jurisdiction of a government, it is said to be “intra vires.”

The broadest revenue-raising powers are accorded to the federal government. Section 91 of the Constitution Act provides, in part,

\[
91. \ldots \text{[I]t is hereby declared that (notwithstanding anything in this Act) the exclusive Legislative Authority of the Parliament of Canada extends to all Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say, \ldots} \]

\[3. \text{The raising of Money by any Mode or System of Taxation.}\]

The more limited revenue-raising powers of the provinces are set out in sections 92(2) and (9), as follows:

\[
92. \text{In each Province the Legislature may exclusively make Laws in relation to Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say, \ldots} \]

\[2. \text{Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes.}\]

\[\ldots\]

\[9. \text{Shop, Saloon, Tavern, Auctioneer, and other Licences in order to the raising of a Revenue for Provincial, Local, or Municipal Purposes.}\]

Section 92(2) grants the provinces the authority to impose direct taxation, to raise revenue for provincial purposes. This authority has been interpreted to include the legislative power to impose user fees.\(^\text{11}\) Section 92(9) authorizes the provinces to

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\(^{10}\) Supra note 9. Unless otherwise stated, references herein to “the Constitution Act” are to the Constitution Act, 1867.

\(^{11}\) See *City of Ottawa v. City of Ottawa Electric Railway Co.* (1929), 64 OLR 537, at 543 (CA), where the court stated: “That the fee or charge imposed by the by-law is a tax is, I think, quite clear. It is fixed at ‘one-tenth of a cent per scheduled passenger mile of travel or along all streets traversed by such service within and under the jurisdiction for the City of Ottawa.’ It is not a licence-fee, and the legislative power to impose the ‘fee or charge’ must rest upon the power to make laws in relation to ‘direct taxation within the Province’ given by para. 2 of sec. 92 of the British North America Act [emphasis added].”
raise revenues for provincial, local, or municipal purposes through the issuance of licences. As discussed in a later section of this article, the interpretation of this provision also has been broadened to include regulatory charges.

Municipal governments are not recognized in the Constitution Act as having separate jurisdiction or authority over any areas or matters. Instead, section 92(8) of that act grants provincial governments jurisdiction over municipalities. (This is why we refer to municipalities as “creatures of the provinces.”) Consequently, any revenue-raising powers that municipalities possess are limited to those that are delegated to them by the particular province within whose jurisdiction they lie.12 In general, user fees and property taxes (under section 92(2)) and licence fees or regulatory charges (under section 92(9)) are the main forms of revenue-raising powers that are devolved to municipalities.

It is important to understand that provinces exercise the delegation of powers to municipalities in different ways, with the result that municipalities across Canada will not all have the same powers. In relation to user fees, this means that a municipality in one province may be able to adopt a user fee for a particular public good or service, and may choose the particular characteristics of that fee, while a municipality in another province may not be permitted to enact a similar fee, or to choose the same characteristics. As a result, careful examination of the legislation governing municipalities in a particular province is required to establish the authority to charge user fees and to determine whether there are any legal limitations on such authority, either in that legislation or in other provincial or federal statutes applicable to user fees.13 Where the governing statute for a municipality or other legislation has not codified a user fee test, the test to determine whether a particular levy constitutes a user fee will follow legal precedent. These legal principles have been established in the case law, as discussed below, and inform the interpretation of the municipal legislation.

THE USER FEE TEST

One of the main legal challenges to municipal user fees is the argument that a municipality has acted outside the provincially delegated authority. Typically, this means that the challenging party argues that the user fee is a tax, and the taxing power either has not been devolved to the municipality (as a form of direct tax) or cannot be so devolved because it is ultra vires the province (as a form of indirect tax). As a result, the case law has developed around ensuring that a levy is, in fact, a user fee.

Currently, the courts apply a two-part test to make this determination. First, the levy is evaluated against four criteria established in Lawson v. Interior Tree Fruit and Vegetables Committee of Direction,14 to determine whether the levy is a tax. Under the

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13 An example of such legislation is the federal User Fees Act, SC 2004, c. 6.
14 [1931] SCR 357.
Lawson test, a levy may be found to be a tax if it is (1) enforceable by law; (2) imposed under the authority of the legislature; (3) imposed by a public body; and (4) generated for a public purpose. Then two additional criteria are applied, as set out in Eurig Estate (Re),15 to determine whether the levy is a user fee. The first requirement under Eurig is that there is a nexus between the cost of the service and the fee. The second requirement is that there is a reasonable connection between the cost of the service and the amount charged.16 With respect to the second requirement, the cost of the service and the amount of the fee do not have to exactly correspond. The respective criteria of the Lawson and Eurig tests and the generally accepted sequence of their application are summarized in figure 1.

In this section, we describe the context for the development of the Lawson and Eurig tests, and discuss how these tests have been applied in the case law.

Is a Levy a Tax?

The Lawson test was established by the Supreme Court of Canada in 1931, and it remained the principal test until the Eurig decision in 1998. As described above, under Lawson, in order to be found to be a user fee, a levy must be found not to be a tax. One of the questions before the court in Lawson was whether the levy fell under provincial jurisdiction, pursuant to section 92(2) or (9) of the Constitution Act. The court applied four criteria in determining that the levy in question was a tax; namely, the levy was “(1) enforceable by law; (2) imposed under the authority of the legislature; (3) levied by a public body; and (4) intended for a public purpose.”17 This is the test that continues to be applied to determine whether a levy is a tax.

In Lawson, the court found that the levy met all the elements of a tax. The levy was enforceable because it could be sued for, a certificate demonstrated the amount

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16 One could argue that these two elements in Eurig are one requirement for a reasonable cost nexus; however, we have chosen to keep the two elements separated since this is how they are commonly described and applied.

Most recently, the Lawson and Eurig criteria were restated in the 2008 Supreme Court of Canada decision in 620 Connaught Ltd. v. Canada (Attorney General), 2008 SCC 7. The question addressed in 620 Connaught was whether a levy on liquor licences for businesses operating in Jasper National Park was a regulatory charge or a tax. It was not argued that the levy constituted a user fee. In its decision, the court provided guidance with respect to the assessment process applied in the determination of fees, using the Eurig criteria. The court stated, at paragraph 19, “A user fee, by definition, is a fee charged by the government for the use of government services or facilities. In the case of user fees, as stated by this Court in Eurig, there must be a clear nexus between the quantum charged and the cost to the government of providing such services or facilities. The fees charged cannot exceed the cost to the government of providing the services or facilities. However, ‘courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice’ (see Eurig, at para. 22).” 620 Connaught demonstrates that the Lawson and Eurig criteria remain valid.

17 The four criteria as summarized by Major J in Eurig, supra note 15, at paragraph 15, paraphrasing the findings of the majority in Lawson, supra note 14, at 363 (per Duff J).
owed, and failure to pay was an offence. The levy was imposed by the authority of the legislature through a public body; it was demonstrated that the committee of direction was a public body because the committee chair was appointed by the lieutenant governor in council, had wide powers of regulation over an extensive territory, and was constituted by and acted according to statute. The court also found that the levy was made for a public purpose, citing, as support for this conclusion, the fact that the committee that imposed the levy was a public body, as well as the extent of the territory and the number of people affected by the levy.\(^{18}\)

**Is a Levy a User Fee?**

In 1998, the Supreme Court of Canada’s decision in *Eurig* added a second test to distinguish a tax from a user fee. In *Eurig*, the appellant was the executrix of an estate who objected to paying approximately $5,700 in probate fees imposed by the province of Ontario. She argued that the fees were a tax, the authority for which

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18  *Lawson*, supra note 14, at 363.
was not procedurally granted by the provincial legislature, and therefore they were ultra vires.\textsuperscript{19} The Constitution Act provides that before a tax can be enacted, it must be approved by Parliament or a provincial legislature.\textsuperscript{20} In the case of Ontario’s probate fees, however, the authority to impose such fees had been delegated by regulation and did not go through the legislature. In determining whether the levy was a tax, the first step for the court was to apply the test set out in \textit{Lawson}. The court evaluated the probate fee against the four criteria in \textit{Lawson} and found that the levy appeared to satisfy all of them.

The court, however, decided that this was not sufficient to determine that the levy was indeed a tax. The seminal point in \textit{Eurig} is a new element that the court introduced in conducting the user fee analysis. The court wrote:

Another factor that generally distinguishes a fee from a tax is that a nexus must exist between the quantum charged and the cost of the service provided in order for a levy to be considered constitutionally valid.\textsuperscript{21}

This led the court to add a second element to its test. In relation to setting the price of user fees, the court stated:

In determining whether that nexus exists, courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice.\textsuperscript{22}

The court relied on the evidence provided to determine that there was no correlation between the cost of the service provided (the service being the issuing of letters probate) and the amount charged by the province. The court found that the levy was tied to the value of the estate, but the cost for issuing letters probate did not increase or decrease depending on an estate’s value. As a result, the court found that there was no nexus between the cost of the service and the levy charged. The court held that the levy was a tax, not a user fee, and was ultra vires the province, since the province had imposed the tax without the properly delegated authority.\textsuperscript{23}

\textsuperscript{20} Constitution Act, supra note 9, sections 91 and 92.
\textsuperscript{21} \textit{Eurig}, supra note 15, at paragraph 21.
\textsuperscript{22} Ibid., at paragraph 22.
\textsuperscript{23} Ibid., at paragraphs 22-23. If a user fee is found to be invalid, the court must then decide the appropriate remedy. This issue was taken up in \textit{Kingstreet Investments Ltd. v. New Brunswick (Department of Finance)}, 2007 SCC 1. In \textit{Kingstreet}, the Supreme Court addressed the question whether restitution is available for the recovery of monies collected under legislation that is later declared to be ultra vires. The court determined that restitution is generally available and that there is no general immunity affecting recovery of an invalid tax. In particular, the court decided that the government that had enacted the ultra vires legislation could amend the legislation to make it valid, and to ensure that it was valid retroactively, so that the government would not have to pay restitution. See also \textit{Barbour v. University of British Columbia}, 2009 BCSC 425.
Application of the Lawson and Eurig Tests

While the Lawson and Eurig tests may appear straightforward, uncertainties may arise in applying their respective criteria. Examples drawn from the municipal-law jurisprudence provide additional clarification on each of the four Lawson criteria, and these will be discussed here.

In Grande Prairie (City) Re,24 a decision of the Alberta Electric Utility Board, the first Lawson criterion was considered, which requires a levy to be enforceable by law in order to be a tax. In this case, the city of Grande Prairie and its natural gas provider, ATCO Gas (“ATCO”), reached an agreement that increased a contractual fee that ATCO was required to pay for the provision of natural gas to the city. The board concluded that the fee was not a tax because it was imposed through an agreement and was not required by law. More specifically, the board was persuaded that the arrangement did not meet the first element of Lawson since the manner of payment was negotiated between the parties to the agreement and was thus not enforceable by law. The board further held that the fee was not compulsory or enforceable by law in the sense that it was charged pursuant to a freely negotiated agreement between the city and ATCO.25 The board was also persuaded by a provision in the contract that the fees were paid in lieu of a tax, reasoning that a fee cannot be a tax if it is paid instead of a tax.26 Grande Prairie is useful as an example of a levy that fails on the first Lawson criterion: that is, where a levy is not compulsory but rather arranged by negotiation, it will be found not to be a tax.

The first element of Lawson was also discussed by the Supreme Court of British Columbia in Cariboo College v. Kamloops (City).27 At issue in this case were development cost charges imposed by the municipality for the purpose of funding certain expenditures on infrastructure (relating to the construction of sewers, water, drainage, highways, and public open space).28 The court concluded that the development cost charge was not a tax29 because Cariboo College was not obliged to obtain a building permit from the city unless it chose to construct a new building, and if it chose to do so, it must pay the development cost charges to defray the city’s capital cost of providing the services.30

In 2012, the BC Supreme Court offered further insight into the interpretation of the first element of Lawson in its judgment in Canadian Wireless Telecommunications Association v. Nanaimo (City).31 At issue in this case was a per-call fee option that wireless service providers (WSPs) could elect to charge in lieu of charging consumers

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24 2003 CarswellAlta 2132 (Electric Utility Board).
25 Ibid., at paragraph 24.
26 Ibid., at paragraphs 29-30.
27 (1982), 133 DLR (3d) 241 (BCSC).
28 Ibid., at paragraph 13.
29 Ibid., at paragraph 30.
30 Ibid., at paragraph 27.
31 2012 BCSC 1017.
a flat monthly rate imposed by the city of Nanaimo to support the 911 emergency call system. For the first Lawson criterion, the court examined whether the single-call fee was compulsory and enforceable by law. On the basis that the WSP must pay the single-call levy if it did not agree to the flat-rate monthly charge, the court found that there was a “practical compulsion” to pay the single-charge levy and found the levy to be a tax.32

Three of the Lawson criteria were considered in Antigonish (Town) Waste Disposal Charges Bylaw, Re,33 a decision of the Nova Scotia Supreme Court. In this case, a university challenged a municipal bylaw that imposed a waste disposal charge on landowners but provided an exemption for residents who were paying the waste disposal charge in their property tax. The result was that the charge applied only to entities that were exempt from paying property tax, such as the university. The court undertook a detailed analysis of the Lawson criteria. As to the first criterion, that the levy must be enforceable by law to be a tax, the court found that (1) the charges would bear interest if they were outstanding, (2) they could be registered as a lien, and (3) the town of Antigonish could sue for an collect payment of the charges.34 The court concluded that these characteristics were sufficient to meet the first Lawson criterion.35

The decision in Antigonish also contributes to further understanding of the third and fourth criteria of the Lawson test. The third criterion, requiring that the levy be imposed by a public body, is rarely considered in any depth, since it is generally obvious that the imposing body is a public body; yet it was considered by the court in this case. In concluding that the municipality was a public body, the court stated, “A municipal corporation is the body politic and corporate constituted by the incorporation of the inhabitants of a city or town for the purpose of local government.”36 The court then referred to two sources supporting this view. First, it cited Rogers, The Law of Canadian Municipal Corporations, which states, “[A] municipality can also be described as a public corporation created by the government for political purposes and having subordinate or local powers of legislation.”37 Second, the court cited a 1911 decision, Dugas v. Macfarlane, that described municipal corporations as “miniature parliaments, institutions by which the people’s will is expressed through elected representatives.”38 The court held that the third Lawson criterion, that the levy must be imposed by a public body, was met on the basis of these authorities.

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32 Ibid., at paragraph 62. This conclusion is particularly interesting given that there were two options for the wireless service provider to select from in terms of payment, and the court examined this point carefully in reaching its final determination.

33 Antigonish Waste Disposal, supra note 7.

34 Ibid., at paragraph 18.

35 Ibid., at paragraph 19.

36 Ibid., at paragraph 21.


38 (1911), 18 WLR 701, at paragraph 24 (YT Terr. Ct.), cited in Antigonish Waste Disposal, supra note 7, at paragraph 22.
The fourth Lawson criterion requires a court to establish that the levy is intended for a public purpose. Unfortunately, the interpretation of this criterion has been inconsistent as between two meanings—either that the revenue generated is intended to be used for public benefit, or that the revenue generated is to be put into a general account (rather than designated to fund a particular good or service). The first interpretation is found in Antigonish. The municipal bylaw in that case included a purpose statement, which was referred to by the court. The court wrote, “It is obvious that the By-law was enacted as a means of helping to defray the costs associated with the use of waste processing facilities.” The conclusion that the court reached was that there was a twofold public purpose: (1) to reduce the tax burden on municipal taxpayers, and (2) to increase the municipality’s revenue. The court found that the bylaw was a tax and not a user fee, and was inconsistent with the legislative scheme that created tax-exempt institutions. In other words, the town of Antigonish was attempting to tax the tax-exempt university.

As seen in Lawson and Antigonish regarding the interpretation of the fourth element, the court did not consider the accounting treatment of the revenue from a user fee; rather, the court was concerned with whether the revenue was fulfilling a “public purpose.” However, by the time of the Eurig decision, the notion of public purpose had shifted. In Eurig, the Supreme Court instead considered the account in which the revenue generated by the levy would be held, in order to evaluate public purpose. The court wrote:

> [P]robate fees do not “incidentally” provide a surplus for general revenue, but rather are intended for that very purpose. The revenue obtained from probate fees is used for the public purpose of defraying the costs of court administration in general, and not simply to offset the costs of granting probate.

The public purpose factor can be influential in the analysis, likely because some of the other elements in the Lawson test are fairly easily established; for example, most levies of concern will be imposed by a government body. The interpretation of the public purpose factor as providing a public benefit is also often easily established, since most government levies could be found to have some sort of purpose that serves the public. The shift in Eurig toward more of a bright-line test, focused on how the revenue is accounted for, is helpful though not consistently reflected in subsequent case law.

An example of the revenue-focused interpretation of the public purpose element is found in Greater Toronto Apartment Association v. Toronto (herein cited as “GTAA”).

This case dealt with a user fee scheme, the intended purpose of which was to divert

39 Antigonish Waste Disposal, supra note 7, at paragraph 25.
40 Ibid., at paragraph 30.
41 Eurig, supra note 15, at paragraph 20.
42 2012 ONSC 4448.
70 percent of the municipality’s residential garbage away from landfill.\textsuperscript{43} The Ontario Superior Court examined the levy against the four \textit{Lawson} criteria and found that it met all of them. The court took specific note of the difficulty with this test, namely, that a user fee may also meet all the criteria for a tax,\textsuperscript{44} a point that we will return to in the next section of this article. The court then went on to consider whether the levy at issue was in fact a user fee and undertook significant analysis to determine the nexus between the levy and the service provided. The court cited \textit{Eurig} and held that the user fees in \textit{GTAA} were different from the probate fees in \textit{Eurig}, which were found not to meet the nexus element. The court used evidence provided by the city of Toronto regarding the cost of the service to support this analysis. The total cost of the program was $237.5 million, with the base amount of the program being established from the previous year. In this respect, the court stated that the fee charged “cannot be said to be arbitrary or unrelated to the cost of the service for which the fee is being collected.”\textsuperscript{45} Ultimately, the city intended to recover only 83 percent of the actual cost of the service from residential user fees. The city did not achieve the level of waste diversion it anticipated and therefore collected more revenue from multi-residence buildings than had been expected. The \textit{GTAA} argued that this failure converted the fee to a tax because it eliminated the nexus between the amount of the fee and the cost of the service. The court found that there was in fact a nexus, stating:

> The fact that some of the City’s assumptions were wrong is hardly surprising. I would venture to say this is almost inevitably the case when one is attempting to predict the future in respect of a question that inherently contains a number of variable values. In any event, in determining whether a nexus exists, it is not for the court to look behind the methodology used and question the assumptions made in respect of individual values adopted.\textsuperscript{46}

The point made clear in this case is that while a user fee is meant solely to recover costs, that purpose does not preclude the accrual of surpluses in any given year, provided that those surpluses were not an intentional design element.

**UNRESOLVED ISSUES FROM LAWSON AND EURIG**

While the criteria established by \textit{Lawson} and \textit{Eurig} are easily identified, their interpretation and application is more complicated. In particular, despite the acceptance of these tests, the legal distinction between a fee and a tax often depends largely on

\textsuperscript{43} Ibid., at paragraph 1.

\textsuperscript{44} Ibid., at paragraph 24: “The problem is self-evident. Based on these criteria, virtually any money collected by the City would be identified as a tax.” See infra note 48 and the accompanying text, where we reproduce the broader context for the court’s comments on this issue.

\textsuperscript{45} Ibid., at paragraph 30.

\textsuperscript{46} Ibid., at paragraph 41.
the particular levy being considered. If a levy is challenged, courts will look beyond mere nomenclature to determine whether the levy has the elements of a user fee or a tax; specifically, they will examine the structure and context of the levy under dispute. In addition, the evolution of the two tests has resulted in inconsistencies between them. The result is significant uncertainty, with many questions remaining unresolved.

In this section, we ponder some of these unresolved questions. The first is, how exactly should the tests be applied? Do all elements of the tests, particularly those in Lawson, need to be examined? Is it possible for a levy to meet all of the Lawson criteria (and thus be found to be a tax) and still meet the Eurig criteria (and thus be found to be a user fee)? What exactly is a “public purpose”? To what activities can user fee revenues be directed? And, depending on the answers to the foregoing questions, would it be more appropriate to apply the test criteria in a different order than that set out in the Lawson and Eurig decisions?

We find that the jurisprudence does provide some clarification with respect to the uncertainties we raise. First, Eurig appears to suggest that it should not be possible for a levy to meet all of the Lawson criteria and still be found to be a user fee, if the public purpose element is interpreted to mean that the revenues generated are put into a general account. Second, as a result, it appears that there is a more logical way of reordering the Lawson and Eurig tests. While the jurisprudence has not taken this step, we suggest that rearranging the Lawson and Eurig criteria to allow for a clearer application of the user fee test may be appropriate. The first factor to consider should be how the revenues are designated; if the revenues go into a general revenue account, the remaining Lawson criteria should be applied to determine whether the levy is a tax. If the revenues go into a specific revenue account that is designated for the cost of the service, the Eurig test to find a nexus should be applied. The user fee analysis in the existing case law, while clearly articulated in terms of the elements required, leaves gaps with respect to the order of application of the test criteria, and whether certain criteria must be met before others are considered. The establishment of a clear procedure would assist the parties to a dispute in presenting their arguments in court, and would be helpful to the courts in ensuring that they are considering all factors appropriately. Such a reordering would provide support for the notion that not all elements of the Lawson test need to be examined in every case.

**How Do the Tests Work Together in Application?**

An initial difficulty in reading and attempting to reconcile the jurisprudence regarding user fees is that the courts seldom examine fully all the elements of the tests. Instead, it is more common for one element to be the deciding factor while the others are left unexamined.\(^4^7\) As discussed above, the question arises as to whether

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\(^4^7\) More recently, however, exceptions may be found; for example, in *Canadian Wireless Telecommunications*, supra note 31, the BC Supreme Court examined all of the requirements for a tax, found that the charge at issue was a tax, and then further ruled out the possibility that the charge could be a user fee.
it is possible for a levy to meet all of the Lawson criteria, implying that the levy would be a tax, and still meet the Eurig criteria, and then be found to be a user fee. This question was specifically asked, but not answered, by the court in GTAA. There does not appear to be a case in which a court states whether or not the entire Lawson test must be applied before the Eurig criteria can be considered. In fact, as noted earlier, the court in GTAA made specific mention of the difficulty of applying the full test. It is worthwhile to quote extensively from the decision with respect to the court’s concern on this point:

Counsel for 373041 Ontario Limited submitted that each of these four characteristics [the Lawson criteria] attached to the “fee” set out in By-law 506-2008. They suggested that it was enforceable because the City could sue for any unpaid fees. More importantly, the fee is collected as part of the Utility Bill sent to an owner. It is an offence to fail to pay the account. The fee is imposed pursuant to a provincial statute, the City of Toronto Act, 2006, and was levied by a public body. Finally, the proceeds are intended for a public purpose, waste diversion. All four criteria are fulfilled and, on this basis, it was asserted that the payment is a tax and not a fee.

The problem is self-evident. Based on these criteria, virtually any money collected by the City would be identified as a tax. This idea was enunciated in 620 Connaught Ltd. v. Canada (Attorney General) [2008 SCC 7, at paragraph 49, as cited in note 16 of the decision]:

... these [characteristics] will likely apply to most government levies.

The true impact of the application of the criteria was explained in MacMillan Bloedel Ltd. v. British Columbia [1985 CanLII 313 (BCSC), at paragraph 7, as cited in note 17 of the decision]:

It was enforceable by law, it was imposed under the authority of the legislature, it was imposed by a public body, and it was made for a public purpose. With great respect, although that case [Lawson] is authority for the proposition that an impost cannot be a tax unless it meets those criteria, I do not think the converse necessarily follows, that anything meeting those four criteria must be a tax. I do not, of course, dispute the ruling in that case that the royalty surcharge was a tax, but those four tests would apply to a ferry fare in British Columbia, although in my opinion that fare is not a tax but a fee for service imposed under statutory authority.48

As the foregoing comments from GTAA suggest, considerable uncertainty surrounds the application of the Lawson and Eurig tests; in particular, it is not clear if all of the elements of Lawson have to be met before Eurig can be applied. Further, as we explain below, there is some confusion in the analysis of the elements of the tests.

48 GTAA, supra note 42, at paragraphs 23-25.
What Is a “Public Purpose”?  

The fourth criterion in the Lawson test requires the court to establish whether the user fee in question is meant for a public purpose. As discussed below, the interpretation of this element varies as between two possibilities: (1) that the revenues generated are put toward the funding of a specific publicly provided good or service; or (2) that the revenues generated go to a general account. The following example illustrates this divergence. Where a levy is imposed on garbage bags for municipal garbage removal, the revenue generated from that levy could be interpreted as funding a publicly provided good (the removal of garbage), in which case the use of the funds would be an element weighing in favour of a tax. However, if a court chooses the second interpretation—that the garbage bag levies are allocated to a general account—then the determination of whether the levy is a tax or a user fee lies in the balance (assuming that the other three Lawson criteria are met). Most revenues collected by government are likely to be found to be supporting the provision of a good or service, while user fee revenue must have a nexus to the good or service, indicating that it belongs to a specific account. Given the inconsistency in the application of this criterion, it is our position that, first, the public purpose element should be clarified, to establish that it is determined on the basis of how the revenue generated is to be allocated; and second, the user fee test should be modified to consider this criterion first. Below, we examine some municipal user fee cases that demonstrate the differences in the interpretation of this aspect of the Lawson test.

In Urban Outdoor Trans Ad v. Scarborough (City), the Scarborough city council passed a bylaw to limit the number of outdoor signs being erected. Under the bylaw, an annual fee was imposed for each third-party billboard sign, charged at $100 per face for ground-mounted signs and $200 per face for roof-mounted signs. The Ontario Court of Appeal concluded that the funds were not intended for a public purpose, on the basis that the funds generated by the fee were not being deposited into a general revenue account. The decision in this case is therefore an example of the shift in interpretation of this element of Lawson, which appears to examine only the accounting treatment of the revenue when evaluating whether the fee is levied for a public purpose. Recall that we discussed this shift earlier, in considering the application of this element in Eurig and GTAA.

It appears, from Eurig, GTAA, and Urban Outdoor Trans Ad, that the public purpose element in Lawson is determined by establishing whether the revenue generated goes to a general revenue account or to a specific account that funds the service. The Supreme Court in Eurig was persuaded that the levy was for a public purpose because the monies levied from the fee were allocated as surplus in general revenue accounts rather than used to directly offset the costs of probate. If the levy is intended for a public purpose, as in Eurig, the revenues from the levy are designated...
for inclusion in general revenues. In contrast, the allocation of the levy to the specific account that funds the service is an indicator that the revenues are not intended for a public purpose, as in *GTAA* and *Urban Outdoor Trans Ad*.

It is clear that this point has not yet been clarified sufficiently in the case law when one considers the analysis in *Canadian Wireless Telecommunications*. In that case, the BC Supreme Court considered arguments that the levy was “provided for the benefit of all residents of the City, and therefore, the fee is intended for a public purpose,”51 and, conversely, that “there is a commercial marketing advantage for a telecommunications operator to be able to offer 911 service to its customers.”52 The court found that because the Canadian Radio-television and Telecommunications Commission mandated the provision of 911 services by the WSPs (wireless service providers), the WSPs could not decline to offer the service and thus the fee was intended to fund a public service.53 Nowhere in its analysis did the court consider the allocation of the revenues.

It is our position that it would be more sensible for the public purpose criterion to be based on the designation of account, rather than on whether the good or service provides a public benefit. Simply put, an argument that a good or service provides a public benefit is easily crafted, since there are no parameters around the element and there is no case law to suggest that a government-funded good or service does not provide any benefit to the public. A clarification that the public purpose criterion requires a court to consider where the revenues are deposited and the service that they fund would provide a stronger point to which courts may turn to strengthen their analysis and to make a reliable and consistent determination. Relating back to broader economic principles in the user fee analysis, this suggestion also supports the principle that users should pay for goods or services that they consume.

**What Programs and Services Can Be Funded from the Specific Account?**

A related question arises with respect to the issue of specific accounts and general accounts.54 If user fee revenues are directed to a specific account, what programs and services can be funded from that account? It does not appear that this issue has been addressed in the case law to this point—an omission that, given the confusion

51 *Canadian Wireless Telecommunications*, supra note 31, at paragraph 76.
52 Ibid., at paragraph 77.
53 Ibid., at paragraph 79.
54 While there is no explicit requirement in the case law that user fee revenues must be put into a specific account, it is not clear how one would satisfy the *Eurig* requirements of a nexus between the cost of the service and the levy, and a reasonable connection between those respective amounts, if the revenues were placed in a general account. The issue is twofold. First, for practical purposes, if funds are allocated to general revenues, it may be more difficult for the municipality to track the source of funds, the amount collected, and the use of the funds. Second, from the court's perspective, some judges will prefer a literal reading of the law, so if the test refers to a “specific account,” those judges will interpret it to mean exactly that.
on this point, is understandable. However, in a practical sense, municipalities must concern themselves with the breadth of revenue collection and spending from specific versus general revenue accounts.

One hint as to the acceptable breadth of spending that appears in the case law may be found in Urban Outdoor Trans Ad, where the court listed the use of funds by the administrative body that collected and used the specific fund (the “Sign Section”). The court found that the specific fund covered the operation of the Sign Section. However, it provided no additional commentary on this point.

A current example from the community of Saanich, British Columbia, illustrates the difficulty of determining whether a levy constitutes a user fee where the revenues collected are allocated to a specific account but used for multiple purposes. In this case, revenues raised from residential garbage collection fees are also used to offset the costs of other municipal environmental programs, including leaf collection, composting, and bus shelter litter pickup. In this instance, while the programs are arguably related, it is not clear from the existing case law whether a court would consider such broad spending to be permissible for a levy that purports to be a user fee.

A relevant consideration in this context is the deference of the courts to the discretion of municipalities to frame and implement bylaws that they deem appropriate for their communities. In this respect, it is presumed that the municipality has significant expertise in exercising its decision-making authority, and that a court will take that expertise into account and not lightly interfere with municipal decisions. The Supreme Court of Canada recently affirmed this position in Catalyst Paper Corp. v. North Cowichan (District), where it stated, “The case law suggests that review of municipal bylaws must reflect the broad discretion provincial legislators have traditionally accorded to municipalities engaged in delegated legislation.” This means that a court must meet a high threshold in finding that a municipality’s policy or decision verges on improper law. The Supreme Court also commented on this point in the same case, stating, “[T]he power of the courts to set aside municipal bylaws is a narrow one.”

Reordering the Test Criteria

A broader question emerges upon examination of the Lawson and Eurig tests as to whether rearranging the order in which the criteria are applied might provide a clearer and more consistent method for determining the nature of a levy. Though the dates of the cases seem to establish the order in which the tests are to be applied,

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57 2012 SCC 2, at paragraph 19. At issue in this case was the ability of the courts to overturn municipal taxation bylaws.
58 Ibid., at paragraph 9.
with Lawson predating Eurig by more than six decades, it appears that it would be both helpful and appropriate to apply the criteria in a different order. We suggest that the public policy element—the fourth criterion in the Lawson test—which states that a levy will be found to be a tax if it is levied for a public purpose, should be the starting point for the user fee analysis, assuming that, as discussed above, this element is interpreted to mean that the revenues are allocated to either a general account (in the case of a tax) or a specific account (in the case of a user fee). We argue that this proposed rearrangement would provide clarity with respect to the state of the law on user fees.

Our examination of the user fee test and its application by the courts also indicates that it should not be possible to meet all of the Lawson criteria and the Eurig criteria. The nexus and reasonable connection requirements under the Eurig test imply that a fee can be charged for a service only if there is a specific revenue fund for that service. In contrast, where a levy satisfies the first three Lawson criteria and also is found to have been imposed for a public purpose, it will be characterized as a tax, with all of the revenues therefrom being paid into a general revenue account. Clearly, a levy cannot be imposed for a public purpose, with the funds going into general revenues, and be treated as a user fee, with the funds going into a specific revenue account.

Under the rearrangement of the criteria proposed here, the first step of the test would be to determine whether the revenue collected from the levy goes to a general revenue account—that is, it is collected for a public purpose according to Lawson—or whether it goes to a specific revenue account, which indicates a nexus according to Eurig. If the revenue from the levy goes to a general revenue account, the other three Lawson criteria would be applied to determine whether the levy is a tax. Conversely, if the revenue goes to a specific revenue account, and the requisite nexus is established, the second criterion of Eurig would be applied to determine whether the amount charged is “reasonable” relative to the cost of the service. Figure 2 illustrates this proposed modification of the user fee test.

**USER FEES AND REGULATORY CHARGES**

Having outlined the legal criteria that distinguish a user fee from a tax, we now need to expand the analysis and consider the difference between a user fee and a regulatory charge. As discussed earlier, the provinces—and, if properly authorized, municipalities—have the authority to charge direct taxes (pursuant to section 92(2) of Constitution Act). In addition, the provinces—and, if properly authorized, municipalities—have the authority to charge licence fees (pursuant to section 92(9) of the Constitution Act).

As we will show, the term “licence fee” becomes synonymous with “regulatory charge” over the course of the jurisprudence. Regulatory charges are an alternative to user fees as a means of raising revenue; however, these two types of levy share some similar features. Accordingly, the issue that arises is how a regulatory charge can be distinguished from a user fee. This is important because, depending on the authorizing legislation, a regulatory scheme can bear a strong resemblance to a user fee.
What exactly are licence fees? In addition to providing the four criteria used to establish that a levy is a tax, the court in *Lawson* held that the jurisdiction of the provincial government to impose direct taxes under section 92(2) of the Constitution Act does not carry over to section 92(9) with respect to licence fees. Although section 91(3) of the Constitution Act seemingly reserves to the federal government the exclusive jurisdiction to impose taxes other than the direct taxes described in section 92(2), the court’s comments in *Lawson* imply that provincial or municipal licence fees may be charged as “indirect taxes”.59

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59 A direct tax cannot be shifted from the person intended to pay the levy, while an indirect tax can. Alarie and Bird have noted that the “distinction between what constitutes a direct tax and what constitutes an indirect tax has been a frequently contested one that has given rise to sporadic and inconsistent treatment by the courts”: Benjamin Alarie and Richard M. Bird, *Tax*
The question has never yet been decided whether or not the revenue contemplated by this head [section 92(9)] can in any circumstances be raised by a fee which operates in such a manner as to take it out of the scope of “direct taxation.” *Prima facie*, it would appear, from inspection of the language of the two several heads, that the taxes contemplated by [section 92(9)] are not confined to taxes of the same character as those authorized by [section 92(2)], and that accordingly imposts which would properly be classed under the general description “indirect taxation” are not for that reason alone excluded from those which may be exacted under [section 92(9)]. On the other hand, the last mentioned head authorizes licences for the purpose of raising a revenue, and does not, I think, contemplate licences which, in their primary function, are instrumentalities for the control of trade—even local or provincial trade. Here, such is the primary purpose of the legislation. The imposition of these levies is merely ancillary, having for its object the creation of a fund to defray the expenses of working the machinery of the substantive scheme for the regulation of trade.60

In other words, if the levy is found to have an indirect incidence, it will be found to be ultra vires the province or municipality, and therefore invalid, because the imposition of such a levy is not permitted under section 92(9) of the Constitution Act. However, if the levy is found to be “ancillary or adherent to a regulatory scheme,”61 meaning that the imposition of the levy is not the dominant purpose but rather an effect of the dominant purpose, then it will be held to be valid, according to the Supreme Court’s interpretation of section 92(9) in *Lawson*. A levy so characterized may be called a regulatory charge.

The question of the validity of a regulatory charge has reached the Supreme Court of Canada on a number of occasions, each time resulting in additional clarity. A review of the decisions reveals modest changes in the test and the tone of the courts.

The first notable case concerning regulatory charges and schemes is the decision of the BC Supreme Court in *Re: LaFarge Concrete Ltd. and Coquitlam*.62 The district of Coquitlam amended a bylaw to change the design of a soil removal licence fee from a flat rate of $50 per year to a volumetric rate of 15 cents per cubic yard of soil removed. LaFarge Concrete Ltd. argued that under the new scheme, the incidence of the charge would be passed on to customers. Consequently, the fee was alleged to be a form of an indirect tax, and therefore outside the municipality’s jurisdiction to impose.
The court found that the levy was an indirect tax yet still intra vires the municipality, and laid the foundation for the test for a regulatory scheme. The court stated, in part:

It appears to me that the principle that emerges from the authorities is that taxation which can be characterized as other than direct, and hence not falling within the ambit of provincial legislation by s. 92(2) of the B.N.A. Act [the Constitution Act, 1867], may still be within the scope of provincial competency if contemplated by, and fairly authorized under, another head such as here—s. 92(9). In my view, the key lies in the question as to what is the primary and real purpose, or pith and substance, of the legislation—is the levy or tax (whether direct or indirect by nature) merely ancillary, or adhesive, to the licensing scheme of regulating or prohibiting trade, or is it essentially a fiscal imposition, or taxation, under a form of disguise or colourable concept?63

The court undertook a pith and substance analysis to determine whether the bylaw was a form of indirect taxation that had been disguised, and was therefore invalid, or instead was ancillary to a regulatory scheme, and therefore valid. In reaching its decision, the court relied upon the following facts: (1) the citizens of Coquitlam had raised concerns about the removal of the gravel; (2) taxpayers were likely to bear the cost of road provision and regulatory expenses; and (3) the 15 cent fee imposed a heavy burden on permit holders and greatly increased their costs of doing business.64

The court concluded:

The bylaw being amended constitutes a complete and detailed code for the regulation of the gravel and soil extraction and removal trade, including the provision of the performance bonds and operation plans and surveys, obviously directed to safety and environmental control.65

This was sufficient to render the levy ancillary or incidental to the regulatory licensing of a trade or business.66

In 1993, a constitutional challenge reached the Supreme Court of Canada in Allard Contractors.67 In this case, the Supreme Court was asked to rule on the validity of a gravel removal fee.68 The appellants argued that there was nothing in the

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63 LaFarge Concrete, supra note 62, at paragraph 14, quoted in part in Allard Contractors, supra note 6, at paragraph 65. The term “colourability” or “colourable concept” is used to describe circumstances where a policy or legislative scheme aims to achieve an outcome that it would not otherwise be entitled to achieve.

64 LaFarge Concrete, supra note 62, at paragraph 17.


66 Supra note 62, at paragraph 18.

67 Allard Contractors, supra note 6.

68 The facts in Allard Contractors are similar to those described above in the LaFarge Concrete case, in the text following note 62.
applicable statute or bylaws that limited the amount of revenue from licensing to the actual costs of the regulatory scheme. The appellants’ objective in making this argument was to demonstrate that there was potential for surplus to be generated that went beyond the cost of the regulatory scheme, invalidating the regulatory charge. The court took note of the standard developed by the line of cases on indirect taxes, that the power of indirect taxation through a regulatory scheme can be used only to defray the costs of regulation. The court observed that

[w]hile Lawson . . . gave a reading to s. 92(9) which opened up the possibility for indirect taxation within that section, it did so in the context of language suggesting that the possibility would be limited to the recoupment of regulatory expenses.

The court then responded specifically to the appellants’ argument, stating:

[I]t is not for this Court to undertake a rigorous analysis of a municipality’s accounts. A surplus itself is not a problem so long as the municipalities made reasonable attempts to match the fee revenues with the administrative costs of the regulatory scheme, which is what occurred in this case. It is easy to imagine reasons for the existence of a so-called “surplus” at any given time. For example, changes in forecasted prices might lead to road repair being over-budgeted, or a municipality might choose not to repair a certain road in order to undertake more extensive repairs or reconstruct at a later date.

Recall that the Eurig test for user fees requires the existence of a nexus between the cost of the service and the fee, and a reasonable connection between the cost and the fee; in other words, the revenues generated by the fee should not exceed the costs of the service. To this point in our review of the case law on regulatory schemes, the term “nexus” has not been used; however, the same principle is emerging with respect to regulatory charges, in that they must be reasonably connected to the cost of the service. Thus, we see a blurring of the line between user fees and regulatory charges.

Westbank First Nation v. British Columbia Hydro and Power Authority is another case that came before the Supreme Court of Canada, involving the validity of a regulatory charge. In its decision, the court summarized the features of regulatory schemes and reformulated the previously identified characteristics into a test to identify a regulatory scheme. In this case, Westbank First Nation was attempting to assess and impose a levy on BC Hydro, an agent of the provincial Crown; however, section 125 of the Constitution Act essentially prohibits one level of government from taxing another level of government. If the levy were found to be a tax, it would

69 Allard Contractors, supra note 6, at paragraph 70.
70 Ibid., at paragraph 58.
71 Ibid.
72 Westbank, supra note 61.
be invalid because of the prohibition in section 125. However, if the levy were found not to be a tax, but rather some type of regulatory charge, then section 125 would be inapplicable, and Westbank First Nation could continue to impose the levy on BC Hydro.73

In its decision, the court summarized “[c]ertain indicia” that have been present when this Court has found a “regulatory scheme.” The factors to consider when identifying a regulatory scheme include the presence of: (1) a complete and detailed code of regulation; (2) a specific regulatory purpose which seeks to affect the behaviour of individuals; (3) actual or properly estimated costs of the regulation; and (4) a relationship between the regulation and the person being regulated, where the person being regulated either causes the need for regulation or benefits from it. This is only a list of factors to consider; not all of these factors must be present to find a regulatory scheme. Nor is this list of factors exhaustive.74

The most recent Supreme Court of Canada decision considering the issue of regulatory charges is 620 Connaught Ltd. v. Canada (Attorney General).75 The issue in this case was the validity of licence fees imposed under the authority of the minister of Canadian heritage on businesses wishing to sell liquor in Jasper National Park. The minister of Canadian heritage was permitted to charge only such fees as were provided for in the governing legislation (the Parks Canada Agency Act). If the licence fee were found to be a tax, it would be held to be ultra vires. The court concluded that the fee was in fact a regulatory charge and was validly imposed.76

There was no suggestion that the levy in this case was a user fee for the provision of government services or facilities. Rather, the question was whether in pith and substance the levy was a tax or a regulatory charge.77 Nevertheless, the court took the opportunity to discuss the distinction between a user fee and a regulatory charge. It affirmed that these forms of levies are still considered to be different, even though they may rely on similar elements. The court’s comments on this point are set out below:

It will be useful to first differentiate a regulatory charge from a user fee. A user fee, by definition, is a fee charged by the government for the use of government services or

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73 The court makes an interesting comment, ibid., at paragraph 22, concerning the establishment of the nexus requirement in Eurig: “This was a useful development, as it helps to distinguish between taxes and user fees, a subset of ‘regulatory charges’ [emphasis added].” The court cites no authority for describing a user fee as a subset of a regulatory charge. Notably, this characterization did not reappear in the court’s subsequent decision in 620 Connaught, supra note 16 (discussed below), where it would have been appropriate, so it is possible that the court has backed away from the concept that user fees are a subset of regulatory charges.

74 Westbank, supra note 61, at paragraph 24.

75 620 Connaught, supra note 16.

76 Ibid., at paragraph 3.

77 Ibid., at paragraph 17.
facilities. In the case of user fees, as stated by this Court in *Eurig*, there must be a clear nexus between the quantum charged and the cost to the government of providing such services or facilities. The fees charged cannot exceed the cost to the government of providing the services or facilities. However, “courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice” (see *Eurig*, at para. 22).

By contrast, regulatory charges are not imposed for the provision of specific services or facilities. They are normally imposed in relation to rights or privileges awarded or granted by the government. The funds collected under the regulatory scheme are used to finance the scheme or to alter individual behaviour. The fee may be set simply to defray the costs of the regulatory scheme. Or the fee may be set at a level designed to proscribe, prohibit or lend preference to a behaviour, e.g. “[a] per-tonne charge on landfill waste may be levied to discourage the production of waste [or a] deposit-refund charge on bottles may encourage recycling of glass or plastic bottles” (see *Westbank*, at para. 29).

After the court set aside the user fee concerns, it proceeded with the regulatory scheme analysis. First, it helpfully restated another consideration that was put forth in *Westbank*, that the government levy would be in pith and substance a tax if it was unconnected to any form of regulatory scheme. The court commented that “[t]his . . . consideration provides that even if the levy has all the other indicia of a tax, it will be a regulatory charge if it is connected to a regulatory scheme.”

This holding makes good sense since it removes the consideration of direct or indirect incidence of a tax from the initial stage of the analysis. The benefit of this approach is clear, given the murky test that must be applied to differentiate direct taxes from indirect taxes. The parameters of a regulatory scheme are, for the most part, clearer than the legal incidence test and less controversial than those attempting to define direct and indirect taxes. The overall order of the regulatory scheme test is therefore reversed: the four *Lawson* elements are still applied to determine whether a levy is a tax, and a fifth element is added, to determine whether there is an ancillary regulatory scheme. If there is no regulatory scheme and the levy is found to be a tax, then a direct and indirect incidence analysis will likely follow.

In *620 Connaught*, the court restated the regulatory scheme analysis set out in *Westbank*. First, the court must consider whether the levy has the attributes of a tax (pursuant to the four *Lawson* criteria). Second, the court must consider whether the levy is connected to a regulatory scheme—an analysis that requires an initial evaluation of the relevant regulatory scheme to determine whether it is sufficient, followed by an examination of the relationship between the levy and the regulatory scheme.

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78 Ibid., at paragraphs 19-20.
79 Ibid., at paragraph 24.
80 Alarie and Bird, supra note 59, at 12.
In application, the court found that the fees for business licences required by the minister of Canadian heritage for the sale of liquor in Jasper National Park met all the attributes of a tax. The court also found that the four criteria for a regulatory scheme, according to Westbank, were met.82

Another distinction, which was not carefully drawn out by the court but which becomes apparent when comparing user fees and regulatory charges, is the court’s treatment of the fourth element of the Lawson test, that to be a tax, the levy must be intended for a public purpose. In the user fee context, we have suggested that this is a significant element in distinguishing user fees from taxes; and accordingly, we have proposed a reordering of the Lawson and Eurig tests to first consider whether the revenues generated from a particular user fee are accounted for in general revenues or in a specific revenue fund. In 620 Connaught, the court did not consider the Lawson elements individually but rather stated, “[t]hese characteristics [referring to the Lawson elements] will likely apply to most government levies.”83 It is unclear what effect this could have on the public purpose element of Lawson, but a prudent argument would be to consider both the general public purpose and the revenue accounting when examining this element.

Returning to the regulatory scheme analysis, the second step as described in 620 Connaught was to discern the relationship between the business licence fees and the regulation of Jasper National Park. The court stated:

In order for a regulatory charge intended to defray the costs of a regulatory scheme to be “connected,” the fee revenue must be tied to the costs of the regulatory scheme.84

The regulatory charge may reflect two separate intentions, as the court initially described when distinguishing a regulatory charge from a user fee:

The fee may be set simply to defray the costs of the regulatory scheme. Or the fee may be set at a level designed to proscribe, prohibit or lend preference to a behaviour.85

The first intention, to match the costs of regulation, seems analogous to there being a nexus between the fee and the cost of the service. The second intention, whether expressed separately or in tandem with the first, opens the door to increased revenue beyond the cost of the service if it is meant to alter behaviour. This is a significant shift in the jurisprudence, further differentiating regulatory charges from user fees, and is discussed in the next section.

82 Ibid., at paragraph 37.
83 Ibid., at paragraph 23.
84 Ibid., at paragraph 38.
85 Ibid., at paragraph 20 (emphasis added).
UNRESOLVED ISSUES CONCERNING USER FEES AND REGULATORY CHARGES

Two main concerns arise from the case law on regulatory charges. First, a theme that emerges in the discussion above is that there are shared features between user fees and regulatory charges, and it can be hard to distinguish definitively between these two types of levies. For example, a levy imposed on landfill waste may be analogized to a levy imposed on the use of a recreation facility and appear to be a user fee; alternatively, as a “charge . . . levied to discourage the production of waste,” such a levy may be viewed as a regulatory charge. Unfortunately, the Supreme Court of Canada has not provided clarity on this issue. There are, however, two ways to resolve this quandary. The first is to look to the municipality’s authorizing legislation to determine whether it specifies that a particular levy is a user fee or a regulatory charge. The danger in choosing this approach is that it relies entirely on the literal wording of the law, rather than the underlying purpose of the levy. The second approach is to apply a pith and substance analysis, the intent of which is to assess the purpose of the levy, beyond the wording of the statute or bylaw. Given that the latter approach was the one adopted by the Supreme Court in Connaught, this appears to be the preferred method of analysis.

The second concern that arises is the introduction of a behavioural modification objective underlying regulatory charges. It is suggested that where a regulatory charge has such an objective, the charge is not necessarily tied to the cost of the good or service being provided, a criterion established by Westbank. However, this objective seems to imply that such a regulatory charge would be found to be an indirect tax, making it ultra vires provinces, and by extension, municipalities. We elaborate on these concerns in the discussion that follows.

What Is the Distinction Between a User Fee and a Regulatory Charge?

To date, no case has been brought before a court in which the court has been asked to decide whether a particular levy is a user fee or a regulatory charge—although in Canadian Wireless Telecommunications it was argued that were the court to find that the levy was not a user fee, in the alternative, the levy was a regulatory charge. Such a challenge may be raised, for example, if the municipality has authority to impose user fees but not regulatory charges, and an individual or business that is unhappy paying the levy seeks to argue that the user fee is a regulatory charge and therefore ultra vires. As discussed above, there are two approaches that a court may use in attempting to distinguish a user fee from a regulatory charge: (1) to examine the authorizing legislation; or (2) to conduct a pith and substance analysis. Each of these approaches is described in more detail below.

86 See supra note 78 and the accompanying text.
**Authorizing Legislation**

“Authorizing legislation” in this context refers to both provincial legislation (likely found in statutes with titles such as the Community Charter or the Municipal Act) and municipal bylaws. The provincial legislation delegates specific powers to municipalities and “authorizes” their exercises of those powers. A municipality may implement only such bylaws as are based on the authorities provided. The bylaws, in turn, authorize policy decisions made by municipal council. Both levels of law will be relevant to any discussion on authorizing legislation. In addition, from the municipal perspective, both levels of law certainly require scrutiny at the beginning of the policy design stage, to ensure that the municipal council is permitted to pursue the proposed course of action.

Our argument is that the authorizing legislation informs the type of levying scheme that is developed. That is, the specific words in the bylaw or the provincial law, as applicable, are the basis on which the parties arguing before the court have suggested the appropriate tests to be applied, and, in turn, those words form the basis for the court’s application of either the user fee test or the regulatory charge test. While this argument may seem simplistic (of course a municipality should pursue only what it is authorized to do by law), one must bear in mind the similarities in the definitions of user fees and regulatory charges. The similarities are such that in some cases, either test could be applied. It could be suggested that, in some circumstances, rather than the authorizing legislation informing the interpretation of the levy, the details of the levy are informing the interpretation of the authorizing legislation. Four cases demonstrate how the wording of the levy informs the interpretation of the legislation.

In *620 Connaught*, the relevant legislation provided that the minister of Canadian heritage was authorized to “fix the fees or the manner of calculating fees in respect of products, rights or privileges provided by the [Parks Canada] Agency.”87 The Supreme Court specified in its definition that “regulatory charges are not imposed for the provision of specific services or facilities. They are normally imposed in relation to rights or privileges awarded or granted by the government.”88 A liquor licence was perceived to be a right or privilege, rather than a service provided by government. Neither party in this case made an argument that the “fee” that was authorized was in fact a user fee.89 Notably, the wording in the legislation is reflected in the definition of the regulatory charge. Additionally, it should be noted that the critical point may not be simply whether “fee” or “charge” is the term found in the authorizing legislation, but that further scrutiny of the law is required to determine the appropriate test.

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87 Ibid., at paragraph 1 (emphasis added), quoting from the Parks Canada Agency Act, SC 1998, c. 31, section 24.
88 Ibid., at paragraph 20 (emphasis added).
89 Ibid., at paragraph 17.
Additional support for this hypothesis is found in the decision rendered in Kirkpatrick v. Maple Ridge. In this case, the Supreme Court of Canada considered the constitutionality of a volumetric fee on the removal of sand and gravel. The enabling bylaw granted the power to “fix a fee for the permit,” and because the fee was volumetric and therefore varied with the amount of soil removed, the Supreme Court disallowed the bylaw. The fixed fee requirement could only be applicable to a flat fee; a variable fee was not permitted. Consequently, the bylaw was struck down.

After the decision in Maple Ridge, attempts were made to reconfigure the municipal bylaw to allow for volumetric fees, and the bylaw at issue was amended. The amended bylaw was ultimately found to grant the appropriate variable-rate volumetric permit fee, which was then considered by the Supreme Court in Allard Contractors. This fee was considered to be a permit fee, analogous to a licence fee under section 92(9) of the Constitution Act. This series of amendments demonstrates the necessity of careful examination of governing legislation.

A more recent example is the 2008 BC Court of Appeal decision in Greater Vancouver Sewerage and Drainage District v. Ecowaste Industries Ltd. The court in this case considered the validity of a waste disposal scheme and whether a disposal fee was a regulatory charge or an unconstitutional tax. The authorizing legislation provided:

Whereas . . .

C. Greater Vancouver Sewerage and Drainage District is operating under a Solid Waste Management Plan which defines a regulatory system for the management of all privately operated municipal solid waste and Recyclable Material operations. The goal of the regulatory scheme is to ensure proper management of privately operated facilities by specifying operating requirements so as to protect the environment and public health, to protect the region’s land base in accordance with the host municipality’s zoning and land use policies, to ensure that regional and municipal facilities and private facilities operate to equivalent standards and to achieve the objectives of the Solid Waste Management Plan.

Given this context, the court delved into the regulatory scheme analysis from Westbank and 620 Connaught and did not consider the disposal fee (despite its name) under the user fee analysis, but rather considered it as a regulatory charge.

The 2001 Ontario Court of Appeal decision in Urban Outdoor Trans Ad demonstrates how a court may choose to deal with the interpretation of authorizing legislation. In this case, the court found that the Municipal Act authorized the annual fee in place, levied against sign companies for each third-party billboard sign,
at a cost of $100 per face for ground-mounted signs and $200 per face for roof-mounted signs. The Municipal Act authorized both fees and charges. Urban Outdoor Trans Ad (the plaintiff) argued that the levy was an indirect tax and therefore the municipality was unauthorized to levy the tax. The city argued that the levy was a fee and was therefore within the authority of the municipality, pursuant to the governing legislation. While the term “user fee” was not explicitly used, the court considered the Eurig analysis and held that the levy was indeed a fee. Urban Outdoor Trans Ad demonstrates a possible approach that a court could take to determine whether a particular levy is a user fee or a regulatory charge, by only applying the test that is suggested by the parties—in this case, the Lawson-Eurig test for a user fee—though arguably, given the governing legislation, the regulatory charge test also could have been applied.

With respect to an existing levy, or where a levy is being proposed but it is unclear as to whether it is a user fee or a regulatory charge, courts will have to decide which test to apply to determine the validity of the levy. Since, as noted above, there is no jurisprudence on the characterization of a particular levy as either a user fee or a regulatory charge, opinions must be discerned from the existing case law as to how a court may proceed with this analysis. As discussed above, in several cases, the wording in the authorizing legislation has guided the court as to the test that should apply:

- In 620 Connaught, the court used identical wording from the legislation imposing the regulatory charge to inform the definition of a regulatory charge.
- In Maple Ridge, the gravel removal bylaw was held to be invalid because it was based on a volumetric amount rather than a flat fee.
- Lastly, in Urban Outdoor Trans Ad, where both a fee and a charge were authorized by the provincial legislation, the court applied the user fee test.

**Pith and Substance Analysis**

It has been established that user fees and regulatory charges are indeed different forms of levies, and that while they have been described in case law, the courts have not yet dealt with a case where it was necessary to establish a means of distinguishing the one form from the other. As discussed above, one strategy to determine which test should be applied is to carefully review the authorizing legislation. However, the authorizing legislation may not be clear as to the nature of the levy, as in 620 Connaught, or it may authorize both fees and charges, as in Urban Outdoor Trans Ad.

As suggested above, in a situation where a court is faced with deciding which test to apply, an alternative method that the court may use is a pith and substance analysis. In the discussion that follows, we will attempt to forecast the types of challenges that may be anticipated by municipalities and then proceed to describe the pith and substance analysis process. We will conclude by discussing the application

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95 Urban Outdoor Trans Ad, supra note 49, at paragraph 12.
of pith and substance analysis in the case law previously reviewed and discerning the features that the courts may rely on for a user fee and regulatory charge pith and substance analysis.

It is possible to forecast circumstances that may arise in which a user fee and a regulatory charge must be distinguished by a court. In addition to the type of attack that has been seen in the jurisprudence to this point—that is, that the levy is ultra vires—future challenges may come in the form of insufficient authorizing legislation, not meeting the requirements of the test, or not meeting an aspect of either test. Both user fees and regulatory charges are vulnerable to attacks on costing, since this is a key feature of the tests although (as will be discussed below) the threshold to be met is not significant. It is also possible that a challenge may involve arguing that a user fee is a regulatory charge, but does not have the authorizing legislation to permit that possibility. Given the decision in 620 Connaught, which arguably authorizes two forms of regulatory charges, for either revenue-raising or behaviour modification purposes, a court will not likely be satisfied with simply reading the authorizing legislation and may also consider, in addition to a careful reading of that legislation, a pith and substance analysis.

A pith and substance analysis is a legal interpretation technique, often used in constitutional analysis. The technique was described as follows in the dissenting reasons in Ontario Home Builders’ Association v. York Region Board of Education:

The identification of the pith and substance of a law involves an analytical process conducted according to the approach carefully described by Sopinka J. in R. v Morgentaler, [1993] 3 S.C.R. 463, at pp. 481-88. As he explained, at p. 482, the analysis “necessarily starts with looking at the legislation itself, in order to determine its legal effect,” but courts also “will look beyond the direct legal effects to inquire into the social or economic purposes which the statute was enacted to achieve,” its background and the circumstances surrounding its enactment . . . and, in appropriate cases, will consider evidence of the second form of ‘effect,’ the actual or predicted practical effect of the legislation” (p. 483).96

This passage points to a close reading of the legislation to determine the legal effect of a law, but also describes a second level of analysis. This second level refers to the incidence of the legislation and the purposes it was intended to achieve. It is likely that a court would undertake both a careful reading of the legislative authority and a pith and substance analysis, if such analysis is a method that the court determines to be appropriate.

While not previously used in the context of distinguishing between user fees and regulatory charges, the pith and substance analysis has been applied in the broader context of the user fee case law. For example, as discussed above, this approach was used by the BC Court of Appeal in LaFarge Concrete, where the court considered

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96 Ontario Home Builders’ Association, supra note 65, at paragraph 117.
whether a volumetric fee on gravel was ancillary to a regulatory scheme or a form of taxation disguised as a regulatory scheme. The court stated:

[T]he key lies in the question as to what is the primary and real purpose, or pith and substance, of the legislation—is the levy or tax (whether direct or indirect by nature) merely ancillary, or adhesive, to the licensing scheme of regulating or prohibiting a trade, or is it essentially a fiscal imposition, or taxation, under a form of disguise or a colourable concept?97

In order to reach a decision in LaFarge Concrete, the court examined the rationale for the imposition of the fee. One of the main reasons for the fee increase was that a new road was required for the trucks hauling gravel to be diverted around the neighbourhood.98 The court also considered the nature of the legislation, in that a detailed regulatory scheme had been enacted, which involved safety and environmental controls.99 As a result of these features, the court determined that the levy was ancillary to the regulatory scheme.100

The Supreme Court of Canada strongly indicated in 620 Connaught that the pith and substance analysis may be employed to distinguish between user fees and regulatory charges, as demonstrated by the court’s use of this method to distinguish between a tax and a regulatory charge. The court stated:

In summary, if there is a regulatory scheme and it is found to be relevant to the person being regulated under step one, and there is a relationship between the levy and the scheme itself under step two, the pith and substance of the levy will be a regulatory charge and not a tax. In other words, the dominant features of the levy will be its regulatory characteristics.101

The language of the Supreme Court in 620 Connaught suggests that the test to determine whether a regulatory scheme exists is the test that should be applied to determine whether the levy is in pith and substance a regulatory scheme.

What Is the Difference Between a Regulatory Scheme and a Behaviour Modification Objective?

The decision in 620 Connaught raises the question as to whether and in what circumstances a levy may be exempt from the reasonable connection or nexus requirement, found as a testable element for both user fees and regulatory charges. Pursuant to

97 LaFarge Concrete, supra note 62, at paragraph 14.
98 Ibid., at paragraph 17.
99 Ibid., at paragraph 18.
100 Ibid.
the decision in *620 Connaught*, the limitation on revenue to the cost of the service appears to be lifted when a regulatory charge is implemented to alter behaviour. However, our view is that this exemption is likely available only in respect of a federal regulatory scheme. This is a recent development in the case law, arising from *620 Connaught* (though alluded to in *Westbank*), and it has yet to be challenged or interpreted. Here we will examine more closely the court’s reasons for the exemption, as set out in *620 Connaught*, and then consider the rationale behind limiting the exemption to levies imposed under the authority of the federal government.

As discussed above, the issue before the Supreme Court in *620 Connaught* was whether liquor licence fees charged to businesses operating in Jasper National Park were part of a regulatory scheme or instead a tax. If the levy was found to be a regulatory charge, it would be within the jurisdiction of the minister of Canadian heritage. The court’s comments extend beyond the constitutional distribution of regulatory fees and taxes, and include a section distinguishing between the application of regulatory charges and user fees. With respect to regulatory charges, Rothstein J, writing for the court, stated:

> [R]egulatory charges are not imposed for the provision of specific services or facilities. They are normally imposed in relation to rights or privileges awarded or granted by the government. The funds collected under the regulatory scheme are used to finance the scheme or to alter individual behaviour. The fee may be set simply to defray the costs of the regulatory scheme. *Or the fee may be set at a level designed to proscribe, prohibit or lend preference to a behaviour.*

This is a significant clarification of the case law. The Supreme Court not only suggested, but nearly advocated, the possibility that a regulatory charge may be set at a level to influence behaviour, rather than measured by the standard that is the test for a user fee and for a different type of regulatory charge, which is intended to defray the costs of the regulatory scheme. The court’s phrasing clearly suggests that there are two types of regulatory schemes, one in which costs are defrayed for the administration of a service (“revenue raising”) and a second type that attempts to influence behaviour through financial incentives (“behaviour modifying”).

Two other paragraphs in *620 Connaught* further this proposition. First, the court reinforced its position when Rothstein J stated:

> Whether the costs of the regulatory scheme are a limit on the fee revenue generated, where the purpose of the regulatory charge is to proscribe, prohibit or lend preference to certain conduct, is not an issue before the Court in this case, and it is not necessary to answer that question here.

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102 Ibid., at paragraph 20 (emphasis added).

103 Ibid., at paragraph 48.
Second, the court cited *Westbank* directly when describing the test for regulatory fees:

This is only a list of factors to consider; not all of these factors must be present to find a regulatory scheme. Nor is this list of factors exhaustive.\(^{104}\)

*620 Connaught* demonstrates that the court is opening a door for regulatory schemes to have a charging component that is not tied to the cost of the service, though the contours of such a scheme are yet to be decided. It would be wise to consider that the second step in the regulatory charge test is titled “the relationship between the licence fees and the regulation.” The title suggests that while the costs do not have to be related to the charges, a “reasonable relationship” is still required in which the regulator would likely have to demonstrate how the behaviour-modifying regulatory charges are intended to modify behaviour.

It is possible, however, that there is a limitation on this behaviour modification regulatory scheme. This limitation comes by way of constitutional jurisdiction and suggests that the scheme is available only to federal regulatory authorities. Referring back to the basis of the constitutional discussion, the federal government is allowed to charge both direct and indirect taxes, pursuant to section 91(3) of the Constitution Act. However, the provinces are only allowed to charge direct taxes, pursuant to section 92(2), and licence fees, pursuant to section 92(9). If the behaviour modification regulatory scheme were to be available to the provinces, it would have the potential to allow indirect taxation without the limitation of cost recovery. Limiting the amount that could be recovered was the rationale for the origin of the cost-recovery principle, as the Supreme Court sought to find a way for sections 92(2) and (9) to interact without creating unwarranted extensions. Section 92(2) allows for revenues to be raised without limitation to cost recovery. Section 92(9) allows cost-recovery methods for indirect taxation, if ancillary to a regulatory scheme. However, if section 92(9) were to be read so as to allow behaviour-modifying regulatory schemes, it could render section 92(2) redundant since the same privileges would be available to both direct and indirect taxation.

This constitutional quandary was contemplated by La Forest in the following passage from *The Allocation of Taxing Power Under the Canadian Constitution*, which was cited with approval by Iacobucci J writing for the majority in *Ontario Home Builders’ Association*:

If section 92(9) is limited to direct taxation, it adds nothing to section 92(2), for there is no doubt that direct taxation may be raised under section 92(2) even though it is framed in the form of a licence. On the other hand if section 92(9) permits a province to levy indirect taxation by means of a licence, there would seem to be no limit on

\(^{104}\) Ibid., at paragraph 26, citing *Westbank*, supra note 61, at paragraph 24.
provincial taxing power (there being no restriction on the types of licences falling within the section) so long as a tax is framed in the form of licensing provisions. Yet the British North America Act [the Constitution Act, 1867] appears to contemplate that indirect taxation should be within the sole competence of the federal Parliament.  

It therefore appears that to avoid the unwarranted extension to the construction that is created by the behaviour-modifying regulatory scheme, the jurisdiction of provinces and the authorities delegated to municipalities should be limited to cost-recovery regulatory schemes. A potential counterargument to this point is that the behaviour modification regulatory scheme still requires a relationship to be established between the charge and the regulatory scheme. So while a behaviour modification regulatory scheme is likely not limited to cost recovery, there are limitations in place in terms of justifying the relationship. It is likely to be difficult to distinguish this costing mechanism from indirect taxation, which may have an alternative purpose or effect that is invalid, though on the face it appears to be valid (the type of measure referred to as a “colourable scheme”).

In summary, the Supreme Court in Connaught appears to clearly open a door for behaviour-modifying regulatory schemes. This type of scheme sets aside the cost-recovery foundation of the user fee test and the regulatory charge test described in Westbank, and appears to allow for charging so long as a relationship may be established with the regulatory scheme. It is likely that this charging will require some evidence as to the consideration and reasonability of the charge. Additionally, a behaviour-modifying regulatory scheme may be available only to the federal government, since it could be considered that such a scheme imposes an unwarranted extension on the constitutional interpretation of sections 92(2) and (9). With that disclaimer, a bold municipality could certainly attempt to implement this type of regulatory scheme as a test case.

CONCLUSION

Municipalities are increasingly turning to user fees as an alternative revenue source. The economic literature advocates a “whenever possible, charge” approach, endorsing user fees for many municipal goods and services. The benefits of user fees, from the economic perspective, are that constituents know the value of the good or service they are consuming and those who most value the goods and services will pay to use them. In this article, we have sought to add to the general understanding of user fees, well established in the economic literature, by providing an outline of the legal tests for taxes, user fees, and regulatory charges, so as to distinguish between these three revenue-generating instruments. This information can be used to inform the

design of user fees so as to survey or avoid a legal challenge. As we have traced through some examples of applying these tests, we have set out some concerns regarding their application, and provided our views on how these concerns could be reconciled. In practical terms, however, municipalities are likely to continue to struggle with uncertainty in their user fee policy until the law is clarified.
Trust Residence After Garron: Provincial Considerations

H. Michael Dolson*

Précis

Les décisions récentes dans l’arrêt Garron et l’adoption du critère de gestion centrale et de contrôle pour déterminer le lieu de résidence d’une fiducie pourraient avoir une incidence importante sur la planification fiscale entre provinces, ne serait-ce que pour le projet de vérification de l’ARC en résultant qui vise les fiducies résidentes de l’Alberta. Le présent article examine les fondements théoriques de l’instauration d’un impôt provincial sur le revenu de fiducie basé sur le lieu de résidence et propose au moins une solution de rechange acceptable, mais imparfaite. L’article examine ensuite le thème du centre de gestion et de contrôle des fiducies et traite de la façon dont ce critère pourrait être appliqué dans des causes futures.

Abstract

The recent decisions in Garron and the adoption of the central management and control test for trust residence may have a material impact on interprovincial tax planning, if for no other reason than the resulting CRA audit project targeting Alberta-resident trusts. This article examines the theoretical basis for the imposition of residence-based provincial income taxes on trust income, revealing at least one acceptable but nevertheless flawed alternative. This article then turns to an examination of central management and control in the context of trusts, and discusses how this test could be applied in future cases.

Keywords: TRUSTS ◆ RESIDENCE ◆ PROVINCIAL TAXES

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* Of Felesky Flynn LLP, Edmonton (e-mail: mdolson@felesky.com). I would like to thank Jon D. Gilbert and Timothy P. Kirby of Felesky Flynn LLP, Edmonton, and Tim Edgar of Osgoode Hall Law School and a co-editor of this journal, for their comments on earlier drafts of this article. Any remaining errors or omissions are solely my own.
INTRODUCTION

Under provincial income tax legislation personal trusts are generally taxed on the basis of the trust’s province of residence; therefore, residence is a key determinant of the total tax obligations of a personal trust. Although the taxation of business income earned by personal trusts is source-based, the residence-based taxation of property income is of paramount importance; assuming that personal trusts are as likely as, or less likely than, individuals to carry on a business directly,\(^1\) it is relatively unlikely that a personal trust would earn significant business income.\(^2\) In most instances, the source of this business income will be in the same province as the trust’s place of residence. Consequently, the rate of provincial income tax applied to the income of a personal trust will, in substantially all cases, depend entirely on the residence of the trust.

In my view, a review of the literature and jurisprudence discussed in this article allows the following conclusions to be drawn with respect to the residence of trusts for the purposes of provincial income tax:

- Although personal trusts are deemed to be individuals for the purposes of the Income Tax Act (Canada) and its provincial equivalents,\(^3\) the policy considerations relating to the place of residence of natural persons are not the same as

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\(^1\) Where a personal trust carries on a business, the trustees will likely be treated as carrying on the business of the trust as principals: Smith v. Anderson (1880), 15 Ch. D. 247, at 275-76 (CA).

\(^2\) If a personal trust carries on a business, the trustees may therefore be exposed personally to the business liabilities of the trust. Such exposure serves as a significant disincentive to the use of a personal trust as a business vehicle. In the income tax context, the personal liability of trustees is avoided by subsection 104(2) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Subsection 104(2) provides that the income of the trustee is not affected by the characterization of a trust as an individual, although subsection 159(3) could impose personal liability on a trustee who makes distributions of trust property at a time when the trust is liable for tax. (Unless otherwise stated, statutory references in this article are to the Act.)

\(^3\) The Canada Revenue Agency (CRA) does not publish T3 statistics similar to its published T1 and T2 statistics. In 2009, only 7.6 percent of individuals who filed T1 returns reported business income, excluding partnership income, and the average per-return business income was $12,135: Canada, T1 Final Statistics—2011 Edition (2009 tax year) (Ottawa: Canada Revenue Agency, 2011), at final table 3 (www.cra-arc.gc.ca/gncy/stts/gb09/pst/fnl/html/tbl3-eng.html).

Subsection 104(2) of the Act; see infra notes 34 and 36 for the equivalent provincial legislation.
the policy considerations relating to the residence of personal trusts, which are more analogous to corporations.

- While the central management and control test for residence may be appropriate in the corporate context, it is not clear that this is an appropriate test for determining the residence of a personal trust. The absence of the source-based taxation regime that applies to corporations places significant pressure on the test for residence that is selected, and the central management and control test is prone to manipulation. A potential alternative would be a test for trust residence that looked to the residence of the settlor (similar to the test currently used for non-resident trusts in section 94 of the Act), although there would be technical issues associated with such a test.

- The central management and control test, as developed by the jurisprudence to date, is not a particularly aggressive test for determining the residence of a personal trust, notwithstanding that tax administrators may attempt to apply the test in this manner. Establishing central management and control of a trust in a particular province should not require anything more than ensuring that significant decisions relating to the property of the trust are made in that province, without regard for the residence of the decision maker.

This article is divided into two parts. In the first part, I review the basis for the imposition of residence-based income taxes on personal trusts by the provinces, and consider potential alternatives. In the second part, I review the rules governing the tax residence of trusts, discuss the recent jurisprudence, and offer some thoughts on how the central management and control test should be applied.

**PROVINCIAL INCOME TAXES—POLICY AND EFFICIENCY**

The reason that the provinces impose personal income taxes, including the income taxes imposed on a personal trust, is obvious: provincial governments require the funds. Pursuant to section 92 of the Constitution Act, 1867, the provinces have responsibility for some of the most expensive functions of government, including health care, education, and the administration of justice. In order to fund these

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4 For a discussion of the problems created by the central management and control test and its susceptibility to manipulation in the corporate context, see Brian J. Arnold, “A Tax Policy Perspective on Corporate Residence” (2003) 51:4 Canadian Tax Journal 1559-66. In the international context, the central management and control test is replaced (except for the purposes of regulation 5907(11)) by Canada’s tax treaties and subsection 250(5) of the Act, which usually resolve conflicts relating to corporate residence on the basis of the place of incorporation. Ultimately, for a multinational corporation operating in Canada, the source-based taxation of business profits, the enactment of the foreign accrual property income regime, and the decision not to tax business profits earned by non-resident subsidiaries significantly reduce the impact of residence in determining the corporation’s liability for Canadian tax.

5 Constitution Act, 1867, 30 & 31 Vict., c. 3.
public goods, the provinces are entitled to impose direct taxes and to borrow money on their own credit.\(^6\) Personal income tax is a direct tax that generates significant revenues.

In aggregate, in 2009 personal income taxes accounted for 30.22 percent of own-source provincial revenues (revenues excluding transfers from other levels of government).\(^7\) The degree of reliance on provincial income taxes varies from province to province; for example, Alberta is more reliant on personal and corporate income taxes than Saskatchewan, which (like the other eight provinces) supplements its revenues from income taxes by imposing a general sales tax.

It is generally accepted that provincial personal income taxes are less efficient than federal personal income taxes (as measured by the marginal cost of public funds), and are also less efficient than a general sales tax, particularly a value-added tax.\(^8\) Provincial taxes also create negative externalities and may lead to non-optimal policies, to the extent that provinces compete with one another in seeking to attract mobile labour and capital.\(^9\) These externalities and non-optimal policies may include tax exporting, the use of regressive taxes that fall on the non-mobile poor and the elderly, and beggar-thy-neighbour tax competition.\(^10\)

The potential negative externalities caused by provincial taxation can be mitigated by ceding the right to tax mobile tax bases, such as income, to the federal government, with the provinces taxing less mobile bases, such as consumption or real property.\(^11\) This was the recommendation of the Carter commission with respect to corporate income taxes—specifically, that the federal government provide sales tax room to the provinces in exchange for exclusive federal use of the corporate income tax.\(^12\)

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\(^6\) Section 92(2) of the Constitution Act, 1867. The term “direct tax” (borrowed from John Stuart Mill’s *Principles of Political Economy*) is intended to capture taxes that are ultimately borne by the person on whom the tax is imposed: *Ontario Home Builders’ Association v. York Region Board of Education*, [1996] 2 SCR 929, at paragraphs 34-35. Examples include personal income taxes, sales taxes, and property taxes.


income tax.\textsuperscript{12} If the provinces must have access to any base that they can tax directly, it is preferable that they impose tax using residence-based or partially residence-based systems, since this should at least prevent tax exportation.\textsuperscript{13}

As discussed in further detail below, all of the provinces have in fact adopted a partially residence-based system for taxing income, with property and employment income being taxed on the basis of residence and business income being taxed on the basis of source. This is a logical choice since, in this respect, the provincial system generally mirrors the system adopted at the federal level: while the Act generally imposes tax on the basis of residence, source-based taxation is used for active businesses carried on outside Canada through foreign affiliates and businesses carried on in Canada by non-residents. Moreover, to the extent that a partially residence-based system prevents tax exportation, it has the potential to be more efficient than systems that do not.

**Policy Considerations—Individuals**

Notwithstanding that the system adopted may have been a logical choice, it is not unreasonable to question whether a residence-based system for personal income tax remains appropriate in an age of increased labour mobility. While many individual taxpayers will have all of their sources of income in the province in which they are resident, it is not uncommon for individuals to be employed in provinces in which they are not resident for income tax purposes, as a result of increasing regional economic disparities and relatively low-cost (or employer-subsidized) travel. Is it appropriate that these individuals are taxed in their province of residence instead of their province of employment?

The problem with the current system can be illustrated by a simple example. An individual employed in Fort McMurray, Alberta maintains a home in Kelowna, British Columbia, where her family lives and to which she returns during the one or two weeks a month when she is not working. The individual will likely be considered a resident of British Columbia for income tax purposes and, under the partially residence-based system, will pay personal income tax in British Columbia and not in Alberta. Since Alberta does not levy a general sales tax, the Alberta government will not realize any revenue from the individual’s consumption of goods and services during the time that she is living and working in the province.

This result would traditionally be justified on the basis that individuals can be assumed to derive more benefits from public goods in the place where they are

\textsuperscript{12} Canada, *Report of the Royal Commission on Taxation*, vol. 6 (Ottawa: Queen’s Printer, 1966), at 214.

\textsuperscript{13} Inman and Rubinfeld, supra note 10, at 318–19. If it is accepted that non-exportation was a reason for the provinces being limited to direct taxation by the Constitution Act, 1867, as Peter Hogg has suggested (Peter W. Hogg, *Constitutional Law of Canada*, 3d ed. (Toronto: Carswell, 1992), at section 30.2(b)), then the adoption of a residence-based tax system by the provinces also furthers constitutional principles.
resident. However, an examination of the benefits received does not necessarily support this conclusion:

- The individual derives benefits from the administration of justice in both British Columbia and Alberta, since her property and physical safety are preserved at the expense of both provinces at various times.
- The individual derives significant benefits from her employment in Alberta. Those benefits are dependent on infrastructure financed by Alberta taxpayers and are also likely to be dependent on natural resources vested in her majesty in right of Alberta.
- If the individual has children, and those children remain in British Columbia, she will derive benefits from the free public education made available to them at the expense of BC taxpayers. The individual’s ability to earn employment income may also be attributable to public education or publicly subsidized post-secondary education, which may have been provided at the expense of the BC taxpayers.
- The individual and her family derive benefits from the infrastructure financed by the BC taxpayers, as well as municipal services financed by transfers from the BC government.
- The individual may require access to provincially funded public health care in either Alberta or British Columbia, and her family will receive this benefit in British Columbia. However, it is important to note that nearly half of lifetime health-care expenses are incurred after age 65, and that proportion will likely increase if the individual survives past age 85. As a result, it is possible that the bulk of the individual’s benefits from public health care will be received in a province in which the individual is not currently resident or employed.
- The individual may derive benefits from social services provided to senior citizens, but it is not known which province, if any, will be required to fund those services.

Whether this is an appropriate result may depend on how one weighs the various benefits. If emphasis is placed on the benefits from employment that are dependent on public goods provided by Alberta, then it does not seem appropriate that Alberta does not tax the income earned in Alberta or the consumption occurring in Alberta. However, if emphasis is placed on the costly benefits from education, infrastructure, and health care that are more likely to be funded by British Columbia, perhaps the result is appropriate.

The all-or-nothing outcome of residence-based taxation of employment and property income favours a shift toward consumption taxes by labour-importing provinces like Alberta. This would permit the labour-importing provinces to raise revenue commensurate with the benefits they provide.\textsuperscript{16} A shift to value-added taxes would also increase the relative efficiency of the provincial tax system, since the distortions caused by the decreased return on investment or labour resulting from the imposition of provincial income taxes would then be reduced.

The all-or-nothing outcome also favours a shift toward source-based provincial income taxation, in addition to other persuasive arguments in support of source-based taxation in the 21st century.\textsuperscript{17} While such a shift may result in increased opportunities for harmful tax competition, it would have the effect of eliminating the tax benefits of interprovincial planning involving the use of trusts, as discussed below.

**Policy Considerations—Trusts**

*Conceptualizing the Trust and Alternatives for Taxation*

Notwithstanding that subsection 104(2) of the Act deems a trust to be an individual in respect of the property of the trust, individuals are not necessarily a good tax policy analogy for personal trusts. The practical purpose of subsection 104(2) is to cause personal trusts to be taxed at individual income tax rates; as a legal abstraction, from a tax policy perspective a personal trust has more in common with investment vehicles such as corporations and partnerships than with individuals.

Robert Couzin has stated that the English common law conceptualizes a corporation as a “fiction or abstraction with a purely metaphysical existence.”\textsuperscript{18} This characterization can also be applied to a trust. Unlike an individual, but like a corporation, a trust is not a physical being, and depends on its constating documents, the laws of equity, and provincial statutes for its metaphysical existence. However, in contrast to a corporation, a trust is not a legal person with its own rights, but is instead an equitable or contractual relationship between the settlor, the beneficiaries, and the trustees, pursuant to which the trustees exercise rights on behalf of the beneficiaries.\textsuperscript{19}


\textsuperscript{19} The status of a trust as a non-entity may explain why it is necessary to resort to the relatively complex deeming of a trust to be an individual in respect of its property in subsection 104(2), instead of simply deeming a trust to be a “person” within the meaning of the definition in
Since a personal trust is not a legal entity, reasonable arguments could be raised against imposing income tax on the personal trust as an entity.\textsuperscript{20} Tax could instead be imposed on the beneficiaries of the trust to the extent of their vested interests or on the basis of interests in the trust created by deeming rules, with income being computed as if the trust were an entity. This is similar to the manner in which tax is imposed on non-resident trusts under subsection 94(3),\textsuperscript{21} and is also similar to the manner in which partners and partnerships (another breed of quasi-entity) are taxed under subsection 96(1).

While theoretically justifiable, the current taxation of trust beneficiaries could be problematic as a result of the unique features of a trust. In contrast to most partnerships, the distribution of trust income and the amount of trust income to be distributed to a particular beneficiary are frequently left to the discretion of the trustee. It could be difficult to determine which beneficiaries should be taxed in respect of the income of the trust, and to what extent each should be taxed, since it is entirely possible that the beneficiaries selected may never benefit from the income of the trust, or may benefit to different degrees. In addition, since distributions may not be compellable, it is possible that the tax would be imposed on beneficiaries who would not have the ability to pay the tax at the time it was imposed, and a refund mechanism would have to be adopted for beneficiaries who paid income tax on income that was ultimately not received.

In the context of subsection 94(3), the issue of who benefits from the trust income and who is able to pay the income tax imposed on the non-resident trust is solved by making the Canadian-resident settlor and the beneficiaries jointly and severally liable for the Canadian income tax payable pursuant to paragraph 94(3)(d), subject to a recovery limit.\textsuperscript{22} This is an imperfect solution to the problem of assigning tax liability as between the beneficiaries and the settlor in the context of a regime that intends to tax beneficiaries currently, since the inclusion of a recovery limit could effectively prevent the collection of tax until such time as distributions are made, while the lack of a recovery limit could effectively cause the tax burden to be borne by the most solvent settlor or beneficiary of the trust, regardless of the benefits actually received.

\textsuperscript{20} A discussion of the policy rationale for the imposition of entity-level income tax on unit trusts and the basis of taxation for unit trusts is beyond the scope of this article. In my view, since a unit trust is a business vehicle that serves as a near-perfect substitute for a corporation, the neutrality principle dictates that a unit trust should be subject to the same entity-level tax as a corporation.

\textsuperscript{21} References to section 94 are references to the current version, which came into effect (in many instances, retroactively) when the Technical Tax Amendments Act, 2012, SC 2013, c. 34, received royal assent on June 26, 2013.

\textsuperscript{22} See subsections 94(7) and (8).
Insofar as a trust is a quasi-entity, the rationale for imposing an entity-level provincial income tax on corporations could also apply to a personal trust, and an integration regime similar to the corporate income tax could be adopted. Since, like corporate profits, distributions of trust income may not be predetermined or compellable, the imposition of entity-level tax as a form of withholding against the personal income tax liability arising on distribution can be justified. This entity-level tax would eliminate the need to identify the beneficiaries who will ultimately receive the economic benefit of the trust income; the beneficiaries receiving a distribution would be taxed at a lower rate that would reflect their share of the entity-level tax paid by the trust.

The Current System and Residence Taxation

Canada and all of the provinces have adopted a hybrid between the two approaches to taxing trust income described above. As a deemed individual pursuant to subsection 104(2), a personal trust is subject to entity-level tax on its income at the highest marginal rate for individuals, but is entitled to deduct from its income all amounts paid or payable to its beneficiaries. The beneficiaries are not taxed on any distributions from a personal trust in respect of which tax was paid by the trust; where the trust makes a distribution to a beneficiary in respect of which tax was not paid, a corresponding amount is included in the beneficiary’s income, and the character of certain items of income is preserved.

The adoption of the hybrid entity system of taxation necessitates the selection of a basis for imposing an entity-level tax on a personal trust. As a result of deeming a trust to be an individual, residence became the basis for imposing federal income tax on worldwide income of the trust. Since, as discussed above, each province has adopted a residence-based system for taxing the non-business income of individuals, provincial income tax on the worldwide non-business income of a personal trust is imposed in the province in which the trust is resident. A similar result would follow if the personal trust were taxed as a corporation.


24 Subsection 122(1). Testamentary trusts are excluded from the application of subsection 122(1) and are taxed at the marginal rates specified in section 117.

25 Paragraph 104(6)(b). Subsection 104(24) provides that an amount is payable to a beneficiary when it is paid or when the beneficiary is legally entitled in the year to enforce payment.

26 Note that, notwithstanding the potential for a deduction pursuant to paragraph 104(6)(b), a personal trust may elect to have its distributed income taxed in the trust and distributed tax-free pursuant to subsection 104(13.1). The ability to make this election is often an important feature of interprovincial tax planning using personal trusts, since it ensures that the trust’s income can be taxed in the low-rate jurisdiction even if all of the income of the trust is distributed.

27 Subsection 104(13).

28 Subsections 104(19) through (22.4). Any other amount included in income pursuant to subsection 104(13) will be treated as income from property pursuant to subsection 108(5).
However, the rationale for selecting the place of residence of the personal trust as the basis for imposing provincial income tax appears substantially weaker than the rationale for imposing residence-based income taxes on an individual or a corporation. A personal trust is not a human being, and therefore does not receive most of the benefits of the public goods provided by any province; unlike a corporation, a personal trust is unlikely to carry on business, and is therefore unlikely to receive public goods from any particular province on behalf of its beneficiaries. With the possible exception of access to the judicial system, substantially all of the public goods that could be connected with a personal trust are provided by the province in which the beneficiaries of the personal trust are resident, and not the province in which the trust is resident (if those provinces are different).

The Downside of Residence Taxation and Reconsidering Alternatives

Since a personal trust does not have a physical existence and is unlikely to carry on any business, imposing provincial income tax on the basis of the residence of the trust separate from the residence of the beneficiaries invites taxpayers to elect the province in which they will pay tax. An individual who wishes to become a resident of a different province for income tax purposes will, at the very least, have to establish a home in that other province and spend considerable time there, while giving up the ability to live in the first province year-round. A corporation carrying on business in a province will typically do so through a permanent establishment, so the ability to relocate to avoid tax will be either limited or commercially impractical. In contrast, whether the test for trust residence is central management and control, the place of residence of the trustees, or the governing law chosen, the residence of a personal trust can be changed by holding the trustee meetings in the preferred jurisdiction, or simply by changing the trustees or the governing law.

The potential lack of connection between the provision of public goods and the residence of a personal trust could also encourage harmful tax competition between the provinces. Given the evidence that highly mobile income is particularly susceptible to being shifted between provinces to avoid provincial income taxes, it is reasonable to expect that residence-based provincial income taxation for a quasi-entity with no physical presence, combined with an easily manipulated test for residence, would lead to the migration of personal trusts to lower-tax provinces. Given the negligible cost of public goods that must be provided to earn this income, there is a significant advantage for the province that imposes the lowest rate of tax on trust income, so interprovincial competition for personal trust tax residence should be expected.


30 Indeed, interprovincial tax competition is a key part of the so-called Alberta advantage and is recognized by the government of Alberta as a driver of economic growth: Philip Bazel and Jack M. Mintz, “Enhancing the Alberta Tax Advantage with a Harmonized Sales Tax” (2013) 6:29 SPP Research Papers 1-37, at 1.
The relative mobility of trust residence, and therefore the relative mobility of trust income, and the lack of connection between that income and the public goods provided, also argues for ceding the taxation of personal trusts to the federal government. This would have the effect of limiting tax competition, but it appears unlikely that the magnitude of the interprovincial income-shifting problem is sufficient to justify such a significant change to the division of taxing powers, or to justify a fundamental change in the test used to determine the provincial residence of personal trusts.31

Since the public good benefits associated with a personal trust and its income will typically be enjoyed in the province where the settlor or the beneficiaries are resident, and since the settlor and the beneficiaries will typically be resident in one province, a more reasonable residence-based approach to taxing personal trusts might be to deem a personal trust to be resident in the province where either the settlor or the beneficiaries are resident. Having regard for the relatively greater likelihood that there will be beneficiaries in multiple provinces, and for the reality that out-of-province discretionary beneficiaries could be added to manipulate any counting test, the residence of the settlor as a test may be a possible alternative.32

Where there are settlors in multiple provinces, the trust could be deemed to be separate trusts, with each trust being resident in the province of residence of the respective settlor(s) and holding property proportionate to the fair market value of the property contributed by the settlors(s).

A test of residence based on the residence of the settlor or the beneficiaries of the trust would not invite the same degree of manipulation as a central management and control test, a trustee residence test, or a governing-law test. The beneficiaries and the settlor of a trust would have significant non-tax reasons to avoid moving between jurisdictions in order to cause the trust to become resident in a lower-tax jurisdiction, and the residence of the trust could not be changed after the settlement of the trust. Limiting the mobility of trust income in this manner should also limit the potential for tax competition between provinces.

That said, the use of a settlor- or beneficiary-driven test for residence is not without its own flaws. For example, a settlor-based test could be frustrated using an arrangement similar to the one in Sommerer v. The Queen,33 where a settlor in the desired jurisdiction settles the trust with a relatively insignificant amount of cash

31 The total tax revenue shifted out of other provinces through Alberta-resident personal trusts, for example, has been estimated to be in the range of “tens of millions of dollars”: Matt McClure, “Alberta Could Owe ‘Tens of Millions’ in Tax Dispute Over Out-of-Province Trust,” Calgary Herald, May 24, 2013.

32 Similar to the rules in section 94, the settlor for the purposes of this residence test would be the person who has borne the economic cost of transferring property to the trust, directly or indirectly, or through a series of transactions with the primary purpose of causing property to be received by the trust. This would not necessarily be the person who has completed the legal formality of settling the trust.

33 2011 TCC 212; aff’d. 2012 FCA 207.
and the trust then purchases the desired property at fair market value in exchange for interest-bearing debt. A settlor-based test would also require rules addressing indirect contributions and contributions by way of series of transactions, similar to the rules in section 94, significantly increasing administrative complexity. Furthermore, contribution of property by different persons at different times, and the resulting separate trusts, could result in situations where compliance and audit become extremely difficult.

While the adoption of a settlor-driven or beneficiary-driven test for trust residence could result in greater harmony between the delivery of public goods and the taxation of trust income, such a test would represent a significant departure from the current entity-based residence test. Moreover, the shift from an entity-based residence test to a settlor-driven or beneficiary-driven test for trust residence would likely require all of the provinces and the federal Department of Finance to act in concert, creating coordination problems. Given the relative simplicity of the entity-based residence test (whether determined by reference to the residence of the trustees or the place of central management and control) and the resulting all-or-nothing taxation of trust income in a single province, and given the relatively insignificant revenue loss for the higher-tax provinces, the cost of achieving greater harmony may well exceed its benefits. Such a fundamental change is therefore unlikely, and arguably unnecessary.

Although, given the difficulties associated with changing the laws for trust residence, such a change may not be justifiable from a bottom-line perspective, there is arguably a distributional aspect to the use of inter vivos trusts that is separate from the issue of potential revenue loss. Since substantially all of the individuals who engage in interprovincial trust planning are high net worth, high income earners, one effect of this planning is to shift the burden of provincial personal income taxes in high-tax provinces to wage earners and other less mobile individuals. For this reason, it is unsurprising that the Canada Revenue Agency (CRA) has seized the opportunity created by the adoption of the central management and control test for trust residence in an attempt to achieve the same results as might be delivered by a more robust settlor-driven residence test.

**RESIDENCE OF TRUSTS**

**Statutory Provisions**

Similar to subsection 104(1) of the Act, a trust is treated as an individual under provincial income tax legislation. For example, the Alberta Personal Income Tax Act defines an “individual” as including a trust or estate, meaning that a trust will be subject to Alberta personal income tax if it is resident in Alberta on the last day of the taxation year. Equivalent definitions and rules are found in the income tax

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35 APITA section 3(1).
statutes of the other nine provinces. As an individual, a trust has a taxation year-end of December 31, unless the trust is an testamentary trust or an estate, in which case it will have the taxation year determined under the applicable statute.

Like the Act, the provincial taxation statutes provide that inter vivos trusts resident in the province will pay tax at the highest marginal rate; and, notwithstanding that inter vivos trusts are individuals for tax purposes, they are precluded from claiming personal tax credits other than charitable donation credits. Some provinces, including Ontario and British Columbia, charge health-care premiums to individuals resident in those provinces, which may be collected through the provincial income tax system; these premiums do not apply to trusts.

None of the provincial taxation statutes or regulations prescribe a method for determining where a trust is resident on the last day of a taxation year. As a result, it is necessary to refer to the jurisprudence in order to determine in which province a trust will be resident for provincial income tax purposes, or if the trust is resident in a province at all.

**Jurisprudence**

**Pre-Garron**

Prior to 2009, the leading Canadian decision relating to the residence of trusts was the decision of the Federal Court Trial Division in Thibodeau Family Trust v. The Queen. In that case, Gibson J considered the residence of an inter vivos trust, the majority of the trustees of which were resident in Bermuda. The trustees were able to

36 See sections 1(1) and 2(1) of British Columbia’s Income Tax Act, RSBC 1996, c. 215, as amended (herein referred to as “BCITA”); sections 2(q) and 6(1) of Saskatchewan’s Income Tax Act, 2000, SS 2000, c. I-2.01, as amended (herein referred to as “SKITA”); sections 1(1) and 3(1) of Manitoba’s Income Tax Act, CCSM, c. I10 (herein referred to as “MITA”); sections 1(1) and 2 of Ontario’s Income Tax Act, RSO 1990, c. I.2, as amended (herein referred to as “OITA”); sections 1 and 22 of Quebec’s Taxation Act, CQLR, c. I-3 (herein referred to as “QTA”); sections 1 and 11 of the New Brunswick Income Tax Act, SNB 2000, c. N-6.001, as amended (herein referred to as “NBITA”); sections 2(7) and 5 of Nova Scotia’s Income Tax Act, RSNS 1989, c. 217, as amended (herein referred to as “NSITA”); sections 1(6) and 3 of Prince Edward Island’s Income Tax Act, RSPEI 1988 c. I-1, as amended (herein referred to as “PEIITA”); and sections 2(1)(i) and 6(1) of Newfoundland and Labrador’s Income Tax Act, 2000, SNL 2000, c. I-1.1, as amended (herein referred to as “NLITA”).

37 See paragraph 249(1)(c) and subsection 249(5) of the Act and the definition of “taxation year” in BCITA section 1(1), APITA section 1(1)(w), SKITA section 2(bb), MITA section 1(1), OITA section 1(1), QTA section 1, NBITA section 1, NSITA section 2(1)(r), PEIITA section 1(1)(q), and NLITA section 2(1)(s).

38 See subsections 122(1) and (1.1) of the Act; BCITA sections 4.1(3) and 4.73; APITA section 36; SKITA sections 9(1) and 41; MITA sections 4(1), rule 1(a), and 4.1(3); OITA sections 4(3)(4) and 4(3.2)(11); QTA sections 750.1.1, 768, 770, and 770.1; NBITA sections 42 and 43; NSITA section 28; PEIITA section 27; and NLITA section 27.

39 See Medicare Protection Act, RSBC 1996, c. 286, as amended, OITA section 2.2(3), and the definition of “beneficiary” in section 1 and the charging provision in section 8.

40 78 DTC 6376 (FCTD).
to adduce evidence that all decisions relating to the property of the trust were made at meetings held in Bermuda, and that, although a trustee-beneficiary resident in Canada had the right to suggest investments, the Bermuda trustees had the right to overrule his recommendations and, on occasion, did so.41

The minister advanced a number of arguments in support of his position that the trust was resident in Canada. First, the minister argued that the central management and control test for corporate residence in *De Beers Consolidated Mines, Limited v. Howe*42 should apply for this purpose. Second, the minister argued that the trust could be resident in both Canada and Bermuda, and the facts provided sufficient basis for the imposition of Canadian tax.43 The following facts were cited as support for the minister’s argument:44

- One of the trustees was resident in Canada.
- The trustee resident in Canada had the power to appoint the other trustees.
- The Canadian-resident trustee was the principal initiator of the trust’s investment program.
- The authority of the Bermuda trustees was circumscribed in respect of certain accounts.
- The Canadian-resident trustee was the chief executive officer of a Canadian corporation that paid the expenses of the trust.
- The Canadian-resident trustee was responsible for the negotiation of the sale of the trust’s most important assets.
- The Canadian-resident trustee would, on occasion, take actions without consulting the Bermuda trustees.

Third, the minister raised a number of issues relating to provincial law, alleging that the appointment or resignation of trustees was ineffective, that the governing laws were the laws of Ontario, that the governing laws were not complied with, that the trust was in fact settled by the Canadian-resident trustee, and that the property of the trust was not transferable in Bermuda. All of these arguments were quickly disposed of by Gibson J, whose most important holding on these points was that a variation of the trust was not necessary to effect a change in the place of administration of the trust.45

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42 [1906] AC 455, at 458 (HL).

43 This argument was premised on the decisions in *Union Corporation, Ltd. v. IRC*, [1952] 1 All ER 646 (CA), and *Unit Construction Co. Ltd. v. Bullock (Inspector of Taxes)*, [1960] AC 351 (HL).

44 *Thibodeau*, supra note 40, at paragraph 16.

45 Ibid., at paragraph 21.
Gibson J went on to address the minister’s first and second arguments. In disposing of the minister’s submission that the central management and control test should be used to determine the place of residence of a trust, Gibson J held as follows:

[I]n my view, such submission is also not valid. The judicial formula for this respecting a corporation, in my view, cannot apply to trustees because trustees cannot delegate any of their authority to co-trustees. A trustee cannot adopt a “policy of masterly inactivity” as commented upon in Underhill on the Law of Trusts and Trustees, 12th Edition, page 284; and on the evidence, none of the trustees did adopt such a policy. Therefore, it is not possible for a trust to have a dual residence for income tax purposes, and therefore it is not possible to find that part of the paramount [omission in original] of “superior and directing authority” of a Trust is and was in two places. In any event, a finding of dual residence of this Trust is not made in this case.46

It is reasonably clear from the comments of Gibson J that he was ruling that the central management and control test was not applicable on the basis that the trustees were not permitted to delegate their authority in the same manner as corporate directors. As a result, it was necessary to resolve the question of residence by some other means.

In deciding that the trust was resident in Bermuda, Gibson J explicitly stated that his formulation of the test for trust residence was to be employed only in the case before him. After considering various factors, Gibson J selected the place of residence of the majority of the trustees and the “majority rules” clause as being the determinative factors.47 Applying these criteria to the facts, the trust was resident in Bermuda and not in Canada.

Although Gibson J’s reasons for judgment do not discuss this point, the factors that he selected as being determinative of residence mirrored the rules that apply when determining, for non-tax purposes, the law that governs the administration of a trust. Under those rules, the place of residence of the trustees, while not conclusive, is of paramount importance in determining the law that governs whether a trust exists and the law that governs the administration of the trust.48 Moreover, the decision in Thibodeau was consistent with at least one older decision relating to provincial succession duties, wherein it was held that succession duties could be levied by the province in which the trustee of a trust was resident, on the basis that

46 Ibid., at paragraph 22 (emphasis added).
47 Ibid., at paragraphs 23-25.
48 Branco v. Veira (1995), 8 ETR (2d) 49, at paragraphs 17-20 (Ont. Gen. Div.), citing Nanton Estate, Re, [1948] 2 WWR 113, at paragraphs 22-24 (Man. KB). See also Re Jagos (Estate of), [2007] ABQB 56, at paragraph 45. However, see Harris Investments Ltd. v. Smith, [1948] 1 DLR 748, at paragraph 1 (BCCA), where the conflict-of-laws issue relating to a trust whose deed did not specify a governing law was resolved in favour of the place where substantially all of the acts dictated by the deed were required to be performed.
an interest in a trust constituted a claim against the trustee, and therefore a chose in action situated in the province.  

As is evident from Interpretation Bulletin IT-447, the minister never accepted the reasoning in Thibodeau. IT-447 states that, as a general proposition, a trust is resident in the place where the trustee who exercises the majority of the control of the property of the trust resides. Moreover, where a substantial portion of the management and control of the trust rests with a person who is not a trustee, the trust is resident where that person is resident. In effect, the minister continued to take the position that the central management and control test was determinative.

Interestingly, the minister did rely on Thibodeau in one subsequent case to establish that a trust, if it existed, was not resident in Canada. The minister also relied on Thibodeau in some technical interpretations, and a reference to the decision appeared in the CRA’s internal instructional materials as authority relating to the residence of trusts. In these instances, the minister’s willingness to embrace Thibodeau seemed to depend on the outcome of reliance on that decision: if the result or potential result of relying on Thibodeau was more Canadian income tax payable, then the minister appeared likely to advance the residence of the trustees as a determinative test without hesitation.

The ratio in Thibodeau was not considered in any provincial income tax residence cases or by any provincial tax administration bodies. However, in Beit c. Québec (Sous-ministre du Revenu), which dealt with the liability of trust beneficiaries for Quebec succession duty, Brossard JCQ held that the principle from Thibodeau was generally accepted, and a trust should be resident in the place where the majority of its trustees were resident.

Notwithstanding the minister’s, at best, lukewarm embrace of Thibodeau, and Gibson J’s caveat that his formulation of the trust residence test was intended to be applied to that case alone, for the next 30 years many practitioners proceeded on the basis that the Thibodeau formulation was the law in Canada. The acceptance of this formulation by many practitioners, and its non-acceptance by the minister, set the stage for what was to come.

49 Attorney General of Nova Scotia v. Davis, [1937] 3 DLR 673 (NSSC). See also Royal Trust Co. v. R, [1949] SCR 329, at paragraphs 32-36, where a similar argument was raised, although the argument was unsuccessful once the court found that there had been a completed gift of the purported trust property.


51 Low v. The Queen, 93 DTC 927, at paragraph 44 (TCC).


The assumption that the ratio in *Thibodeau* was the law of trust residence was shattered by the successive decisions of the Tax Court of Canada, the Federal Court of Appeal, and the Supreme Court of Canada in the *Garron* case. In *Garron*, all three courts held that the correct test for the residence of a trust was the central management and control test favoured by the minister, and that the person with central management and control need not be a trustee.

The material facts in *Garron* were broadly similar to the facts in *Thibodeau*. In *Garron*, the property of the purportedly non-resident trusts initially consisted of shares of private corporations, which were sold in transactions negotiated by a Canadian-resident beneficiary of one of the trusts, and either distributed to other trusts or replaced with a portfolio of securities. The sole trustee of the trusts was a corporation resident in Barbados that was licensed to provide trustee services. The trustee could be replaced at any time by a protector, who could himself be replaced by a majority of the beneficiaries who had attained a specified age. The evidence disclosed that the Canadian-resident beneficiaries were largely responsible for the investment decisions of the trusts, and that the trustee would simply ratify the decisions of the Canadian-resident beneficiaries and perform administrative tasks.

At trial, Woods J rejected *Thibodeau* on the basis that Gibson J had not intended his formulation to become a test for trust residence in other cases, and held “that there was nothing on the particular facts in *Thibodeau* that would support a finding that the trust was resident in Canada.” Woods J further held that, in light of *Robson Leather Co. Ltd. v. MNR*, Gibson J was not correct in holding that a trustee could be presumed to comply with its fiduciary obligations, or that a trustee could not delegate its authority, and that these determinations should be made on the basis of the facts of each case.

Since there are many significant factual similarities between *Thibodeau* and *Garron*, including Canadian residents who negotiated the sale of significant assets and initiated investment decisions, it is difficult to accept Woods J’s characterization of the *Thibodeau* facts. However, it was undoubtedly reasonable for Woods J to conclude that trustees should not be assumed to comply with their fiduciary obligations where the facts suggest otherwise, since the assumption of compliance would lead courts to ignore blatant abdications of office by trustees.

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56 Full details of the facts in *Garron* can be found in the decision of the Federal Court of Appeal, supra note 55, at paragraphs 15-49.

57 *Garron*, supra note 55 (TCC), at paragraph 138.

58 77 DTC 5106 (FCA).

59 *Garron*, supra note 55 (TCC), at paragraphs 145-150.
After concluding that the *Thibodeau* formulation was inapplicable, Woods J adopted the *De Beers* central management and control test as the appropriate test for trust residence, for two reasons: (1) the function of both trusts and corporations is the management of property; and (2) adopting the same test for corporations and trusts achieves consistency, predictability, and fairness. According to Woods J, Parliament left the test for trust residence to the courts, and the courts should not develop a different test than the one that they have adopted for corporations without good reasons for doing so.60

At the Federal Court of Appeal, Sharlow JA noted that many commentators had believed that *Thibodeau* established a test for the residence of trusts, but held that Woods J was correct that this was not the case, and that the correct test is central management and control.61 In her view, it was not appropriate to adopt a rigid test, such as the place of residence of the trustees, and residence should instead be determined on the basis of a fact-driven inquiry as to where the trust “keeps house and does business.”62 Ordinarily, central management and control would be located where the trustees are resident, but this must be determined on a case-by-case basis.

Sharlow JA also considered two new arguments raised by the taxpayers. First, the taxpayers argued that the trust could not itself be resident anywhere, since it lacks legal personality, so reference must be made to the residence of the trustee. The second, related argument was that subsection 104(1) embodies the trust in the trustee.63 Sharlow JA disposed of these arguments by noting that the Act treats the trust as though it were a person, thus creating an implicit statutory fiction that the trust need not be resident where the trustee is resident. Further, the reference in subsection 104(1) to the trustees exists for administrative convenience, and does not necessarily signal that Parliament intended that a trust be resident where its trustee is resident.

The decision of the Supreme Court of Canada in *Garron* is rather unsatisfying, since it adds little to the decision of the Federal Court of Appeal. The brief, 19-paragraph decision belies the importance of this issue to many Canadian taxpayers, and does not reflect the skilful argument before the court or the thorough reasons given by Woods J and Sharlow JA. Interestingly, the decision in *Garron* appears to be only the second income tax decision issued by the Supreme Court since 1980 without attribution to a particular justice,64 a practice typically reserved for more contentious issues,65 and the first such decision in which the Supreme Court has given its own reasons for allowing or dismissing an appeal.

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60 Ibid., at paragraphs 158-162.
61 *Garron*, supra note 55 (FCA), at paragraphs 57-62.
62 Ibid., at paragraph 62 (quoting from *De Beers*, supra note 42, at 458).
63 Ibid., at paragraphs 63-64.
64 The other such decision being the very brief reasons in *Del Zotto v. Canada*, [1999] 1 SCR 3.
The Supreme Court began its analysis by suggesting that there was “a dearth of judicial authority” relating to the residence of trusts—a questionable statement in light of the decision in *Thibodeau*, which the court declined to address. The court disagreed with the taxpayers’ submissions relating to the non-entity status of trusts and the reference to trustees in subsection 104(1), for substantially the same reasons as those expressed by Sharlow JA, although the court did note the importance of subsection 104(2), which separates a trust and its trustees for the purposes of the charging provision in subsection 2(1).

Agreeing with Woods J that the function of both corporations and trusts is the management of property, the court held that the central management and control test was appropriate, and that this would promote “consistency, predictability and fairness.” Like Woods J, the court was not able to identify any good reason why there should be totally different tests of residence for corporations and trusts.

It is questionable whether the adoption of the central management and control test enhances “consistency, predictability and fairness,” although the application of the test to trusts certainly enhances fairness from a neutrality standpoint, given the observed similarities between corporations and trusts. In essence, a quantitative analysis of the place of residence of the trustees was supplanted by a much more qualitative or subjective analysis of where the mind and management of a trust is exercised. Correctly or incorrectly, for over 30 years, many Canadians and their tax advisers had been operating on the assumption that the *Thibodeau* formulation was the test for trust residence. The sudden adoption of the central management and control test represents a game changer and was certainly not predictable. Arguably, given the widespread acceptance of the *Thibodeau* formulation, such a game changer should have been left to Parliament.

Although *Garron* was decided in the context of determining the residence of a trust for the purposes of the federal Act, there is no compelling reason why *Garron* would not apply in the context of interprovincial residence. As a result, whether a trust is resident in a particular province in a taxation year will depend on whether the central management and control of the trust is located in that province on the last day of that taxation year.

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66 *Garron*, supra note 55 (SCC), at paragraph 8.
67 Ibid., at paragraphs 10-13.
68 Ibid., at paragraphs 14 and 16 (quoting Woods J at the Tax Court of Canada, supra note 55, at paragraph 160).
69 See, for example, *Vancouver Society of Immigrant and Visible Minority Women v. MNR*, [1999] 1 SCR 10, where a majority of the Supreme Court of Canada, per Iacobucci J, declined to substantially revise entrenched common-law definitions of charitable purposes, on the basis that such changes were within the domain of Parliament.
Central Management and Control

If central management and control is the test for determining the residence of trusts, it is necessary to understand what “central management and control” means. The Supreme Court simply restated the De Beers standard of “keeping house and doing business,” and explained that, in the corporate context, central management and control would be exercised in the place where the powers of the board of directors of the corporation are exercised.70

It is apparent that central management and control is a question of fact to be resolved in each case, and there is no formula that will establish that central management and control is located in a particular place. This was made clear by Sharlow JA, who noted that the use of a protector, the use of the same professional advisers, and the making of strong recommendations by the beneficiaries as to the management of property would not, in and of themselves, cause central management and control to be situated with persons other than the trustee.71 However, where the decisions that would typically constitute control over the property of the trust were dictated to the trustees, central management and control would be situated with the persons dictating those decisions.72

As indicated by the courts in Garron, the threshold for a decision that is “dictated” to a trustee is high. However, following the recent decision of the English Court of Appeal in Revenue and Customs Commissioners v. Smallwood,73 it would be open to a trial judge to find that the central management and control of a trust resides elsewhere than with the trustee in circumstances where the trustee is appointed as part of a preordained scheme originated by some other person, and the trustee does not, in fact, do anything except carry out the preordained transactions.74 In such cases, the person orchestrating the scheme can be found to have central management and control of the trust.

Sharlow JA provided the following additional guidance with respect to the meaning of “central management and control” in the trust context:

By analogy from DeBeers, supra, the task is to determine where a trust “keeps house and does business,” i.e. where the powers and discretions of the trustee are really being exercised. It may well be that in most cases, the residence of the appointed trustee is a sufficient

70 Garron, supra note 55 (SCC), at paragraphs 8-9.
71 Garron, supra note 55 (FCA), at paragraphs 67-68.
73 [2010] EWCA Civ. 778; rev’g. [2009] EWHC 777 (Ch.). This decision relates to the “place of effective management” under the bilateral tax treaty between the United Kingdom and Mauritius. However, the jurisprudence relied on by the Court of Appeal to determine the meaning of “place of effective management” is the same as the jurisprudence relied on to determine “central management and control,” so there should not be any practical difference between these terms.
74 Smallwood, supra note 73 (CA), at paragraph 70.
basis in fact for determining the residence of the trust. This is the case where the trustee is given and actually exercises the powers and discretions regarding the management and control of the trust property, and does so where he resides. However, a rigid legal test that necessarily ties the residence of a trust to the residence of the trustee regardless of the facts is, in my view, not sound in principle because it denies the central theme of the jurisprudence on the determination of residence for tax purposes, which is that residence fundamentally is a question of fact. I conclude therefore that where a question arises as to the residence of a trust for tax purposes, it is appropriate to undertake a fact driven analysis with a view to determining the place where the central management and control of the trust is actually exercised.\footnote{Garron, supra note 55 (FCA), at paragraph 62 (emphasis added).}

It appears that Sharlow JA was of the view that the location of central management and control of a trust is determined by identifying the person exercising management and control over the property of the trust, and the place where this control is exercised. This makes sense given that the reason for the existence of trusts is the holding of property for others and that, in most cases, the trust will be a passive owner of property and will not carry on an active business that requires day-to-day management.

This interpretation of the central management and control test accords with what appear to have been the most critical facts in issue in Garron. In particular, persons other than the trustee were able to direct dispositions of the property of the trusts, to choose the investments made by the trusts, to cause the trusts to make distributions, and to determine what tax planning the trusts would engage in, notwithstanding that these rights were reserved to the trustee. These powers are essentially property rights.

What, then, is required for a person to have “control” over the property of a trust? Control over property was recently considered by the courts in the context of beneficial ownership in \textit{Prévost Car Inc. v. The Queen}\footnote{2008 TCC 231; aff’d. 2009 FCA 57.} and \textit{Velcro Canada Inc. v. The Queen}.\footnote{2012 TCC 57.} In those cases, the courts identified four incidents of beneficial ownership of property: possession, use, risk, and control.\footnote{Ibid., at paragraph 29.} With respect to the determination of central management and control, possession and use of the trust property and the incurring of risks associated with the trust property are generally not in issue, whereas control of the trust property is of paramount importance.

In \textit{Velcro}, Rossiter ACJ adopted a definition of “control” that reads, “to exercise power or influence over” property, and gave meaning to the phrase “power or influence” by reference to the indicia of possession, use, and risk.\footnote{Ibid., at paragraphs 41-42.} Of the various indicia of control identified by Rossiter ACJ in the context of monies received as
royalty payments, some should be relevant in determining “control” of trust property, such as securities, real property, or other investments. These indicia include the following:

- The right to receive any income from the property held by the trust, and the right to put the income from the property to any desired use.80
- The right to exercise “dominion” over the property.81 Dominion could include the right to vote shares, the right to enforce payment of debts, and the right to freely dispose of the property held by the trust.
- The right to “employ” the trust property.82 Trust property could be employed either by pledging it as security for borrowing by the trust, by holding it for capital appreciation or income generation, or by otherwise using the property in whatever manner it can be used.
- The right to incur risk of economic losses.83 In the case of a trust, the risk of economic loss is always borne by the beneficiaries, and the property of the trust should not be available to creditors of any person other than the trust or a beneficiary with a fixed interest. However, a person with control over property may have a right to determine how the risks associated with the trust property are to be mitigated, or if those risks are to be mitigated at all.

Combined with the directions of Sharlow JA in *Garron*, these indicia of control over property can be used to gain some insight into what the central management and control of a trust should entail. If, as a matter of fact, the trustee exercises the rights that constitute control over the property of the trust, then the trustee should be the person having central management and control of the trust. In contrast, if some person other than the trustee exercises control over the property of the trust, or dictates to the trustee how the rights constituting control should be exercised, then that other person should have central management and control of the trust.

Once the identity of the person who has central management and control is ascertained, the residence of the trust can be resolved by identifying the place where that person exercises the powers constituting central management and control. Typically, this would be the place in which the person exercising these powers is resident, but that will not necessarily be the case. In a situation where very little management or control of trust property is required (as might be the case if substantially all of the assets of the trust consist of preferred shares of a private corporation), it might be possible for the person who has central management and control to ensure that central management and control is exercised in a province or country other than the

80 Ibid., at paragraph 35.
81 Ibid.
82 Ibid., at paragraph 36.
83 Ibid., at paragraph 39.
province or country in which that person resides. One must caution, however, that this will require the decision making in connection with the trust property to be taken in a more formal manner than might otherwise be the case.

An argument could be made that the comments of the courts in Garron that the determination of central management and control is factually driven, and that there is a “line to be drawn,” combined with the comments of the courts that the central management and control test for trusts is “similar” to the central management and control test for corporations, means that the central management and control test is to be applied as a de facto control test. In this interpretation of the decisions in Garron, the actual act of making decisions and the place where those decisions are made is disregarded, while paramount importance is placed on the ordinary location of the persons who effectively control the decision making for the trust.

I strongly disagree with this argument for a number of reasons, set out below, and I believe that this interpretation of the central management and control test is an attempt to replace what was said in Garron with what those advancing the argument would have preferred to read.

- The attempt to read meaning into the use of the phrase “similar” ignores the fact that the central management and control test for trusts cannot be the “same” as the central management and control test for corporations as articulated in De Beers, since a trust does not have a board of directors. This is why the Federal Court of Appeal adopted the central management and control test by analogy to De Beers.

- The above interpretation of the word “similar” ignores the context in which it appears. When Woods J held that “[i]t is desirable that the test for corporations and trusts be as similar as the circumstances allow,” after discussing the similar functions of corporations and trusts and the need for consistency, predictability, and fairness, the reasonable interpretation is that Woods J was concerned with neutrality, not with creating latitude for the courts to rely on de facto control in determining residence.

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84 For this reason, the central management and control test should not be effective as an anti-avoidance rule. It should be relatively simple for a properly informed and diligent taxpayer to locate central management and control in a desirable jurisdiction, particularly where little management of property is required. Indeed, Arnold, supra note 4, argues that the central management and control test for corporate residence should be repealed on the basis that it is too prone to ongoing manipulation. For further thoughts on how central management and control may be located in a desired jurisdiction, see Howard Carr, “Residence of a Trust: Fundy Settlement v. Canada” (2012) 18:9 Trusts & Trustees 907-10.

85 Garron, supra note 55 (FCA), at paragraphs 67-68.

86 Garron, supra note 55 (SCC), at paragraph 16, and (TCC), at paragraphs 159-160 and 170.

87 Garron, supra note 55 (FCA), at paragraph 62.

88 Garron, supra note 55 (TCC), at paragraph 170.
As evidenced by the decision of the Court of Appeal in *Wood v. Holden*, the central management and control test for corporations is a formalistic test; provided that decisions were not dictated, central management and control was located where the directors were when they made the relevant decisions by signing the relevant resolutions. In *De Beers*, the critical fact was that all significant decisions were made at meetings of the directors in London; no inquiry was made as to whether the decisions made at those meetings had been contemplated by the directors before arriving in London to formally make those decisions. The jurisprudence since *De Beers* has developed such that paramount importance is accorded to the place where directors meet, and not the place where the directors (or even the sole director) are resident. The Canadian courts were undoubtedly aware of this formalism when they adopted the central management and control test.

The use of a formalistic central management and control test for corporations and a de facto central management and control test for trusts would undermine the neutrality principle upon which the decisions in *Garron* are premised.

The use of de facto control tests is not novel, and such tests can be found throughout the Act. If the courts intended trust residence to be based on the place of residence of the individual with de facto control, as opposed to the place where decisions are made, the courts would know how to articulate such a test.

For these reasons, in my view, once the elements of control in respect of the trust property have been ascertained, it is the place from which that control is exercised that is relevant, and not the day-to-day location of the “controller.” If it can be proved that control is exercised at a meeting in a particular jurisdiction, then, by analogy to a corporation and the making of decisions in the place where the board of directors meets, central management and control is situated in that particular jurisdiction. Again, this may require a more formal decision-making process than would typically be associated with a domestic personal trust, such that there is evidence of the place where decisions are made, but it does not require the person with control to remain in the desired jurisdiction of residence at all times.

To summarize, a trust will be resident in a province in a taxation year if, on the last day of that taxation year, central management and control of the trust is exercised in the province. For these purposes, central management and control should

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90 *De Beers*, supra note 42, at 459.


92 See, for example, paragraph 40(2)(a); subsection 44(7); subsection 125(7), the definition of “Canadian-controlled private corporation”; subsection 251.1(3), the definition of “controlled”; and subsection 256(1).
be a reference to the control of the property of the trust, and central management and control should be exercised by the person who is determined to have control over the trust property. The question of provincial residence should be resolved by answering three questions of fact:

1. What bundle of rights constitutes control of the property owned by the trust?
2. Who is the person exercising or dictating the exercise of the rights that constitute control of the trust property?
3. From where does this person exercise those rights or dictate the exercise of those rights on the last day of the taxation year?

If the answer to question 3 is that the rights are exercised in the particular province on the last day of the taxation year, the trust is resident in that province in the year. If the answer to question 3 is that the rights are exercised outside the particular province on the last day of the taxation year, the trust is not resident in that province in the year.

**The CRA's Audit Program and Dispute Resolution**

It appears that, following the decision of the Tax Court of Canada in *Garron*, the CRA’s aggressive tax planning audit groups have begun an audit program targeting Alberta-resident trusts with beneficiaries resident in other provinces. The CRA’s primary position is that the central management and control of these trusts is located in the provinces in which the beneficiaries are resident, and that the trusts should therefore be subject to tax at the higher non-Alberta rates. In some instances, the CRA is also alleging that the appointment of the Alberta trustee is a sham.

In most cases, the purpose of the Alberta trust is to hold non-voting common or preferred shares of a private corporation resident in another province. The corporation pays dividends on the common shares (or deemed dividends on the repurchase of the preferred shares) in order to receive a refund of refundable dividend tax on hand under subsection 129(1), and the trust pays tax on the resulting taxable dividend at Alberta rates. The Alberta trust may only receive sufficient cash to pay the tax payable on the dividends, along with a promissory note for the remaining amount payable, or may be paid in cash that is then used by the Alberta trust to acquire marketable securities or other income-producing property.

The CRA’s audits of these Alberta trusts often focus on the central management and control or the day-to-day management of the private corporation in which the

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94 This is an attempt to achieve a result similar to the result in *Antle v. Canada*, 2010 FCA 280; aff’g. 2009 TCC 465.
Alberta trust owns shares, instead of identifying the person who controls the property of the Alberta trust. In many cases, this has resulted in reassessments being vacated by the CRA’s Appeals Division, once the Garron analysis is properly focused on the trust and the trust property, as opposed to the private corporation in which the trust owns shares. While the CRA’s approach to locating central management and control using the day-to-day operations of this subsidiary corporation achieves a result that is defensible from a policy perspective, for the reasons discussed above, its approach requires a jurisprudential evolution in order to be technically correct.

In addition to the focus on the management of the private corporation, the CRA’s audits of Alberta trusts have been fixated on the tax-avoidance motivation underlying the creation of the Alberta trust. While the English Court of Appeal decision in Smallwood suggests that tax avoidance might be relevant in the case of a pre-ordained series of transactions where the trustees terminate their office as part of the series, the CRA is applying this reasoning to Alberta trusts that continue after the initial series of transactions, including those where the Alberta trusts acquire and hold investments into the indefinite future.

In my view, the CRA auditors are allowing the tax-avoidance motivation to colour their analysis, and the resulting incomplete or inadequate analysis has also resulted in the issuance of reassessments that have been vacated by the CRA’s Appeals Division. Since the Duke of Westminster principle is still the law in Canada, a tax-avoidance motivation should not be relevant in determining the tax consequences of an arrangement, absent the potential application of a specific anti-avoidance rule or the general anti-avoidance rule (GAAR). This principle applies to the determination of trust residence, since the underlying facts that are relevant in locating control of trust property are not somehow altered by the motivation of the settlor or the beneficiaries of the trust.

As is the case with disputes relating to the residence of individuals, the proper forum for an appeal from a reassessment issued under a provincial taxation statute is the superior court of the province in which the CRA alleges that the trust is resident. The Tax Court of Canada does not have the jurisdiction to hear such an appeal, since provincial taxation statutes are not listed in section 12 of the Tax Court of Canada Act. In my experience, the CRA’s letters accompanying its notices of confirmation

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95 See, for example, Copthorne Holdings Ltd. v. Canada, 2011 SCC 63, at paragraph 65, citing Inland Revenue Commissioners v. Westminster (Duke), [1936] AC 1 (HL).

96 An interprovincial tax-avoidance motivation is relevant in applying GAAR only insofar as it relates to determining whether an avoidance transaction exists: Husky Energy Inc. v. Alberta, 2011 ABQB 268, at paragraphs 72-73; aff’d. 2012 ABCA 231, leave to appeal to the Supreme Court of Canada dismissed.

97 See, for example, the definition of “court” in BCITA section 1(1), APITA section 1(1)(g), SKITA section 2(i), and MITA section 1(1). Also see the appeal provisions in OITA section 23(1).

98 RSC 1985, c. T-2, as amended.
for provincial reassessments arising out of trust residence disputes often state that an appeal may be filed in the Tax Court of Canada, but that is not correct.

The challenge of identifying the proper forum for resolving trust residence disputes, particularly where trust residence is an alternative basis of assessment, is highlighted by the recent decision of the Court of Queen’s Bench of Alberta in *Sheila Holmes Spousal Trust v. Canada (Attorney General)*.99 Holmes involved an application by a trustee for a declaration that the trust was duly constituted and that the trust was not a sham. The determination of the validity of the trust and the validity of the trustee’s appointment was potentially dispositive of the question whether the income and capital gains realized by the trust would be taxed in Alberta, where the would-be trustee was resident, or in Ontario, where the would-be settlor and beneficiaries were resident.

Nixon J dismissed the trustee’s application for declaratory relief, on the basis that the Tax Court of Canada had the exclusive jurisdiction to determine the validity and residence of the trust (as it had done in *Antle*),100 and that any interpretation of Alberta law required was within the competence of the Tax Court of Canada.101 This was clearly the correct conclusion on the facts presented in the decision, since the issue of the validity of the trust and the validity of the trustee’s appointment were not merely ancillary to the minister’s reassessment, but went to the very heart of the dispute. Granting declaratory relief would have usurped the fact-finding role of the trial judge who might eventually consider the correctness of the reassessment.102

While Nixon J correctly declined to interfere with the jurisdiction of another court, her reasons for judgment are not as precise as they could have been in identifying the court to which this courtesy was owed. Nixon J cited *Garron* and *Antle* as examples of cases where the matters to be determined had been dealt with by the Tax Court of Canada, and where the Tax Court of Canada had made all necessary findings of fact to determine those matters.103 Nevertheless, while the matters in issue in *Holmes* were similar to the matters in issue in *Garron* and *Antle*, the distinction between the latter two cases and *Holmes* is the statute under which the tax in dispute was assessed. In *Garron* and *Antle*, tax was assessed pursuant to the Act, and the questions of whether the trust was duly constituted (in *Antle*) and where the trust was resident (in *Garron*) arose in the context of determining whether federal income tax was payable. In *Holmes*, the settlor was to be assessed pursuant to both the federal

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99 2013 ABQB 489.
100 *Antle*, supra note 94.
102 For a more detailed summary of the facts and analysis in *Holmes*, including an argument that the decision of Nixon J is incorrect, see Allison Blackler and Joel Nitikman, “Case Comment,” in 2013 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2013), 2:1-29.
103 *Holmes*, supra note 99, at paragraph 22.
Act and the equivalent Ontario statute (the OITA), or, in the alternative, the trust was to be assessed under the OITA only, and the critical issue in either case was the jurisdiction in which provincial income tax was payable.

To the extent that the minister ultimately assesses the trust as the agent of the province of Ontario pursuant to the OITA, on the basis that the trust was resident in Ontario, the proper forum for the dispute between the trust and the minister will be the Ontario Superior Court of Justice pursuant to sections 23(1) and (2) of the OITA. The exclusive jurisdiction of the Superior Court of Justice to hear an appeal from such an assessment was noted by both Nixon J and the attorney general of Canada. As stated above, the Tax Court of Canada does not have the jurisdiction to resolve a dispute arising under a statute that is not listed in section 12 of the Tax Court of Canada Act, and that list does not include the OITA.

To the extent that the minister ultimately assesses the settlor to include the income or capital gains purportedly realized by the trust in the settlor’s income for the purposes of the Act, either because the trust was a sham or because subsection 75(2) applied, the Tax Court of Canada would be the proper forum to contest the reassessment. The proper forum for contesting any corresponding reassessment of the settlor under the OITA is the Superior Court of Justice, although the CRA will generally confirm, vary, or vacate reassessments under the provincial income tax statutes on the basis of a decision of the Tax Court of Canada in an appeal from a corresponding assessment under the Act.

**CONCLUSION**

Owing to the relatively mobile nature of trust income, the increasing top marginal tax rates in some provinces, and the game-changing decision in *Garron*, it is possible that in the future there will be an increase in the number of provincial trust residence cases. This will be an interesting area to watch, particularly if the provincial superior courts—as might be expected, given the CRA’s ongoing interprovincial tax-avoidance audit project—are left to develop the post-*Garron* law of trust residence without further guidance from the Tax Court of Canada and the Federal Court of Appeal.

In my view, the decision in *Garron*, when read together with the decisions in *Velcro* and *Prévost Car*, creates a framework for establishing control over trust property, and thus locating central management and control of a trust. The fact that

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104 Supra note 36.

105 I assume that if the CRA’s Appeals Division determined that the trust was a sham or that subsection 75(2) applied, the federal income tax paid by the trust would be applied against the resulting federal income tax liability of the settlor or would be refunded to the trust, as the case may be. If this were not the case, the liability of the settlor under the Act would also be a critical issue.

control relates to property, and not to underlying corporate activities or the intentions of the settlor, means that a determination of who has control of trust property should be relatively mechanical. As is the case with corporate residence, there is no basis for the application of the central management and control test as an interprovincial anti-avoidance rule for trusts.

It is impossible to predict whether the change from a trustees’ residence test to a central management and control test for trust residence will curb any of the abuses perceived by the CRA, once taxpayers familiarize themselves with the central management and control test and how it may be manipulated, but this seems unlikely. It is my expectation that, given further guidance from the courts, taxpayers will become adept at establishing central management and control in desirable jurisdictions, and trust residence cases will become as infrequent as corporate residence cases post-De Beers. Time, however, will tell.
Policy Forum: Editor’s Introduction—Addressing Treaty Shopping

Treaty shopping is part of the Organisation for Economic Co-operation and Development (OECD) project on base erosion and profit shifting (BEPS). On March 14, 2014, the OECD released a public discussion draft on the issue, which was followed by a finalized report and a set of recommendations released on September 16, 2014 after a period of consultation. The Department of Finance has been ahead of the OECD on this particular subject: it released a consultation paper on August 12, 2013, followed by a detailed description of a proposed anti-treaty-shopping rule in the February 11, 2014 federal budget. The proposed rule has proved contentious for two reasons: (1) it is a domestic rule rather than an article to be incorporated in selected treaties, and (2) it is formulated as a “one of the main purposes” test modified by a set of rebuttable presumptions.

The Department of Finance appears to be on an accelerated timeline with its anti-treaty-shopping project, although it recently expressed a willingness to wait for the final OECD BEPS report on the subject before proceeding further. Finance apparently undertook its project because of its dissatisfaction with the judicial reasoning in three treaty-shopping cases; however, its relative haste in issuing the proposed rule before the publication of the OECD’s recommendations is difficult to understand. Earlier this year, on the premise that there was sufficient time to provide some input into Finance’s consultative process, the Canadian Tax Foundation held a seminar on treaty shopping. Finance then released a detailed description of its

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4 Canada, Department of Finance, Treaty Shopping—The Problem and Possible Solutions (Ottawa: Department of Finance, August 2013).
6 Canada, Department of Finance, News Release, August 29, 2014.
7 Velcro Canada Inc. v. The Queen, 2012 TCC 57; Canada v. Prévost Car Inc., 2009 FCA 57; and MIL (Investments) SA v. The Queen, 2006 TCC 460; aff’d. 2007 FCA 236.
proposed anti-treaty-shopping rule in the 2014 budget (barely one week after the Foundation’s seminar), indicating that departmental thinking had progressed relatively quickly past the formative stage of consultation. Because treaty shopping has commanded so much recent policy attention in Canada and internationally, we thought it worthwhile to present some of the seminar participants’ deliberations as articles for this feature. In these articles, three of the participants discuss the experiences of some other jurisdictions in addressing treaty shopping. In addition, a senior Canadian tax practitioner critiques Finance’s preferred approach of enacting a domestic anti-treaty-shopping rule.

In the first article, Ken Snider argues that Finance’s proposed rule would constitute an override of the Canadian tax treaties that were concluded before certain changes were made in 2003 to the commentary on article 1 of the OECD model treaty. Snider recommends that Finance abandon the proposals in favour of renegotiation of a select set of bilateral treaties to include an anti-treaty-shopping article. He suggests that Finance’s concerns about this particular approach, as emphasized in both the consultative paper and the 2014 budget, are overstated. He also wonders why, until very recently, Finance had chosen to proceed without waiting for the OECD’s final recommendations on treaty shopping, especially given the somewhat different approach reflected in the OECD’s work.

In the second article, Jonathan Schwarz reviews the experiences of the United Kingdom and the European Union with various approaches to treaty shopping. In its 2011 budget, the UK government proposed to introduce domestic legislation intended to deny treaty benefits in certain circumstances. This proposed legislation was subsequently abandoned in favour of the recently enacted UK general anti-avoidance rule (GAAR) to serve the same function. Schwarz notes that this approach arguably constitutes a treaty override and should be rejected in favour of the adoption of specific anti-treaty-shopping articles in UK treaties. His review of the relevant UK case law in a non-GAAR environment suggests that a creative approach to treaty interpretation can be a robust alternative anti-treaty-shopping tool.

In the third article, Patricia Brown describes the historical development of the limitation-on-benefits (LOB) approach used by the US Treasury department to address treaty shopping. She emphasizes the incremental manner in which incorporation of LOB articles in US treaties has unfolded, including the rejection of conceptually simpler, but more factually complex, approaches, such as a “one of the main purposes” test. With respect to recent refinements to the series of objective tests characteristic of the US LOB approach, Brown focuses on the nexus requirement in the exception for publicly traded corporations. She concludes that a US-style LOB article has proved effective against most common forms of treaty shopping, although its effectiveness requires the threat of application of more general judicially developed anti-abuse doctrines. Brown cautions, however, that its utility should not be assessed in terms of an increase in withholding taxes collected by the United States. She believes that the US insistence on the inclusion of a LOB article has proved effective in extracting reciprocal reductions in withholding taxes from its major trading partners, including Canada. She also cautions that the necessary negotiation and renegotiation
process requires the commitment of substantial government resources, and coun-
tries should be aware of the difficult logistics of implementation.

In the fourth article, Graeme Cooper highlights the importance of fundamental policy responses to treaty shopping. He suggests that the silence of the Australian Treasury Department on the subject is most likely attributable to the fact that the incentive to engage in treaty shopping is lessened by the adoption of consistent treatment of cross-border investment irrespective of the investor’s residence in a treaty or non-treaty country. As Cooper observes, this policy position can be justified on the basis of a perceived gain in national welfare and has been implemented across a range of treatments that are commonly the focus of treaty shopping. Cooper also reviews Australia’s use of many of the standard anti-treaty-shopping responses in those areas in which inconsistent treatment is maintained for residents of treaty and non-treaty countries.

Tim Edgar
Editor
Policy Forum: Canada’s Anti-Treaty-Shopping Proposals and International Treaty Obligations

Ken Snider*

KEYWORDS: GENERAL ANTI-AVOIDANCE RULE ■ INTERNATIONAL TAXATION ■ OECD ■ TAX TREATIES ■ TREATY SHOPPING

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INTRODUCTION

Treaty shopping1 is a deepening global controversy with competing interests across the private and public spectrum. The Organisation for Economic Co-operation and Development (OECD) has identified “treaty shopping” as one of the most important

* Of Cassels Brock & Blackwell LLP, Toronto (e-mail: ksnider@casselsbrock.com). I would like to thank Melissa Wright of Cassels Brock & Blackwell LLP for her helpful research.

1 The expression “treaty shopping” has been defined by the OECD on various occasions. It is commonly understood to mean attempts by residents of third states to access the benefit of a treaty between two contracting states. In the consultation paper (infra note 12), Finance stated that such a practice is generally considered an “improper” use of treaties, and cited the OECD commentary (infra note 8).
sources of base erosion and profit shifting (BEPS) concerns. The Canadian Department of Finance announced proposals regarding domestic anti-treaty-shopping legislation ("the proposals") in the 2014 federal budget. Finance released draft legislation on August 29, 2014 implementing measures from the 2014 budget but did not include the proposals. Finance stated that after engaging in consultations on the proposals, it will await further work by the OECD and the G20 in relation to the BEPS initiative. On September 16, 2014, the OECD released its BEPS recommendations, which are designed to create a single set of international tax rules to end base erosion and the artificial shifting of profits. This release included the OECD’s Action 6 report. The effect of the Action 6 report on the formulation of proposed amendments ("the future proposals") is unknown at this time.

The premise of this article, which was originally written before the release of the Action 6 report, is that Finance will propose draft domestic anti-treaty-shopping legislation amending the Income Tax Conventions Interpretation Act (ITCIA) that will prevail over Canadian tax treaties to the extent that there is inconsistency.

The proposals represent a profound change to Canadian international tax policy. The potential adverse effect is inestimable, especially for investors who have relied in good faith on well-established Canadian treaty policy not to mention relevant Canadian case law. In this article, I argue that, prior to the release of the Action 6 report, there were compelling reasons why the proposals would breach Canadian legal obligations under many tax treaties and especially those treaties in force prior to the 2002 update to the OECD model convention adopted by the Council of the OECD on January 28, 2003 ("the 2003 commentary"); moreover, the claims made in support of the proposals by Finance are not supported by the 2003 commentary. The proposals also conflict with the OECD public discussion draft on BEPS Action 6. I anticipate that Finance will be drafting the future proposals in a manner that will allow it to claim that it is following the Action 6 report.

4 Canada, Department of Finance, Legislative Proposals Relating to Income Tax and Sales Tax (Ottawa: Department of Finance, August 29, 2014).
7 Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, as amended.
Subject to the formulation of the future proposals, I submit that Finance should address treaty shopping by negotiating treaty amendments to reflect its new treaty policy regardless of any delays and concessions that may be required. I do not recommend improving the proposals, and therefore I do not focus on their architecture or details. Excellent reviews of these matters are available elsewhere.10

**FIRST PRINCIPLES FIRST**

The genesis of the proposals is the 2013 federal budget, which announced the treaty-shopping consultation process.11 This announcement was followed by the release of the consultation paper,12 which formed the basis for a period of consultation leading to the release of the proposals in the 2014 federal budget. The consultation paper summarizes possible approaches to prevent treaty shopping. As stated by Finance, the threshold question is whether treaty shopping should be addressed by Canada’s domestic tax laws or whether Canada should negotiate treaty-based rules. Finance stated that “a treaty based approach, on its own . . . would not serve as a timely response to the treaty shopping problem faced by Canada today.”13

In contrast, if Canada were to adopt a domestic law approach, amendments could be implemented in a timely manner. Domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD and the United Nations (the “UN”); both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping. For clarity, if a domestic law approach were adopted, it would provide that the domestic law provisions prevail over tax treaties; however, it should be recognized that Canada’s intention would be to clarify and codify its position concerning treaty shopping in a manner consistent with the OECD and UN Model Commentaries as well as the laws and practices of several other countries.14

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11 Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 373.

12 Canada, Department of Finance, Treaty Shopping—The Problem and Possible Solutions (Ottawa: Department of Finance, August 2013).

13 Ibid., at section 6.2.

14 Ibid. (emphasis added, notes omitted).
In the 2014 budget, Finance clearly stated its preference for a domestic-law approach. It reiterated the justification for such an approach described in the consultation paper:

Several stakeholders expressed a preference for a solution to treaty shopping that would require the re-negotiation of Canada’s tax treaties. This is based in large part, on the view that a domestic law response to treaty shopping would alter the balance of compromises reached in the negotiation of tax treaties. However, the absence of an anti-treaty shopping rule in a tax treaty does not mean that there is an implicit obligation to provide benefits in respect of abusive arrangements. As discussed in the consultation paper, domestic law provisions to prevent tax treaty abuse are not considered by the OECD or the United Nations to be in conflict with tax treaty obligations and a number of other countries have enacted legislation to that effect.

In addition, some stakeholders have asserted that only a few of Canada’s tax treaties would need to be re-negotiated in order to significantly curtail treaty shopping. As stated in the consultation paper, even if it were possible to re-negotiate—within a reasonable period of time—Canada’s treaties with certain countries where conduit entities are common, other conduit countries may emerge. Accordingly, a treaty-based approach would not be as effective as a domestic law rule.\(^{15}\)

Finance thus provides two justifications for a domestic-law approach. The first is that there will not be any conflict between the proposals and tax treaties, a justification apparently based on the proposition articulated in the 2003 commentary that domestic rules determine the facts that give rise to tax liability and therefore do not conflict with tax treaties.\(^{16}\) Second, Finance refers to the time and uncertainty involved in treaty renegotiation and says that other conduit countries may emerge to frustrate such efforts. Second, Finance implies that other countries have enacted domestic anti-abuse rules. However, Finance does not comment on the substance of such legislation in specified countries having regard to their respective legal and tax systems and tax treaties, or on how any of the foregoing may differ from the proposals and from the Canadian context. Nor does it comment on whether these other countries are overriding their tax treaties. The selective and casual mention of other jurisdictions cannot serve as a legal or policy justification for the proposals. In addition, the proposals are inconsistent with the 2003 commentary that refers to “main purpose” and “object and spirit.”\(^{17}\)

\(^{15}\) 2014 budget, supra note 3, at 350-51.

\(^{16}\) See the 2003 commentary, supra note 8, at paragraphs 8-22.1 of the commentary on article 1.

\(^{17}\) It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.
The analysis of whether the proposals will breach any Canadian tax treaty, regardless of when it became effective, should not start with OECD commentary on the model convention: it is necessary to first define Canada’s legal obligations under its tax treaties. An international principle of primary importance is pacta sunt servanda (the parties must honour the agreement). This maxim expresses one of the fundamental and universally recognized principles of the law of treaties; indeed, the principle “serves as a cornerstone of social interaction, peace and justice.”

The principle has been codified in the preamble and article 26 of the Vienna Convention on the Law of Treaties 1969, to which Canada has subscribed. It reads as follows: “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” Without such a principle, no treaty would be binding. Canadian courts have upheld this obligation.

Article 31(1) provides that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. The intention of the parties is of central importance in international law. Determining intention is not a search for a subjective determination; rather, it is a search for an objective determination derived from the text of the treaty and the interpretive rules of articles 31 and 32 of the Vienna Convention. Articles 31(2) and (3) discuss context. Article 32 addresses supplementary means of interpretation. No mention is made of OECD commentaries, and the provision does not expressly authorize the use of supplementary means of interpretation arising after the particular treaty was concluded.

The relationship between the OECD commentaries and the Vienna Convention is nuanced and complex and has been the subject of many learned texts and articles. Observers have noted that there is no consensus concerning the application of articles 31 and 32 and the commentaries.

The determination whether the proposals will contravene Canada’s treaty obligations must relate to a specific tax treaty and must be based on accepted principles of treaty interpretation and the relevant case law. This determination is not decided with finality by the ever-changing OECD commentary, as helpful as the commentary may be in the negotiation and interpretation of particular bilateral treaties.

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20 For example, David A. Ward et al., The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model (Kingston, ON and Amsterdam: International Fiscal Association (Canadian branch) and International Bureau of Fiscal Documentation, 2005).
Canadian tax treaties, with certain exceptions,\textsuperscript{21} do not have any language suggesting that the signatories were concerned with treaty shopping, let alone that they desired to curtail it. The entitlement to treaty benefits under Canadian tax treaties is not ambiguous and has been judicially considered. Finance’s assertion that the proposals are consistent with obligations under all of Canada’s tax treaties without exception is untenable for the reasons discussed in the next part of this article.

A CRITIQUE OF THE CLAIM THAT THE PROPOSALS DO NOT CONFLICT WITH CANADA’S TAX TREATIES

Status of OECD Commentaries

The changes to the commentary on article 1 of the OECD model convention strongly suggest that one can reject previous comments of the OECD to the effect that under the pacta sunt servanda principle anti-abuse measures must be included in treaties and that in their absence treaty benefits must be granted.\textsuperscript{22} The changes have shifted the onus: states that have entered observations must put provisions into their treaties to restrict the application of domestic anti-avoidance rules of the other states.\textsuperscript{23} These observations do not derogate in any way from the argument that Finance misconstrues the status of the OECD commentaries on prior treaties, seemingly disregards Canadian case law on the status of the OECD commentary in interpreting tax treaties, and does not mention specific observations by Luxembourg and the Netherlands concerning the 2003 commentary. Also noticeably absent is any mention of the approximately 81 tax treaties entered into before the 2003 commentary.

Paragraph 22.1 of the 2003 commentary, which posits that domestic rules determine the facts that give rise to tax liability and therefore do not conflict with tax treaties, does not provide a legal justification for a comprehensive treaty override, and it cannot plausibly be considered an invitation or permission from the OECD to enact domestic anti-treaty-shopping legislation. To conclude that there was no obligation to extend treaty benefits would require much stronger wording in view of prior OECD statements on negotiating treaty amendments, not to mention a legal justification that would cover every tax treaty. Finance seems to have elevated the 2003 commentary to legal authority in supporting the proposals—an interpretation that a court would not accept on the basis of case law.

\textsuperscript{21} The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1985, July 29, 1997, and September 21, 2007 (herein referred to as “the Canada-US treaty”), and the tax treaties that have specific anti-avoidance rules.


\textsuperscript{23} Ibid.
Undoubtedly, the OECD commentaries are important in interpreting tax treaties based on the OECD model convention, but they do not have the force of law in Canada. At most, they are relevant to the extent that they do not represent a major change.24 When such a change does occur, the OECD commentaries can be relevant only for treaties concluded after the change is made. For example, the Tax Court of Canada stated the following in *MIL (Investments) SA v. The Queen*:

Article 31(1)(c) of the Vienna Convention states “there shall be taken into account, together with the context, any relevant rules of international law applicable in the relations between the parties.” I interpret that to mean that one can only consult the OECD commentary in existence at the time the Treaty was negotiated without reference to subsequent revisions. The Respondent’s own expert on cross-examination agreed that subsequent revisions should be ignored:

Q. First, I understand that using the commentaries that came out in 2003 to the OECD Convention, the Article 1 commentaries, I think we both agree that trying to apply those commentaries to interpret a treaty that was put in place in 1989 is nonsense. Would you agree with that?

A. That is correct.

Overall, I found Steichen’s opinion and testimony not substantively convincing. In particular, in light of the OECD commentary and the decision by Canada and Luxembourg not to include an explicit reference to anti-avoidance rules in their carefully negotiated Treaty, I find there is no ambiguity in the Treaty permitting it to be construed as containing an inherent anti-abuse rule. Simply put, the “ordinary meaning” of the Treaty allowing the Appellant to claim the exemption must be respected.25

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Subsequent commentaries that elaborate on prior commentaries and are fair interpretations of the articles of the Model may be useful in the interpretive process. However, it is questionable how useful they may be, or what they may add in many cases when the articles of the treaty are interpreted in accordance with Article 31 of the Vienna Convention, with the aid of prior commentaries in accordance with the principles of logic and good sense. . . . We also are of the view that later commentary contradicting previous commentary should never be taken into account in interpreting existing treaties. To do so would be to deny the effectiveness of existing OECD commentary as part of the legal context in establishing the intentions of the parties negotiating particular tax treaties based on the commentaries and the Model current at the time and to delegate to the CFA an international law-making capacity for which there is no support. In short, later commentaries that go beyond a fair interpretation of the text of the particular treaty should be given little or no weight by national courts dealing with the interpretation and application of pre-existing treaties. [Emphasis added.]

25 *MIL (Investments) SA v. The Queen*, 2006 TCC 460, at paragraphs 86-87; aff’d. 2007 FCA 236.
Subsequently, in *Prévost Car Inc. v. Canada*, the Federal Court of Appeal stated that

> the worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model Convention a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions (see Crown Forest Industries Ltd. v. Canada . . . [1995] 2 S.C.R. 802 (S.C.C.). . . .

The same may be said with respect to later Commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries. . . .

I therefore reach the conclusion, that for the purposes of interpreting the Tax Treaty, the OECD Conduit Companies Report (in 1986) as well as the OECD 2003 Amendments to the 1977 Commentary are a helpful complement to the earlier Commentaries, insofar as they are eliciting, rather than contradicting, views previously expressed. Needless to say, the Commentaries apply to both the English text of the Model Convention (beneficial owner) and to the French text (bénéficiare effectif).

In *Sommerer v. The Queen*, the Tax Court similarly rejected the Crown’s reliance on the 2003 version of the commentary on article 1 of the OECD model. The court accepted the argument that only the 1977 commentary could be taken into account because the 2003 commentary conflicted with the earlier version. This position is based on the Federal Court of Appeal’s remarks in *Prévost* concerning the use of subsequent OECD commentary.

The 2003 commentary to article 1 regarding the consistency of domestic anti-abuse rules and treaty obligations arguably represents a major change to prior OECD commentary and should thus be relevant only for bilateral treaties subsequently negotiated. I develop this proposition in the next section of this article.

**OECD Commentaries and Reports Prior to the 2003 Commentary**

The OECD commentaries, as well as statements made in two OECD reports, are of central importance in assessing whether the proposals will breach approximately 81 of Canada’s tax treaties in effect prior to the 2003 commentary. A comprehensive review of the OECD commentaries and relevant reports prior to the 2003 commentary is beyond the scope of this article. The following summary is intended only to demonstrate that the OECD position articulated during this period clearly supported pacta sunt servanda and the need to negotiate treaty amendments. More particularly,

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27 *Sommerer v. The Queen*, 2011 TCC 212.
28 supra note 26.
29 Canada currently has 92 tax treaties in force.
30 See Arnold, supra note 22.
it is clear that the OECD commentaries and reports prior to the 2003 commentary supported treaty amendments to address perceived treaty abuse, and in no way recommended that countries adopt domestic legislation to deny treaty benefits under treaties that were in force prior to the commentary.

The provisions of the 1977 OECD model convention deal with the conduit situation in a rudimentary way, expressing only a general concern that the improper use of treaties should be avoided. The conduit company report31 adopted by the OECD Council on November 27, 1986 briefly elaborates on this position at paragraph 43, stating that treaty benefits must be granted in the absence of any clauses with safeguards against the use of their provisions. The conduit company report further recommends that countries be prepared to provide all possible help by exchanging information and to remedy such a situation by adequately revising the particular treaty. This position is treated in more detail in the OECD’s subsequent tax treaty override report.32 That report defines a treaty override as “a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.”33 The tax treaty override report strongly urges member countries to avoid any legislation “intended by the legislature to have effects in clear contradiction to international treaty obligations.”34 Thus, the intention of the legislature is the primary element in the OECD’s decision to censure a treaty override. To clarify this subjective element, the tax treaty override report cites three examples of situations that involve or are similar to a treaty override but that are distinguishable and not the subject of the report. Although the report explicitly “recognize[s] the legitimacy of the objective pursued,”35 it says that the denial of treaty benefits must be done under existing rules. It suggests that this type of case might be the object of a mutual agreement procedure, and that the OECD Fiscal Affairs Committee remains strongly opposed to treaty overrides.36 Paragraph 34 of the tax treaty override report, adopted by the OECD Council on October 2, 1989, states that

[the Committee has considered the arguments that might be put forward to defend the use of overriding legislation and recognised that in a number of cases the legitimacy of the objective pursued—in particular where they aim at counteracting abuse of

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33 Ibid., at paragraph 2.

34 Ibid., at paragraph 5.

35 Ibid., at paragraph 34.

36 On the basis of this report, many of the provisions of ITCIA would not be considered a “treaty override.” The proposals are significantly different in nature from other provisions of ITCIA (other than GAAR).
conventions—is well founded but the Committee remains strongly opposed to overriding legislation. Member countries have so far refrained from taking retaliatory measures (which all agree would not be conducive to better understanding in the international tax field) against overriding legislation but the Committee noted that there is growing dissatisfaction with the continued use of such legislation which could erode confidence in the international tax treaty network as a whole.37

In 1992, the commentary to article 1 of the OECD model convention was modified in response to concerns about the “improper” use of tax conventions. Paragraph 7 of the 1992 commentary provides that double tax conventions should not help tax avoidance, but notes that

it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres [to exploit the differences in tax levels as between States and the advantages provided by various countries’ taxation laws]. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.38

Finance seemingly did not respond to this commentary by expressly preserving the application of the general anti-avoidance rule (GAAR) in its tax treaties that entered into force prior to the 2003 commentary.

The 1992 commentary suggests in paragraph 10 that some of these situations are dealt with in the convention by the introduction of the concept of “beneficial owner” in articles 10, 11, and 12 or other provisions. It also indicates that

[it] may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.39

Paragraph 11 of the 1992 commentary indicates that the concern about the use of conduit and base companies to obtain treaty benefits not intended by the contracting states in their bilateral negotiations “has led an increasing number of Member countries to implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws” (emphasis added). Paragraph 12 of the 1992 commentary indicates only that

several solutions have been considered [to address the treaty-shopping problem] but, for the reasons set out in the above-mentioned reports, no definitive texts have been drafted, no strict recommendations as to the circumstances in which they should be

37 Tax treaty override report, supra note 32, at paragraph 34.
38 Paragraph 7 of the commentary to article 1, adopted by the OECD on July 23, 1992 (emphasis added).
39 Ibid., at paragraph 10 (emphasis added).
applied [have been] made [and no] exhaustive list of such possible counter-measures [has been] given. The texts quoted below are merely intended as suggested benchmarks that treaty negotiators might consider when searching for a solution to specific cases.\textsuperscript{40}

The 1992 commentary then outlines several possible approaches to be considered.

**CANADA’S TREATY POLICY PRIOR TO THE 2003 COMMENTARY**

Canada’s treaty policy prior to the 2003 commentary is also an important factor in assessing whether the proposals would breach Canada’s international treaty obligations. In this part of the article, I demonstrate that an anti-treaty-shopping policy of Finance first found expression only in 1993, while the Canada Revenue Agency (CRA) issued favourable tax rulings for 20 years thereafter. Indeed, Finance appears to have overlooked its own behaviour prior to the 2003 commentary and CRA rulings practice in formulating its conclusion that there will be no conflict with treaties. To the contrary, Finance and the CRA arguably facilitated treaty shopping.

**GAAR**

Compelling evidence that Canada has not historically had an anti-treaty-shopping policy is apparent in the history of GAAR,\textsuperscript{41} which was enacted in 1988. The provision, as enacted, was expressly applicable only to a misuse or abuse of the Income Tax Act.\textsuperscript{42} No reference was made to tax treaties in the legislation, in any government explanatory note, or in the CRA information circulars.

It is likely that the reason for this absence of concern in the 1970s and 1980s was that treaty shopping into Canada was not very lucrative, given the high Canadian treaty rates compared with the 25 percent Canadian statutory withholding rates. The treaty-reduced rates negotiated in the mid-1980s and thereafter, not to mention certain exemptions, changed the financial incentives for investors and the cost to the Canadian government. Specifically, the changes to Canada’s tax treaties, especially the treaties with the Netherlands and Luxembourg, meant that non-residents could profit from treaty shopping more than they had in the past.

It is perhaps not surprising, therefore, that it was not until 1993 that the CRA stated that it might seek to apply GAAR to treaty shopping,\textsuperscript{43} which precipitated a

\textsuperscript{40} Ibid., at paragraph 12 (emphasis added).


\textsuperscript{42} RSC 1985, c. 1 (5th Supp.), as amended.

debate about whether GAAR could apply to the abuse of a tax treaty.\(^{44}\) In this respect, the technical explanation of the third protocol introduced in 1995 to the Canada-US treaty stated that the limitation-on-benefits (LOB) article is not reciprocal and that “Canada prefers to rely on general anti-avoidance rules to counter arrangements involving treaty-shopping through the United States.” The fourth protocol (effective March 28, 1984) had a unidirectional LOB provision that could permit the United States, but not Canada, to deny treaty benefits. The fourth protocol provided as follows:

> It is understood that the fact that the [LOB] provisions of this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State [Canada] to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.\(^{45}\)

The debate about the relationship between GAAR and tax treaties was ultimately resolved by a 2005 amendment to the Income Tax Act, retroactive to 1988, that expressly made GAAR applicable to a misuse or abuse of a tax treaty. At the same time, ITCA was amended, retroactive to 1988, to provide that GAAR applies notwithstanding any treaty provisions to the contrary.\(^{46}\) Yet the new anti-treaty-shopping policy from the early 1990s was not reflected in subsequent tax treaties or in the CRA’s rulings practice. In particular, after issuing statements about GAAR and treaty shopping in the early 1990s, the CRA issued a series of advance income tax rulings on the investment by Luxembourg and Netherlands corporations into Canada and the favourable capital gains provision in article XIII.\(^{47}\) This practice clearly demonstrates the detrimental reliance that taxpayers and advisers placed on a common understanding of treaties and administrative practice.

Although there are many deletions in the published rulings, there is no evidence, including caveats, that suggest that treaty shopping was of concern. In addition, the use of third-country conduits arose in respect of the fifth protocol to the Canada-US tax treaty because of the hybrid entity rules. In the CRA round table at the 2009 annual

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\(^{44}\) Tremblay, supra note 41.

\(^{45}\) Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital signed at Washington on September 26, 1980 as amended by the protocols signed at Ottawa on June 14, 1983 and March 28, 1984, article 18, new article XXIX A(7).

\(^{46}\) ITCA was introduced in 1984 and has been amended on numerous occasions to deal with various treaty interpretation matters, particularly when the government lost a case dealing with treaty interpretation. ITCA was introduced to reverse the decision of the Supreme Court of Canada in *The Queen v. Melford Developments Inc.*, 82 DTC 6281 (SCC). That case dealt with the ambulatory definition of an undefined term in the Canada-Germany treaty.

tax conference,\textsuperscript{48} question 4 addressed an increase in the paid-up capital of an unlimited liability company (ULC). In response, the CRA stated that it would not normally expect GAAR to apply under certain conditions. Question 5 dealt with interposing a Luxembourg SARL (société à responsabilité limitée) to obtain relief under the Canada-Luxembourg treaty. The CRA stated that the comments regarding GAAR in response 4 applied. In 2009, the CRA issued a favourable tax ruling on the interposition of a Netherlands company between a ULC and its US parent.\textsuperscript{49} These responses and the ruling facilitated the use of treaties in a manner that Finance now says is offensive. At the 2013 International Fiscal Association meeting, the CRA announced that taxpayers should not expect Rulings to look favourably on a ruling request involving the interposition of an entity located in a third jurisdiction to avoid the application of article IV(7) of the Canada-US treaty.\textsuperscript{50}

As is well known, the government was unsuccessful in using GAAR and arguing that there was an inherent anti-abuse rule in the Canada-Luxembourg treaty to challenge treaty shopping in \textit{MIL (Investments) SA v. The Queen}.\textsuperscript{51} MIL involved the redomiciling of a Cayman corporation to Luxembourg in order to use the convention to avoid Canadian tax on a capital gain. In regard to the justification for the proposals, Finance seems not to think that this case refutes any suggestion that the proposals do not conflict with the 2003 commentary. In \textit{MIL}, the Tax Court said the following:

\textit{Abusive Avoidance under the Treaty}

Having found that the Sale and none of the transactions in the Series are avoidance transactions, it is not necessary for me to analyze whether any of those transactions is abusive under subsection 245(4). If I were to do such an analysis, however, I would focus on whether a specific provision or article of the Treaty or Act was misused or abused. In the Appellant’s case, I would consider specifically, the exemptions relied upon by the Appellant in Article 13(4).

An example of potential abuse can be found in \textit{RMM Canadian Enterprises Inc. v. MNR}, 97 DTC 302. There, the Appellant attempted to structure a “surplus-stripping” transaction as a capital gain in order to have an exemption pursuant to Article XIII of the Canada-US treaty as opposed to a dividend which would be treated less favourably under Article X. In such circumstances, it would not necessarily be unreasonable to apply section 245 to recharacterize the capital gain as a dividend for the purposes of denying the Treaty benefit.

In written argument, Respondent’s counsel argued that “treaty shopping” is an abuse of bilateral tax conventions and that this is recognized by the Supreme Court of Canada. In oral argument, the following passage from \textit{Crown Forest Industries Ltd. v. The Queen} . . . [1995] 2 S.C.R. 802, at page 825, was quoted to establish that if the Supreme

\textsuperscript{50} CRA document no. 2013-0483801C6, May 23, 2013.
\textsuperscript{51} \textit{MIL (Investments) SA}, supra note 25.
Court had access to section 245, it would have used that section to deny a benefit from “treaty shopping”:

“It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements. . . .”

I do not agree that Justice Iacobucci’s obiter dicta can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent’s counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined.

Canada has negotiated a broad network of carefully negotiated tax conventions with many different nations. Prior to negotiating the Treaty, Canada undoubtedly had knowledge of Luxembourg’s treatment of capital gains.52

This reasoning clearly provides support for the position that the proposals would breach all of the pre-2003 commentary treaties.53 Although the post-2003 commentary does not expressly refer to GAARS, it is understood that such a reference is not considered necessary for treaties negotiated thereafter.54 But it remains an open question whether these treaties will nevertheless be breached by the proposals, which, it is submitted, are inconsistent with the 2003 commentary.

It is notable that Canada has included in approximately 16 more recent tax treaties a “main purpose” test similar to that in the proposals in order to deny access to treaty benefits in specific articles. For example, article 12(7) of the recent Canada-Hong Kong treaty provides that

[a] resident of a Party shall not be entitled to any benefits provided under this Article in respect of a royalty if one of the main purposes of any person concerned with an assignment or transfer of the royalty, or with the creation, assignment, acquisition or transfer of rights in respect of which the royalty is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the royalty, is for that resident to obtain the benefits of this Article.55

52 Ibid., at paragraphs 70-73 (TCC).
53 The government also attempted to challenge treaty shopping on the basis of “beneficial ownership” in Prévost Car Inc., supra note 26, and Védro Canada Inc. v. The Queen, 2012 TCC 57. In neither case was GAAR argued. The government lost in both Prévost and Védro.
54 See Arnold, supra note 22.
55 Agreement Between the Government of Canada and the Government of the Hong Kong Special Administrative Region of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Hong Kong on November 11, 2012.
In regard to treaties negotiated after 2003, it is clear that the 2003 commentary on article 1 is entirely focused on domestic rules that determine the facts that give rise to a tax liability. The proposals appear to be crafted so as to determine the facts as contemplated without reference to an object-and-spirit or other purpose test.56 The CRA takes the position that a main purpose test is a question of fact to be determined objectively.57 This view was recently supported by the Federal Court of Appeal in Groupe Honco Inc. v. Canada.58 However, as David Ward noted, a domestic rule that determines facts is not a mandate for the wholesale overriding of tax treaties.59

Comments on Specific Tax Treaties and Observations to the 2003 Commentary

The Canada-Netherlands treaty (signed on May 27, 1986 and amended by the protocols signed on March 4, 1993 and August 25, 1997) and the Canada-Luxembourg treaty (signed on September 10, 1999) warrant comment because of their widespread use in planning and their honourable mention in the consultation paper, not to mention the comments made in MIL Investments concerning the Luxembourg treaty.

Neither treaty mentions tax avoidance or abuse, and hence there is no object-and-spirit test in either treaty that lends itself to a GAAR challenge. In fact, the generous capital gains provisions of both treaties do not even follow the OECD model convention, and they further diminish Finance’s claims regarding the 2003 commentary. One can reasonably conclude that the treaties, and especially article XIII, were negotiated by Finance to facilitate foreign investment in Canada by residents of third states. These treaties have been enormously successful in that respect. In regard to article XIII, the domestic law of the Netherlands and Luxembourg would impose tax on a capital gain realized by a Canadian tax resident in very limited circumstances in comparison with the “taxable Canadian property” rules in the Income Tax Act (and this was particularly the case at the time the treaties were negotiated).

56 In contrast, GAAR does not determine facts or recharacterize transactions per se. Both the Income Tax Act and the jurisprudence on this point are clear: section 245 “does not permit the recharacterization of an event for purposes of determining whether s. 245(2) applies. Recharacterization is permissible under s. 245(5)(c) only where it can be found that s. 245(2) applies on the basis of transactions which have not been subjected to recharacterization”: Canadian Pacific Limited v. The Queen, 2000 DTC 2428, at paragraph 10 (TCC); aff’d. 2002 DTC 6742 (FCA).
It is inconceivable that the intention of the parties in these two treaties was that treaty entitlements for the indeterminate term of the treaty should be based on a unilateral approach taken by Canada as much as 30 years later in the case of the Netherlands treaty and 15 years in the case of the Luxembourg treaty. The comments on prevailing OECD commentary and other factors buttress this conclusion.

The Netherlands treaty was apparently renegotiated at the behest of the US government to curtail double dipping into the United States.\textsuperscript{60} If Finance had any concern about inbound treaty shopping, it would have negotiated a very different treaty. (It had included a specific anti-avoidance provision in the 1978 Canada-UK treaty).\textsuperscript{61} Finance was presumably very familiar with the US use of LOB provisions to curtail treaty shopping but had no interest in the US approach or other treaty-based anti-avoidance rules. The Luxembourg treaty is more recent but also entered into force before the 2003 commentary and after statements from the CRA concerning GAAR.

Recent attempts to use the Access to Information Act to obtain information about the negotiation of these two tax treaties and treaty abuse were unsuccessful.\textsuperscript{62} It may be that Finance either was not aware of or chose to disregard the observation made by each of Luxembourg and the Netherlands in respect of the 2003 commentary:

\begin{itemize}
  \item \textbf{27.6 Luxembourg} does not share the interpretation in paragraphs 9.2, 22.1 and 23 which provide that there is generally no conflict between anti-abuse provisions of the domestic law of a Contracting State and the provisions of its tax conventions. Absent an express provision in the Convention, Luxembourg therefore believes that a State can only apply its domestic anti-abuse provisions in specific cases after recourse to the mutual agreement procedure.
  \item \textbf{27.7 The Netherlands} does not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and controlled foreign companies provisions do not conflict with the provisions of tax conventions. The compatibility of such rules and provisions with tax treaties is, among other things, dependent on the nature and wording of the specific provision, the wording and purpose of the relevant treaty
\end{itemize}


\textsuperscript{62} Tax Policy Branch officials advised that information dealing with the negotiation of treaties is highly sensitive and would not be released as part of an access-to-information request in respect of any combination of the following provisions of the Income Tax Act: paragraph 13(1)(a) (information obtained in confidence from the government of a foreign state or an institution thereof) and paragraph 15(1)(g) (on the positions adopted or to be adopted by the government of Canada, governments of foreign states, or international organizations of states for the purpose of present or future international negotiations).
provision and the relationship between the domestic and international law in a country. Since tax conventions are not meant to facilitate the improper use thereof, the application of national rules and provisions may be justified in specific cases of abuse or clearly unintended use. In such situations the application of domestic measures has to respect the principle of proportionality and should not go beyond what is necessary to prevent the abuse or the clearly unintended use.

The relevance of an observation is that these countries do not share the views stated in the interpretation of the Commentary. It is axiomatic that any interpretation in the commentaries will not apply if the negotiating party did not intend the Commentary to be used as a basis for interpretation. Their observations undisputedly refute any suggestion that the Proposals do not conflict with the Netherlands Convention and Luxembourg Convention because of the 2003 Commentary.63

Obviously, these tax treaties do not reflect Finance’s current treaty-shopping policy. Nevertheless, dissatisfaction with a thoroughly negotiated treaty is hardly a reason for Canada to unilaterally propose rules that will restrict treaty benefits that would have been unimaginable when the treaties entered into force. Canada’s duty to comply with these (and other) treaties is unequivocal, especially in view of the observations on the 2003 commentary.

THE RANKING OF TAX TREATIES IN CANADIAN LAW

The question arises whether a breach of tax treaties by Canada is unlawful in Canada. In Canada, tax treaties provide that the treaty does not come into force until it is ratified by the states that have signed it. Once the tax treaty is in force, the parties are obligated under international law to implement the treaty. Canada does not recognize a treaty as part of its domestic law. Consequently, a treaty that requires a change in domestic legislation can be implemented only by the enactment of a statute. This is the case with tax treaties. Many countries share this dualist approach, but others do not. For example, the US constitution makes all treaties part of the supreme law of the land. Treaties are equal in standing to regular laws. The general rule in the United States is that the provision that is later in time governs.

It is clear that the proposals, when enacted, will not be unconstitutional in Canada. The courts will apply Canadian statutory or common law even if it is inconsistent with a binding treaty. A leading Canadian constitutional law expert has said that

[In a case where Canada’s internal law is not in conformity with a treaty binding upon Canada, then Canada is in breach of its international obligations and may be liable in international law to pay damages or suffer other sanctions, but the breach of a treaty is irrelevant to the rights of parties to litigation in a Canadian court. The only concession which the Canadian courts have been prepared to make in recognition of Canada’s international obligations is to interpret statutes so as to conform as far as

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63 Paragraphs 27.6 and 27.7 of the 2003 commentary on article 1, supra note 8 (emphasis added).
possible with international law. But where the language of a statute is clearly and unmistakably inconsistent with a treaty or other rule of international law, then there is no room for interpreting it into conformity with the international rule and the statute must be applied as it stands.64

Accordingly, even if legislation enacting the proposals clearly breaches a particular treaty, a Canadian court must apply the legislation (assuming that it is clearly drafted). However, just because Finance can propose domestic legislation that is lawful in Canada but breaches treaty obligations does not mean that it should do so.

Interestingly, some enacting legislation gives paramountcy to tax treaties. For example, the implementing legislation for the Canada-US treaty (assented to in 1984) and for the Canada-Netherlands treaty provides as follows:

In the event of any inconsistency between the provisions of this Act or the Convention, and the provisions of any other law, the provisions of this Act and the Convention prevail to the extent of the inconsistency.65

The implementing legislation does not refer to ITICA. The fact that certain treaties prevail in the event of inconsistency makes it spurious to suggest that the proposals will not violate tax treaties when the implementing legislation has this paramountcy provision. It is expected that Finance will want to amend such implementing legislation to provide for paramountcy of ITICA.

The enacting legislation for many tax treaties provides that ITICA has paramountcy in the case of any inconsistency. For example, the legislation that implemented the Canada-Slovenia treaty provides as follows:

5.(1) Subject to subsection (2), in the event of any inconsistency between the provisions of this Part or the Convention and the provisions of any other law, the provisions of this Part and the Convention prevail to the extent of the inconsistency.

(2) In the event of any inconsistency between the provisions of the Convention and the provisions of the Income Tax Conventions Interpretation Act, the provisions of that Act prevail to the extent of the inconsistency.66

The same wording is used in the legislation that implements many other tax treaties, including the Canada-Luxembourg treaty.

A treaty override may present alternative remedies to the other state if the other state is sufficiently concerned. Such remedies could include filing a protest or, at the draconian worst, cancelling the treaty.67 The latter was strongly discouraged in the

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67 Li and Sandler, supra note 19, at 895.
OEC
tax treaty override report. The taxpayer that is denied treaty benefits because of a treaty override is in a difficult position. The taxpayer is not a party to the tax treaty and cannot succeed in contesting an assessment on the basis of Canada’s contravention of the treaty, assuming that the treaty override legislation is clearly drafted.

**OECD DISCUSSION DRAFT**

The OECD discussion draft on treaty shopping is the result of work focused on the following areas identified by BEPS Action 6:

1. treaty provisions and/or domestic rules to prevent the granting of treaty benefits in inappropriate circumstances;
2. clarification that tax treaties are not intended to be used to generate double non-taxation; and
3. tax policy considerations for countries to consider before deciding to enter into a tax treaty with another country.

The discussion draft distinguishes between (1) cases where a person tries to circumvent limitations imposed by the treaty itself, and (2) cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits. The discussion draft treats treaty shopping as case 1 and suggests that countries adopt a treaty-based approach in response, with a main article based on a US-style comprehensive LOB clause supplemented by a more limited purpose-based article.

Endorsement of a domestic-law approach in curtailing treaty shopping is conspicuously absent. If that was a preferred approach, one would have expected a detailed discussion. In fact, note 12 in the discussion draft states that

[u]nder the principles of public international law, as codified in Articles 26 and 27 of the *Vienna Convention on the Law of Treaties* . . . , if the application of a domestic anti-abuse rule has the effect of allowing a State that is party to a tax treaty to tax an item of income that that State is not allowed to tax under the provision of the treaty, the application of the domestic anti-abuse rule would conflict with the provisions of the treaty and these treaty provisions should prevail.68

It is impossible to reconcile the proposals with the discussion draft. Like others, I have questioned why Finance did not wait for the release of the discussion draft before releasing the proposals, and why the proposals seem fundamentally inconsistent with the recommendations in the discussion draft. Because of the lack of any requirement of a finding of abuse, the proposals are broader than both GAAR and the approach of the discussion draft, which in paragraph 8 proposes the denial of a

68 Discussion draft, supra note 9, at note 12. This was pointed out by Steve Suarez, supra note 10.
treaty benefit “unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provision of the Convention.” Ironically, Finance also chose to reject the comments in the 2003 commentary in respect of “object and purpose,” notwithstanding that Finance quoted them in its consultation paper:

A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.69

Perhaps Finance wishes to avoid an object-and-purpose test, given the reasoning and result in the MIL decision. Finance may also object to the possibility that the government may bear the onus to establish object and purpose in the face of clear treaty language and the absence of any Canadian anti-treaty policy at the time of the particular treaty. The OECD discussion draft is superseded by the Action 6 report.

THE ACTION 6 REPORT

The explanatory statement for the seven 2014 deliverables stated that the first set of reports and recommendations addresses seven of the actions in the BEPS Action Plan. The proposed measures,

while agreed, are not yet formally finalised as they may be impacted by some of the decisions taken with respect to the 2015 deliverables with which they interact. They do reflect consensus on a number of solutions to put an end to BEPS.70

The four reports are in draft, and detailed implementation steps are described in the explanatory statement.

The foreword to the Action 6 report states that BEPS requires a coordinated response but that countries have sovereignty over tax matters and measures may be implemented in different countries in different ways as long as they do not conflict with the international legal commitments of the country. Action 6 required, inter alia, the development of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. The Action 6 report, like the OECD discussion draft, distinguishes between two cases:

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69 Paragraph 9.5 of the 2003 commentary on article 1, supra note 8 (emphasis added).

1. Cases where a person tries to circumvent limitations provided by the treaty itself.
2. Cases where a person tries to circumvent the provisions of domestic tax law by using treaty benefits.71

Like the discussion draft, the Action 6 report treats treaty shopping as falling within case 1.72 The Action 6 report recommends a three-pronged approach:

1. include in the title and preamble of tax treaties a clear statement that the contracting states intend to prevent tax avoidance and specifically intend to avoid opportunities for treaty shopping;
2. include in tax treaties a specific anti-abuse rule based on LOB provisions included in treaties concluded by the United States and a few other countries; and
3. in order to address other forms of treaty abuse, including treaty shopping that would not be covered by a LOB provision as described above, include in treaties a more general anti-abuse provision based on the principal purposes of the transactions or arrangements (“the PPT rule”).

The approach in the Action 6 report is the same as that in the OECD discussion draft. Domestic anti-abuse rules were not added as a fourth prong in the Action 6 report. The Action 6 report states that the combination of a LOB provision and the PPT rule may not be appropriate for countries that have domestic anti-abuse rules and that those countries either may not require the general treaty anti-abuse provision or may prefer a more restricted version.73 The Action 6 report states that “[a]s long as the approach that countries adopt effectively addresses treaty abuses along the lines of this report, some flexibility is therefore possible.”74

The Action 6 report’s recommendations reiterate the three-pronged approach, adding “or domestic anti-abuse rules or judicial doctrines that would achieve a similar result.”75 In this regard, the report seems to endorse a domestic-law approach with surprising brevity, but not as a fourth prong, nor was it mentioned in the explanatory statement. The discussion draft did not endorse this alternative.

In the sections dealing with “[c]ases where a person tries to circumvent the provisions of domestic tax law using treaty benefits,” new paragraphs are added to the commentary on specific legislative anti-abuse rules. The report states that

71 Supra note 6, at 20.
72 Ibid., at 21, paragraph 13.
73 Ibid.
74 Ibid., at 21, paragraph 14.
75 Ibid.
where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of “pacta sunt servanda.”\footnote{Ibid., at 90, paragraph 5.}

It is perplexing that pacta sunt servanda is not mentioned in connection with treaty shopping under “[c]ases where a person tries to circumvent limitations provided by the treaty itself.” One might assume that this omission was intentional and that it implies a shared view that a domestic anti-abuse rule in regard to treaty shopping would not contravene the pacta sunt servanda doctrine, provided that the rule was “along the lines” of a LOB provision and the PPT rule. Is that the case just because there was a consensus among members concerning the draft recommendations in the Action 6 report? At this point, it is a matter of speculation whether there will be any more detail regarding a domestic-law approach, which would provide more assistance in assessing any future proposals when the recommendations are finalized.

It is not known whether Finance will release future proposals before the recommendations are finalized.

It is anticipated that Finance may view the Action 6 report as OECD approval for proceeding with the future proposals. However, Finance should draft the future proposals very clearly “along the lines” of the report—namely, the future proposals should be a LOB provision, a PPT rule, or both in order for Finance to claim that it has OECD support. The present proposals cannot reasonably be considered to fit this description.

**RECOMMENDATIONS TO RENEGOTIATE TAX TREATIES**

The statements in the consultation paper and the 2014 budget about the difficulties in negotiating changes to tax treaties seem exaggerated for several reasons and can hardly constitute a justification for contravening tax treaties. Instead, following a course of seeking treaty amendments, Canada would demonstrate both nationally and internationally that it honours its international treaty obligations notwithstanding any inconvenience, delay, or cost. This approach would strengthen rather than weaken the treaty network. The expenditure of time is a necessary price to pay for treaty compliance.

For several decades, the US Treasury Department has been pursuing the inclusion of a LOB article in both renegotiated and new tax treaties. The objective of limiting the perceived abuse of US tax treaties in the outbound profits distribution context is clear. It is peculiar that the United States, a country often accused of using aggressive treaty overrides, has adopted an effective long-term treaty policy of treaty amendments even though it has the constitutional ability to override treaties. In contrast, Finance seeks to change the fundamental entitlement to treaty benefits in a single amendment to ITCIA.
The Netherlands has also renegotiated many tax treaties to provide for an anti-avoidance provision in exchange for reduced withholding tax rates. Numerous Dutch tax lawyers have advised me, that on the basis of past practice, they believe that the Dutch finance authorities are open to such a negotiation with Canada. Perhaps the real reason that Canada does not want to pursue treaty amendments is that it would have to make certain concessions to the treaty partner. Even Luxembourg may consider treaty amendments. For example, the Luxembourg-Russia treaty has an anti-avoidance provision:

It is understood that a resident of a Contracting State shall not be entitled to a reduction of or exemption from taxes provided for in this Convention on income derived from the other Contracting State if, as a result of consultations between the competent authorities of both Contracting States, it is established that the main purpose or one of the main purposes of the creation or existence of such resident was to obtain the benefits of this Convention which would otherwise not be granted.

77 The Netherlands treaties and provisions are as follows: Armenia, signed on October 31, 2001 (main purpose test in protocol, article XII(3)); Bahrein (LOB clause, article 10(11)); Barbados (LOB clause, articles 31(1) and (2)); China, 2013 (not yet in force; article 23 will most likely contain a provision that allows the states to enforce their domestic anti-abuse rules notwithstanding the treaty provisions); Croatia, signed on May 23, 2000 (main purpose test, article 10(9)); Egypt, signed on April 21, 1999 (main purpose test, article 10(4)); Estonia, signed on March 14, 1997 (main purpose test, articles 11(8) and 12(7)); Germany (not yet in force; article 23(1) will most likely contain a provision that allows the states to enforce their domestic anti-abuse rules notwithstanding the provisions of the treaty (the main German national anti-abuse rules are article 42 of the German Tax Law [anti-abuse-of-law provision; fraus legis], article 50d(3) of the Income Tax Law [anti-treaty-shopping provision], and chapters 4, 5, and 7 of the External Tax Relations Law); Hong Kong (LOB clause, article 27(3), redirects to anti-avoidance rules in the Dutch national law); Japan, signed on March 3, 1970 (LOB clause, article 21); Jordan, signed on October 31, 2006 (main purpose test, article 10(3)); Kazakhstan, signed on April 24, 1976 (main purpose test in protocol, article XI(2)); Kuwait, signed on May 29, 2001 (LOB clause in protocol, article 5); Latvia, signed on March 13, 1994 (main purpose test, article 10(8)); Macedonia, signed on September 11, 1998 (LOB clause in protocol, article V); Malta (main purpose test in protocol, article IV(1)); Mexico, signed on September 27, 1993 (main purpose test, articles 11(8) and 12(7)); Morocco, signed on August 12, 1977 (main purpose test, articles 11(7) and 12(7)); Panama (LOB clause, articles 10(3)-(6)); Qatar (main purpose test, article 10(7)); Romania, signed on March 5, 1998 (main purpose test, article 10(7)); South Africa, signed on October 10, 2005 (main purpose test, article 10(8)); Suriname, signed on November 25, 1975 (main purpose test, article 10(2)(a)); Switzerland, signed on November 12, 1951 (main purpose test in protocol, article 8); Tunisia, signed on May 16, 1995 (main purpose test, articles 8(3)); United Arab Emirates (main purpose test, article 10(9)); United Kingdom (main purpose test, articles 10(3), 11(5), 12(5), and 20(4); United States, signed on December 18, 1992 (LOB clause, article 26); and Uzbekistan, signed on October 12, 2001 (main purpose test, articles 11(6) and 12(6)).

78 In particular, I would like to thank Mark van Casteren of Loyens & Loeff for his assistance.

If treaties were renegotiated with a relatively small number of countries that have both a favourable domestic tax regime and a tax treaty with Canada, a great deal of treaty shopping into Canada would be curtailed. From a practical perspective, in other words, it is reasonable to conclude that significant progress may be made more quickly than Finance suggests, albeit perhaps with some withholding tax concessions and the provision of transitional relief.

Finance’s assertion that other conduit countries would emerge is ambiguous. Presumably, Finance is referring to countries with which Canada has current tax treaties. For new treaties, conduits can easily be addressed as Canada has done in recent tax treaties. If a current treaty partner decides to facilitate a conduit by making its domestic legislation much more favourable, a number of options are open to Finance—including terminating the treaty in the worst-case scenario.

**CONCLUSION**

Canada should honour its obligations under its tax treaties. To do otherwise would be a radical and irreversible step with an incalculable effect. The rationale offered by Finance to explain why the proposals did not conflict with tax treaties was untenable. Contrary to Finance’s statements in the consultation paper, the proposals were not even consistent with the recommendations expressed in the OECD discussion draft and the Action 6 report. It remains to be seen whether future proposals will be “along the lines” of the Action 6 report, and whether they will override tax treaties—especially treaties that were in force before the 2003 commentary—in a broad and fundamental manner. Canada could achieve its objectives of curtailing treaty shopping through treaty amendments, as other counties have done; however, the stage is set for a domestic rule with support from the OECD and the G20. It is hoped that the future proposals honour pacta sunt servanda.
Policy Forum: UK and EU Approaches to Treaty Shopping

Jonathan Schwarz*

**KEYWORDS:** TAX TREATIES • ANTI-ABUSE • TREATY SHOPPING • TAX AVOIDANCE • UNITED KINGDOM • EUROPEAN UNION

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**INTRODUCTION**

In this article, I first provide a UK perspective on treaty shopping and treaty abuse. I consider judicial approaches to treaty shopping, examine anti-abuse measures in UK tax treaties, and look at the new domestic-law general anti-avoidance rule (GAAR) as it relates to treaties. Judicial reluctance to allow treaty shopping or other treaty abuse suggests that existing measures in treaties are sufficient and that a case has not been made for the introduction of general anti-abuse rules in this area. Broad domestic treaty overrides jeopardize the international legal order and rule of law. Second, I examine EU law by reference to the approach taken by the Court of Justice of the European Union in relation to treaty shopping. The cases are essentially constitutional in nature because they test the validity of tax treaty provisions against the fundamental freedoms in the treaties constituting the European Union as taxpayers challenge the jurisdiction of member states to conclude treaties containing limitation-on-benefits (LOB) provisions. I then look at what might be termed “directive shopping” in relation to the EU direct tax legislative measures.

* Of Temple Tax Chambers, London (e-mail: jonathan.schwarz@taxbarristers.com).
UK JUDICIAL APPROACHES

Her Majesty’s Revenue and Customs (HMRC) describes treaty shopping as “the improper use of a DTA [double taxation agreement], whereby a person acts through an entity created in another state with the main or sole purpose of obtaining treaty benefits which would not be available directly to such a person.”1 The courts have adopted this characterization. In Indofood International, Evans-Lombe J said,

It is clear that the original loan by the noteholders through the issuer to the parent guarantor amounted to treaty shopping in the sense that there was no other reason why they should have done so through a Mauritian company save for the purpose of taking advantage of the double taxation treaty between Indonesia and Mauritius.2

The UK discourse, however, seldom distinguishes between treaty shopping in the sense described above and abuse in the sense of using treaty provisions for unintended purposes.3 This is reflected in a wide variety of measures that have appeared in UK treaties,4 most of which are aimed not at treaty shopping but at preventing abuse. For example, a specific anti-abuse provision was included in the 1980 UK-Netherlands treaty5 aimed at limiting access to tax credits in respect of dividends paid by UK-resident companies to Netherlands-resident companies under articles 10(3)(b) and (c). Under those articles, a Netherlands-resident corporate shareholder was entitled to payment of a partial tax credit upon receiving dividends from a UK-resident company6 if that shareholder, either alone or together with one

2 Indofood International Finance Ltd. v. J P Morgan Chase Bank NA, [2005] EWHC 2103, at paragraph 42 (Ch.).
3 Somewhat confusingly, HMRC’s International Manual says that “broadly, treaty shopping can be regarded as an arrangement put in place to take advantage of a provision in a double taxation agreement (DTA) for tax purposes.” Supra note 1, at INTM511050, “Thin Capitalisation: Practical Guidance: Introduction: Referrals to Business International.”
4 Jonathan S. Schwarz, Schwarz on Tax Treaties, 3d ed. (Surrey, UK: CCH, 2013), chapter 17.
6 The Netherlands was only the second country, after the United States, to conclude a treaty with the United Kingdom that conferred such tax credit payments on non-UK-resident shareholders. A number of subsequent UK treaties extended tax credit payments to residents of some contracting states, but the practice was far from universal. Interestingly, other treaties that permitted tax credit payments did not contain the same limitation on this benefit as the UK-Netherlands treaty. The Netherlands, however, had an established reputation as a holding company location by reason of its domestic exemption for dividends received on substantial participations and a treaty network that eliminated or reduced Netherlands withholding tax on dividends.
or more associated companies, controlled directly or indirectly 10 percent or more of the voting power in the UK company. Article 10 provided in part as follows:

Notwithstanding the provisions of sub-paragraphs (b) and (c) of this paragraph, no tax credit shall be payable . . . unless the company shows that it is not controlled by a person or two or more associated or connected persons together, who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividends.7

The availability of tax credits under article 10 of the UK-Netherlands treaty was at issue in *EVC International*.8 The case involved a joint venture in which the joint venture vehicle was a Dutch company owned by several participants. An Italian company held small minority participation. At the time, the UK-Italy treaty did not grant repayment of tax credits to Italian residents. The Court of Appeal upheld the application of the limitation where the Netherlands-resident company was controlled by non-qualifying persons or by persons “associated or connected with” such persons. The court agreed that the provision was an anti-avoidance measure to prevent the artificial creation of entitlement to tax credits and accepted that the joint venture structure was not a scheme designed for the purpose of creating an entitlement to a tax credit where none would otherwise exist. However, it rejected the argument that the absence of such a purpose would render the anti-avoidance provision inapplicable, with the result that the joint venture vehicle was ineligible for the tax credit. The case illustrates the inflexibility of such provisions and the necessity to consider carefully the class or classes of persons that ought to be entitled to, or that ought to be excluded from, treaty benefits.

*Indofood* suggests a proper course of action for states that believe that a particular treaty confers benefits in circumstances that they consider inappropriate—namely, termination of a tax treaty where the treaty is regarded as no longer acceptable and the relevant states cannot agree on new terms.9 The Indonesian government adopted such a course of action because it believed that domestic-law changes in Mauritius allowed non-resident parties in Mauritius to engage in treaty shopping and tax abuse. The ensuing commercial dispute over the expression “beneficial ownership” in the Indonesia-Mauritius treaty came before the English court because the unavailability of treaty benefits permitted the Indonesian borrower to repay loans to bondholders. The English court was required to decide how an Indonesian court would have interpreted the expression “beneficial ownership” in the Indonesia-Mauritius treaty. The Court of Appeal noted that there is no free-standing principle of Indonesian law which requires an advantage apparently obtained under a tax avoidance scheme to be denied to a participant in that

7 Supra note 5, at article 10(3)(d)(i).
9 *Indofood*, supra note 2, at paragraph 25.
scheme, though the existence of a tax avoidance scheme may be relevant to questions of legislative interpretation.10

This statement is an early suggestion that the principles of interpretation themselves may operate to defeat treaty shopping. In fact, HMRC has tried to develop that line of reasoning in arguing such cases. For example, in *HMRC v. Smallwood*, which concerned a trust that migrated to Mauritius in order to benefit from the capital gains provisions of the UK-Mauritius treaty, HMRC contended in the Court of Appeal that

> the purpose of the DTA was to grant relief against double taxation. It was specifically not its purpose to facilitate the avoidance of tax in both jurisdictions. . . . It therefore requires to be construed purposively with that primary object in mind.11

Much the same argument was accepted in *Bayfine UK*, where the Court of Appeal said that

> the primary purposes of the Treaty are, on the one hand, to eliminate double taxation and, on the other hand, to prevent the avoidance of taxation. In seeking a purposive interpretation, both these principles have to be borne in mind. Moreover, the latter principle, in my judgment, means that the Treaty should be interpreted to avoid the grant of double relief as well as to confer relief against double taxation.12

*Bayfine* was not a treaty-shopping case; it concerned tax avoidance by means of complex arrangements involving two offsetting forward contracts with a US bank concluded by two UK subsidiaries of US corporations that had a common US parent, and mismatching entity characterizations between the two states, with the object of claiming a foreign tax credit in both the United Kingdom and the United States. Although the court’s reasoning was based on an erroneous assumption that the expression “fiscal evasion” in the title of the treaty is properly equated to tax avoidance, credit for foreign tax under the UK-US treaty was justifiably denied on the basis that article 23 (elimination of double taxation) ought to be read so as to confer relief from double taxation and not to grant credit in the United Kingdom for tax that was not payable in the United States because, under the treaty, the United States would also be giving credit for UK tax. Such a conclusion may be reached on the basis of the purpose of the treaty and the article to relieve double taxation, but without relying on extending the reasoning by reference to an alleged anti-avoidance purpose.

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10 Ibid.
GENERAL ANTI-ABUSE RULES
IN RECENT UK TREATIES

Since the first tax treaties were concluded, traditional UK treaty policy has been to include specific anti-avoidance or LOB provisions in particular treaty articles. A number of the approaches adopted by the United Kingdom in its treaties have found their way into the OECD commentary. Only the UK-US treaty of 2001 contained a general LOB article patterned on the article in the US model treaty.

This situation changed in 2010, when general anti-abuse provisions started to appear in some but not all UK treaties. A new UK-Germany treaty concluded on March 30, 2010 was accompanied by a joint declaration addressing the improper use of the convention. The declaration prescribed an approach to interpretation of the treaty by reference to paragraphs 9.4, 9.5, 22, and 22.1 of the OECD commentary on article 1 of the OECD model convention. The joint declaration states, in part, that

this Convention shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance where those provisions are used to challenge arrangements which constitute an abuse of the Convention.

The reason for this statement is unclear, but it appears to reflect the parties’ lack of confidence that the ordinary principles of treaty interpretation would operate in the manner suggested by the commentary.

The joint declaration also states that

an abuse of the Convention takes place where

1. a main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position and
2. obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of the Convention.

16 Ibid.
The UK-Germany treaty was followed by a revised UK-China treaty concluded on June 27, 2011 that provides as follows:

**Miscellaneous Rule**

Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement.\(^\text{17}\)

A more measured but apparently all-embracing anti-abuse article in the revised UK-Spain treaty of 2013 reads as follows:

No relief shall be available under this Convention if the main purpose or one of the main purposes of any person concerned with the creation, assignment or alienation of any shares, debt-claims, assets or other rights in respect of which income or gains arise was to take advantage of this Convention by means of that creation, assignment or alienation.\(^\text{18}\)

Similar language had previously been used in many UK treaties, but it was limited specifically to dividend, interest, and royalty articles.

The UK-India treaty of October 30, 2012 extends the anti-abuse rule specifically to the establishment or maintenance of residence in a contracting state:

Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.\(^\text{19}\)

Other treaties concluded during the same period, including those with Albania, Barbados, Belgium, Hungary, Liechtenstein, the Netherlands, Norway, and Zambia, do not contain a general anti-abuse rule.

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\(^\text{18}\) Convention Between the Kingdom of Spain and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital of March 14, 2013 (SI 2013/3152), at article 23(2).

\(^\text{19}\) Protocol to the Double Taxation Agreement Between the United Kingdom and the Republic of India, signed at London on October 30, 2012 (SI 2013/3147), at article 28C(1).
THE UK LEGISLATIVE APPROACH: GAAR AND TAX TREATIES

The March 2011 budget proposed legislation in Finance Bill 2012 to counter avoidance schemes that exploit treaties. In August 2011, a draft treaty GAAR to override all UK tax treaties was published; however, it was dropped in September pending the publication of a report on the possible introduction of a GAAR in the United Kingdom. In November 2011, the Aaronson report recommended a GAAR, including an override of all UK tax treaties. The UK GAAR, which was enacted in 2013 and has effect from July 17, 2014, applies to “tax arrangements”:

Arrangements are “tax arrangements” if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements.21

Tax arrangements fall foul of the UK GAAR if they are “abusive”:

Tax arrangements are “abusive” if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including—

(a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,

(b) whether the means of achieving those results involves one or more contrived or abnormal steps, and

(c) whether the arrangements are intended to exploit any shortcomings in those provisions.22

HMRC provides an example of the kind of treaty case that will be regarded as abusive under the UK GAAR. In the example, UK-resident individuals, who separately carried on trades as information technology consultants in the United Kingdom, individually entered into contracts to provide their services to a Manx partnership consisting of five Manx companies. The partnership then contracted out the services of each individual to end users. Each Manx company was a trustee of a Manx trust, of which one of the UK-resident individuals was the settlor and life tenant. The scheme relied on the UK-Isle of Man treaty, which, it was claimed, exempted from UK tax the share of the partnership profits received in the United Kingdom by each individual in his or her capacity as a beneficiary under the trusts. No tax was

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21 Finance Act 2013, c. 29, section 207(1).
22 Ibid., section 207(2).
paid in the Isle of Man, and tax was paid in the United Kingdom at an effective rate of about 3.5 percent. HMRC views the overseas partnership and trust as contrived and abnormal in the context of UK individuals carrying on a trade in the United Kingdom and results in income for UK tax purposes that is significantly less than income for economic purposes.23

The example is based on the facts in Huitson v. HMRC.24 To counteract this dubious arrangement, retrospective legislation overriding the treaty was introduced. This legislation effectively closed off appeals by some 300 individuals who had participated in the scheme. This approach to treaty abuse has little to recommend it as a matter of principle. The treaty with the Isle of Man has been in place since 1955, so there has been more than adequate opportunity to amend or terminate it if it was thought to operate inappropriately or to grant benefits in undesirable circumstances.

The extension of the UK GAAR to override treaty obligations is difficult to understand in light of the intolerance shown by the courts to treaty shopping (Smallwood) and treaty abuse (Bayfine). HMRC has sought to justify the UK GAAR treaty override on three grounds. First, it contends that the UK GAAR is targeted at abusive schemes, and therefore it accords with international law.25 That contention makes little sense in light of article 26 of the Vienna Convention on the Law of Treaties.26 Second, it says that other jurisdictions with GAARS (such as Australia, Canada, and South Africa) take the view that their GAARS override DTAs. Third, HMRC relies on paragraphs 9.4, 9.5, 22, and 22.1 of the OECD commentary on article 1 of the model. The OECD commentary has been held to be a supplementary means of interpretation27 and thus within and subject to the constraints of article 32 of the Vienna Convention on the Law of Treaties. The OECD commentary in this respect is largely assertion, and it conflates jurisprudential principles (which include treaty interpretation) with legislative measures. To that extent, it contradicts the OECD recommendation concerning treaty override.28

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23 United Kingdom, HM Revenue & Customs, HMRC’s GAAR Guidance (London: HMRC, April 2013).


In 2008, Lord Bingham said that

[the] rule of law in the international legal order is damaged in those situations where there is a “willingness of some states in some circumstances to rewrite the rules to meet the perceived exigencies of the political situation.”

The proper place for any limitations on treaty benefits and measures to protect against the abuse of treaties is thus in the treaties themselves.

**EU Judicial Approaches**

The compatibility of treaty LOB provisions with EU law was considered by the Court of Justice in *ACT Group*. The case concerned the repayment of imputation tax credits on dividends paid by UK-resident companies to Dutch-resident shareholders pursuant to articles 10(3)(b) and (c) of the UK-Netherlands treaty. One issue was the LOB provision in article 10(3)(d), which denied entitlement to a tax credit (that would otherwise exist) if the Netherlands-resident shareholder were controlled by a person not entitled to the tax credit. This category included residents of states that did not have a treaty with the United Kingdom conferring a tax credit on UK-source dividends.

The court ruled that the LOB provision did not infringe the right of establishment or the free movement of capital. In reaching this conclusion, the court held that the tax credit available under a treaty is not a benefit separable from the remainder of the treaty but is an integral part of the treaty and contributes to its overall balance, and that this overall balance includes the LOB provision. Advocate General Geelhoed also observed that a consequence of the coexistence of national tax systems is that disparities will exist between them which do not amount to restrictions on fundamental freedoms and that, under EU law, the power to choose the criteria of, and to allocate, tax jurisdiction in tax treaties lies purely with member states. These conclusions give broad authority to member states to limit treaty benefits under the terms of the treaty in question. However, the decision examines the question only in the context of the source state’s entitlement to restrict treaty benefits; the court has yet to consider whether a restriction on the fundamental freedoms arises in the residence state by reason of LOB articles in double tax treaties. A challenge may well be made on the basis that it is an infringement, for example, on the right of establishment to conclude a treaty that permits only certain residents to claim treaty benefits and excludes others by reason of ownership or investment emanating from another member state.


In the Canadian context, the decision will have an impact on the extent to which EU member states may be willing to agree to LOB articles in tax treaties with Canada. The risk of infringement will rest with the EU member states.

**EU TAX LEGISLATION**

Two pieces of EU legislation sit directly with the provisions of tax treaties. The parent-subsidiary directive\(^31\) prohibits withholding taxes on dividends paid by subsidiaries in one member state to a parent company in another member state and requires the member state of the parent company to grant credit or exempt such dividends from corporate income or profits tax. Similarly, the interest and royalties directive\(^32\) prohibits withholding taxes on certain intragroup interest and royalty payments. The directives deal with limitations on benefits and abuse in different ways.\(^33\)

The November 25, 2013 proposal to amend the parent-subsidiary directive is indicative of current thinking. The longstanding provision in article 1(2) permitting member states to apply domestic or treaty-based anti-abuse rules to the directive would be replaced by a common mandatory anti-abuse rule:

> Member States shall withdraw the benefit of this directive in the case of an artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of obtaining an improper tax advantage under this directive and which defeats the object, spirit and purpose of the tax provisions invoked.\(^34\)

An arrangement is “artificial” if “it does not reflect economic reality.” Indicia of artificiality include:

- (a) the legal characterisation of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole;
- (b) the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct;
- (c) the arrangement includes elements which have the effect of offsetting or cancelling each other;

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\(^{33}\) Schwarz, supra note 4, at chapter 14.

(d) the transactions concluded are circular in nature;
(e) the arrangement results in a significant tax benefit which is not reflected in the business risks undertaken by the taxpayer or its cash flows.35

The “essential” purpose may be equated with the “main” purpose of an arrangement, and an “improper” tax advantage may perhaps be equated with an “abusive” tax advantage.

A single common anti-abuse rule, rather than individual rules of member states, would thus apply throughout the European Union, and, as an EU rule, would be subject to interpretation by the Court of Justice. The use of the directive by residents of states outside the European Union may be curtailed in some cases. A stated purpose of the amendment is “an equal application of the EU directive without possibilities for ‘directive-shopping’ (i.e. to avoid that companies invest through intermediaries in Member States where the anti-abuse provision is less stringent or where there is no rule).”36

The prospects for the proposal’s adoption are uncertain. The unanimous approval of member states is required to enact tax law in the European Union. The proposal was not presented for adoption by the EU Ecofin Council (the relevant EU legislative institution) at its May 6, 2014 meeting in order to assist the passage of the less controversial amendment of the parent-subsidiary directive (which itself was not adopted);37 in the tax treaty context, this serves as a useful reminder of the consensual nature of international instruments.

CONCLUSION
I have described aspects of the UK and EU approaches to treaty shopping and treaty abuse. In my view, the discussion of this issue is not assisted by the conflation of “treaty shopping” and “abuse.” If access to treaty benefits by residents of third states is regarded as unacceptable in some or all circumstances, then a US-style LOB article setting out either the permitted or the excluded category of such persons is an appropriate and effective response: it complies with the principles of legality and is consistent with international law. Purpose-based provisions are inherently uncertain and still raise the question whether treaty shopping is an abuse or an intended use of treaties applicable to persons that are residents of a contracting state under the domestic law of the contracting state, where no other qualification is expressed.

35 Ibid., at new article 1a(2).
36 Ibid., “Explanatory Memorandum,” at paragraph 2.

Patricia A. Brown*

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INTRODUCTION

For more than 30 years, the United States has included in all of its newly negotiated income tax treaties a limitation-on-benefits (LOB) article intended to prevent (or at least limit) treaty shopping by residents of third countries. In fact, over the past two decades, one of the priorities of the US tax treaty program has been to renegotiate existing treaties in order to add a LOB provision. From the US perspective, treaty shopping that allows “residents of countries other than the countries that are parties to the treaty to derive treaty benefits (such as rate reductions on passive income) by channeling investments through entities organized in or resident in a treaty jurisdiction)” violates the principle that tax treaties represent a deal negotiated between two sovereign states.¹

* Director, Graduate Program in Taxation, University of Miami School of Law (e-mail: pbrown@law.miami.edu).

¹ Testimony of John E. Chapoton, Assistant Secretary (Tax Policy), United States Department of the Treasury, before the House Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs, April 13, 1983: “We believe that an income tax treaty is a contract between two countries designed to benefit directly the residents of the two countries and not indirectly residents of third countries.”
Although treaty shopping has been described as constituting tax avoidance, the Treasury Department now views treaty shopping more pragmatically. As long as residents of third countries can enjoy the benefits of reduced withholding rates by engaging in treaty shopping, they will not lobby their governments to enter into treaties that provide reciprocal benefits to US taxpayers. Proof that LOB provisions are working can be seen in the fact that countries such as Japan and Canada have, after many years, agreed to much-desired reductions in withholding rates. The price of those reductions was time-consuming and difficult negotiations.

As of the time of writing, it appears likely that the Organisation for Economic Co-operation and Development (OECD) will be adding a US-style LOB provision to the OECD model convention as part of its base erosion and profit shifting (BEPS) project. As a result, more countries may begin negotiating LOB provisions in the future. Accordingly, it seems to be a suitable time to review the development of the US LOB provision and determine whether it provides useful lessons for the international community.

**TRANSACTION-SPECIFIC ANTI-TREATY-SHOPPING RULES**

It is important to keep in mind that the LOB provision is not the only tool used by the United States to attack the inappropriate use of tax treaties. Other useful doctrines include substance over form, economic substance, step transaction, and beneficial ownership. Although these doctrines are more commonly used in domestic circumstances, in 1999 the Senate Foreign Relations Committee confirmed their application in the treaty context. A pending treaty-shopping case against Ingersoll Rand suggests that the Internal Revenue Service believes that a particular structure may implicate a number of these doctrines at the same time. In general, the doctrines are used to attack particular transactions, while the LOB provision is used to attack entities. For example, for the anti-conduit regulations to apply, there must have been a reduction in withholding rates, which means that some entity must have satisfied the requirements of the applicable LOB provision.

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2 Ibid.
3 Statement of Leslie B. Samuels, Assistant Secretary (tax policy), Department of the Treasury, Before the Committee on Foreign Relations, United States Senate, October 27, 1993.
6 Of course, the negotiation process could be considerably shortened if the OECD is successful in developing a multilateral process for modifying existing tax treaties. In that case, most countries would face a steep learning curve in connection with the implementation of such provisions but not the negotiation of them.
The US Treasury Department has even flirted with a UK-style “main purpose” test, including it in treaties with Italy and Slovenia that were signed in 1999. When the treaties were presented to the Senate for advice and consent to ratification, the Senate Foreign Relations Committee was harshly critical of the main purpose test. The committee stated that the “new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty.” It noted that the main purpose test was similar to subjective tests that had formed the basis of some earlier anti-treaty-shopping provisions. Quoting the Treasury Department’s technical explanation to the proposed treaty, the committee said that the “fundamental problem presented by this approach” was that “it is based on the taxpayer’s motives in establishing an entity in a particular country, which a tax administrator is normally ill-equipped to identify.” As a result, “[t]hese subjective tests have been replaced in recent treaties (including the proposed treaty) with limitation on benefits provisions that apply clear, bright-line objective tests.” The Senate entered a reservation to each of the two treaties requiring the main purpose provisions to be struck before the treaty could enter into force. The committee also made it clear that although it would consider “appropriate ways to address tax avoidance in the treaty context,” the Treasury Department would face an uphill battle should it propose any such main purpose test in future treaties. As a result, even the US treaty with the United Kingdom, which was signed in 2001, did not include the test; instead, the treaty introduced more targeted rules addressing conduit arrangements. The United States continues to resist the adoption of a main purpose test in connection with the BEPS project.

THE DEVELOPMENT OF OBJECTIVE TESTS

The OECD received hundreds of pages of comments on its discussion draft on treaty abuse. Many of the comments suggested that a US-style LOB provision is too complicated and called for a simpler provision. Of course, the original provisions used by the United States to combat treaty shopping were relatively simple. They were also almost completely ineffective.

The relatively simple one-sentence provisions that were introduced in the early 1960s did not become today’s multi-page LOB extravaganzas overnight. The current version of the LOB provision consists of a series of objective tests. Residents of a contracting state that satisfy one of the tests essentially are presumed to have a good

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8 Ibid., at 5. The committee elaborates on its theme by continuing, “It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer’s ability to rely on the treaty.”

9 Ibid., at 5-6.

10 Slovenia promptly accepted the Senate reservation, allowing that treaty to enter into force in 2001. Italy was much slower to accept the reservation, and the US-Italy treaty entered into force only in 2009.

business reason for structuring their activities through that contracting state. Each new definition or rule has been a response to a particular issue or need of the parties. Once a provision is introduced in one agreement, it is likely to be replicated—or expanded—in another agreement. This evolutionary process is interrupted every decade or so when it becomes clear that the provision has evolved in such a way that it no longer serves its purpose of preventing treaty shopping.

Several US tax treaties entered into after the Second World War included provisions in the dividend article that denied the benefits of the “direct dividend” rate to corporations that were established with the purpose of qualifying for that rate. Those provisions, relying as they did on the subjective intention of the taxpayer in establishing the entity, were not particularly effective in preventing the use of treaties by residents of third countries.

These provisions were succeeded by a provision directed at “investment or holding companies,” which first appeared in the 1962 US-Luxembourg treaty and was soon followed by a similar provision in the US-Netherlands treaty as it applied to the Netherlands Antilles. These more objective provisions initially disqualified entities that were entitled to specified beneficial tax regimes in their state of residence or that enjoyed a lower level of taxation as a result of “special measures.” Eventually, even the reference to special measures was dropped, so that the provisions could apply whenever the tax imposed on the treaty-benefited income was substantially less than the tax that would be imposed on corporate profits generally. The ownership test included in such provisions was an additional, not an alternative, requirement and thus was seldom an issue. The provisions could easily be avoided by ensuring that the company was subject to the same corporate tax regime as any other company resident in the jurisdiction (even if that regime included a participation exemption, allowed extreme thin capitalization, or provided a deduction for dividends).

US faith in the investment or holding companies provision evaporated in early 1981, with the release of the Gordon report on tax havens. The report highlighted abusive structures that did not rely on the existence of “special measures” (which it equated with a “special rate of tax”). The report’s discussion of holding company structures demonstrated that the same result could be achieved through reducing the corporate tax base by allowing high levels of deductible payments. Accordingly, focusing on ownership and special measures is not enough—base erosion must also be prevented.

The effect of the Gordon report can be seen in the rapid renegotiation of the US-Jamaica treaty. The treaty that had been signed on May 21, 1980 included the then standard investment or holding companies provision. The treaty was transmitted to the Senate on August 4, 1980; before the Senate could consider it, the treaty was amended by a protocol signed on July 17, 1981, which included a new “limitation on

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12 Richard A. Gordon, “Tax Havens and Their Use by the United States Taxpayers: An Overview: A Report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division), Secretary of the Treasury (Tax Policy).”
benefits” provision. This provision included the seeds of what became the “standard” US LOB provision. The main test was an ownership/base erosion test: an entity could be denied benefits, even if it was owned by residents of a contracting state, if its income was eroded (and therefore not taxed in its state of residence) through deductible payments to residents of third states. Thus, the rule responded directly to the concerns raised in the Gordon report. However, now that every entity had to satisfy both prongs of the test, proof of ownership became crucial. Because of the difficulties of proving ownership of a publicly traded company, the US-Jamaica provision presumed that a company in whose stock there was substantial trading in a contracting state was owned by residents of the contracting state of which the company was a resident.

Because the ownership/base erosion test included in the US-Jamaica protocol was significantly more effective than the “special measures” provision in earlier treaties, entities owned by residents of third countries generally did not qualify for treaty benefits. In many cases, however, there were legitimate business reasons for establishing the entity in the treaty country. This point was recognized through the introduction of other avenues by which entities that have legitimate business reasons for being resident in a jurisdiction may qualify for treaty benefits.

Two important concepts thus make an appearance in the US-Jamaica provision in the form of guidelines to be followed in applying the catchall second paragraph, under which an entity qualifies for benefits if it is determined that the entity was not treaty shopping. If a Jamaican entity is owned by residents of third countries, it nevertheless qualifies for benefits if the treaty-benefited income is derived in connection with business operations conducted in Jamaica. If the Jamaican entity is owned by individual residents of third countries who would have been entitled to substantially similar benefits under US tax conventions, the entity also qualifies for benefits.

Thus, in less than two years, the main components of the modern LOB provisions—ownership/base erosion, publicly traded companies, active conduct of a trade or business, and even derivative benefits—evolved from the old investment or holding companies provision. From 1982 to 1992, there was little change in the US approach to the LOB provisions. There generally was an ownership/base erosion test and an active trade or business test. The ownership presumption regarding publicly traded companies soon became a stand-alone rule pursuant to which such companies simply qualified for benefits without regard to ownership. By 1989, it had become clear that the determination of an entity’s qualification under the residual rule was within the discretion of the competent authority of the contracting state providing the benefits. Over time, rules were added to make it clear that individuals did not have to meet any of the other tests and to address specific issues relating to governments and government-owned entities and to tax-exempt entities such as charities and pension funds. The language of these provisions was tightened over the years, adding much to their length and complexity. However, since each of those changes was made in response to taxpayer behaviour, it is hard to imagine reverting to simpler drafting.
Unlike the other tests in the US-Jamaica protocol, the derivative benefits test fell out of favour and did not appear again until 1992 in the US-Mexico treaty and, of course, in the US-Netherlands treaty. In essence, the derivative benefits test is simply an ownership/base erosion test with a much broader universe of “good” owners and recipients of base-eroding payments. The ownership/base erosion test is limited to certain persons resident in the same contracting state as the entity that claims benefits. Under the derivative benefits test, the entity may qualify even if it is owned by residents of specified third states and makes payments to residents of specified third states, as long as those third-country residents would have qualified for the same benefits had they received the income directly from the source state.

The theory behind the derivative benefits test is that third-country residents are not treaty shopping if they would have been entitled to the same treaty benefits. Nevertheless, it is clear that allowing benefits under a derivative benefits test allows for regime shopping. That is, the treaty-benefited income need not be paid on to the “equivalent beneficiaries” in the third countries. In many cases, the entity located in the treaty country that is claiming benefits under the derivative benefits provision also qualifies for a beneficial regime, so that the treaty-benefited income might not suffer significant taxation. For example, one of the primary benefits to Canadian multinationals of the elimination of the withholding tax on interest in the 2007 protocol to the US-Canada treaty is not that interest can be paid straight from US subsidiaries to Canadian parent companies, but rather that the Canadian multinationals can once again utilize finance subsidiaries in the Netherlands or Ireland because the subsidiaries will now qualify for benefits under the derivative benefits provisions of treaties with those countries.

**NEXUS AND THE PUBLICLY TRADED COMPANY TEST**

For multinational companies, the “publicly traded company” test is by far the best way to qualify for treaty benefits. If a company meets the requirements of the test, then all of its income, and the income of its subsidiaries resident in the same country, qualifies for treaty benefits. Conceptually, the test is harder to understand, since even the earliest LOB provisions allowed trading in either contracting state to qualify a company under the test. In fact, unlike the other tests in the LOB provision, the publicly traded company test did not require the taxpayer to establish a nexus with its country of residence. Rather, there seemed to be an assumption that establishing nexus was not necessary in the case of publicly traded companies because publicly traded companies do not engage in treaty shopping. More pragmatically, the test

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13 In earlier treaties, the owners and recipients of such payments could be in either of the two contracting states. This policy changed with the 2004 protocol to the US-Barbados tax treaty, negotiated in response to a number of high-profile corporate inversions out of the United States.

ensures that multinational corporations can easily qualify for treaty benefits. Without such a test, the LOB provision would be much harder to sell politically.

The importance of the publicly traded company test can be seen in the number and types of comments received by the OECD with respect to the version of the LOB provision that was included in the public discussion draft. A number of comments focused on one aspect of the test—the requirement that an entity that is not primarily traded in its country of residence (or, in many cases, within a regional grouping that includes its country of residence) must have its primary place of management and control in its country of residence. A common misperception seems to be that the “primary place of management and control” test was intended to deal with corporate inversion transactions. Although the test was adopted in conjunction with anti-inversion provisions, its purpose was different. Accordingly, if governments acceded to the suggestions in the comments, they would in fact facilitate a particularly expensive form of treaty shopping.

The Publicly Traded Company Test Goes Global

Although many Europeans describe the 1992 US-Netherlands treaty as the first US tax treaty to have a LOB provision, it is really only the first that anyone had to worry about. The treaty was important because it was the first of a series of renegotiated tax treaties with countries where treaty shopping was widely acknowledged to be a problem but which also were significant US trading partners and fellow members of the OECD. It would have been difficult to terminate any of those agreements. By the end of the 1980s, however, the threat of treaty overrides by Congress had become sufficiently credible that those countries began to come (reluctantly) to the negotiating table.

The LOB provision in the US-Netherlands treaty has been described as “the most complicated set of tax treaty provisions ever devised,” but in most respects it did not substantially change the practical effect of the standard provisions in earlier treaties. However, a more generous publicly traded company test loosened the test’s already tenuous nexus requirement. The US-Netherlands treaty, like some earlier treaties, anticipated that the term “recognized stock exchange” would include third-country exchanges. More importantly, by the time the treaty entered into force, it had been agreed that the term “recognized stock exchange” would include the principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo, and Toronto. New treaties with Austria, Ireland, Luxembourg, and Switzerland, all considered by the Senate in 1997, similarly include expansive lists of third-country exchanges.

In its 2007 study addressing inappropriate use of tax treaties and proposed responses, the Treasury Department provided the following assessment of the development of the publicly traded company test:

15 Testimony of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Foreign Relations, United States Senate, October 27, 1993.
In its original form, the publicly traded test focused on corporations that were regularly traded on the stock markets in their home country and reflected the view that such corporations likely would not be used by residents of third countries for treaty shopping purposes. The parameters of the test evolved with changes in the global financial markets. With the growth of regional markets, corporations that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign corporations are listed and substantially traded on U.S. exchanges. The publicly traded test has been structured to take into account both home-country trading and also U.S. and regional third-country trading to reflect the realities of modern global financial markets. However, it has become clear that, in some circumstances, additional nexus between the corporation and its country of residence is necessary to effect the underlying objective of the LOB provision.  

This well-reasoned explanation of the evolution of the publicly traded company test unfortunately has relatively little to do with the facts. Presumably, the reference to “the growth of regional markets” was intended to explain trading tests that included third-country exchanges. The list of third-country exchanges in the US-Slovenia treaty, for example, consisted of Frankfurt, London, Paris, and Vienna. One can imagine that a capital-hungry Slovenian company might go to any of those exchanges to raise capital. However, if the rise of regional financial markets was a significant factor, one would have expected that more of the treaties entered into in the 1990s—particularly treaties with countries in Eastern Europe and other emerging markets—would have included such provisions. They do not. By contrast, as noted above, the treaties with the Netherlands, Luxembourg, Ireland, and Switzerland included as recognized stock exchanges the stock exchanges of Sydney, Tokyo, and Toronto, which clearly cannot be explained by reference to regional trading. Accordingly, the inclusion of an expansive list of third-country exchanges serves mostly as a diagnostic tool for treaty havens.  

16 United States, Department of the Treasury, Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (Washington, DC: Department of the Treasury, November 2007), at 80 (herein referred to as “the treaty report”), which was mandated by sections 424 and 806 of Pub. L. no. 108-357, the American Jobs Creation Act of 2004.  

17 The US treaties with Denmark and the United Kingdom also included relatively expansive lists of third-country exchanges. Although these two countries do not fall into the same category as the Netherlands, Ireland, Switzerland, and Luxembourg, there were signs in the 1990s that Denmark might be trying to compete for that business. See, for example, “Using Denmark as a Holding Company Jurisdiction” (taxand.com/news/newsletters/Using_Denmark_as_a_Holding_Company_Jurisdiction?utm_source=T axands_T ake_S eptember_2010&utm_medium=email &utm_campaign=Using_Denmark_as_a_Holding_Company_Jurisdiction). The United Kingdom was never an attractive location for a conduit company because the advance corporation tax, imposed on a company at the time that it paid a dividend, could not be offset by foreign tax credits. When the advance corporation tax was eliminated with respect to
The expansion of the publicly traded company test to third-country markets would not have been problematic if publicly traded companies were not used for treaty shopping. By 2001, however, it had become clear that such an assumption was simply incorrect. That realization led to the last major change to the LOB provision, a drastic revision of the publicly traded company test.

Adding Insult to Injury: Treaty Shopping by Inverted Companies

The corporate inversion transactions that became a political issue in the United States in the early 2000s were not about tax treaties, but the transactions’ success depended on them. Their purpose was to reduce the overall corporate tax on business operations by removing foreign subsidiaries of US companies from the US tax net. They also offered the prospect of substantially reducing US corporate tax on any remaining US operations by stripping income out of the United States. In order to achieve those two goals, however, an inverting company would have to find a new home that imposed little or no tax and had a favourable tax treaty with the United States. Thus, if the injury was leaving the United States for tax reasons, the insult was using US tax treaties to strip income out of the United States while incurring minimal withholding taxes.

Inverted companies could satisfy the publicly traded company test under standard LOB provisions because such provisions generally did not distinguish between trading in the two contracting states—trading in the United States was treated as a nexus to the other contracting state to the same extent as trading in that other state. This problem was corrected in the 2004 protocol to the US-Barbados tax treaty, which included a complete rewriting of the LOB provision. In particular, the publicly traded company test was modified so that a company can qualify for benefits only if its principal class of shares is primarily traded on a recognized stock exchange in its country of residence (or, in the case of Barbados, on the other stock exchanges that made up its regional stock exchange).†

The Need for a New Nexus: Primary Place of Management and Control

The Treasury Department soon ran into problems when it tried to replicate this simple solution in other treaties. Other countries wanted to ensure that their resident companies would not be prevented from, or penalized for, raising capital in the US financial markets.† A new test for establishing nexus was necessary: accordingly,
a “public corporation that does not have sufficient nexus to its residence country through trading on the stock exchanges in that country must establish nexus through primary management and control in its residence country.” The treaty report made it clear that this revised publicly traded test, developed in the context of the 2004 protocol to the US-Netherlands treaty, was about stopping third-country treaty shoppers.

Who were these third-country treaty shoppers that had managed to claim benefits despite “the most complicated set of tax treaty provisions ever drafted”? At the time, relatively few Dutch companies were traded primarily in the United States or on one of the third-country exchanges listed in the US-Netherlands treaty. Among the few companies in that category, however, some were clearly treaty shopping. James Hardie Industries has publicly expressed its treaty-shopping goals. In 2001, the company, which had been in business as a resident of Australia for over a century, announced that it would be moving to the Netherlands in order to qualify for the 5 percent withholding rate applicable to dividends paid by its substantial US subsidiaries to the parent corporation rather than the 15 percent rate that then was applicable to all dividends under the US-Australia tax treaty. In 2010, the company moved its corporate domicile to Ireland because it could be more certain of receiving US tax treaty benefits there.

As the Treasury Department described, the point of the primary place of management and control test was to establish nexus with respect to a particular type of company—namely, a company that the treaty partner already considered to be a resident. However, it was a company that, although publicly traded, was not primarily traded in its home markets. It also would not meet the ownership/base erosion test, usually because it was owned by residents of a third country. It might not meet the “active conduct of a trade or business” test. What test would prove that the company had non-tax reasons for being resident in the jurisdiction?

The answer—in the form of the primary place of management and control test—is that the company (or the group of which the company is the parent) actually must be run from that country. That is, the country of which the company is claiming to be a resident must be

the country where the corporation’s executive officers and senior management employees exercise the most day-to-day responsibility for the strategic, financial, and operational decision making of the corporation, and where the most day-to-day activities necessary for preparing and making those decisions take place.

20 Ibid.
21 “Given developments in trading patterns, the new publicly traded test better serves the intended purpose of limiting treaty shopping by third-country residents” (ibid.).
23 Treaty report, supra note 16, at 82.
The US model technical explanation explicitly stated that the primary place of management and control test is “to be distinguished from the ‘place of effective management’ test which is used in the OECD Model and by many other countries to establish residence.”24 In part, this statement was prompted by the fact that at the time the test was developed, a discussion paper had been issued under the auspices of the OECD that suggested that the “place of effective management” test might be interpreted to mean the place where meetings of a company’s board of directors are held.25 In May 2003, while the 2004 protocol with the Netherlands was being negotiated, the Technical Advisory Group (TAG) released a formal proposal that would have incorporated a modified version of this approach in the OECD commentary.26 By 2008, the Committee on Fiscal Affairs provided an alternative view: “Many countries . . . considered that the TAG’s proposed interpretation gave undue priority to the place where the board of directors of a company would meet over the place where the senior executives of that company would make key management decisions.”27 Even though the OECD’s final conclusions might have been consistent with the concept behind the primary place of management and control test, there is still a virtue in adopting a test that is relevant only for the purposes of determining whether a company is treaty shopping. As noted above, many countries use the place of effective management as a test for determining corporate residence. Because the purpose of the test is to establish the residence of a company that is incorporated in another country (and therefore to establish taxing authority over that company), the tax authorities have an incentive to interpret the language aggressively and make the test easy to meet. As described above, that intention is the exact opposite of the intention behind the primary place of management and control test in US LOB provisions.

CONCLUSION

A US-style LOB test prevents most common forms of treaty shopping, at least when it is combined with anti-abuse rules aimed at specific transactions. However, it is not at all clear that the United States has significantly increased the amount of withholding taxes that it collects. Instead, it measures the success of the expanded LOB rules

by the extent to which it achieves its goal of reducing withholding rates in treaties with important trading partners (such as Japan and Canada) or widens its treaty network to other countries that may be important sources of investment capital (such as Israel). The achievement of these goals has required substantial resources: having even one treaty without a LOB provision is almost as bad as having no LOB provisions in any treaty. Accordingly, a country should be very clear about its goals, and realistic about the difficulty of negotiating LOB provisions, before embarking on an anti-treaty-shopping strategy based primarily on the introduction of a LOB provision into its tax treaties.
Policy Forum: Australia’s Twin-Track Approach to Treaty Shopping

Graeme S. Cooper*

KEYWORDS: INTERNATIONAL TAX  TAX TREATIES  TREATY SHOPPING  AUSTRALIA

INTRODUCTION

Treaty shopping is not a new problem, but it has recently achieved a degree of public prominence that it used to enjoy only in academic circles. Canada has obviously been grappling with the problem of treaty shopping—it released a 2013 consultation paper on treaty shopping1 and announced a series of measures in the 2014 budget,2 actions prompted no doubt by the decisions in MIL (Investments),3 Prévost

* Of Sydney Law School, University of Sydney (e-mail: graeme.cooper@sydney.edu.au).
3 Canada v. MIL (Investments) S.A, 2007 FCA 236.
Car, and Velcro. Somewhat earlier, the 2011 UK budget proposed new legislation to deny benefits in cases of treaty abuse. Although the measure was later withdrawn, the United Kingdom claims that it still intends to address the issue.

Canada and the United Kingdom are not alone in being troubled by treaty shopping. One of the action items in the OECD’s 2013 action plan on base erosion and profit shifting (BEPS) is to prevent treaty abuse by developing “model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.” It is more than a little curious, therefore, that the activity elsewhere in the world has not been matched by similar pronouncements from the Australian government. The government has been a vocal supporter of the OECD’s BEPS project since its inception, and the silence from our politicians and Treasury officials (though not from our tax administrators) on treaty shopping is odd.

In this article, I address Australia’s approach to treaty shopping and some possible explanations for the government’s silence. Australia adopts a two-pronged approach to the problem of treaty shopping. Australia’s treaty practice certainly adopts many of the current recommendations: attempting to buttress treaties through limitation-on-benefits (LOB) provisions, embedding anti-abuse rules, and enlisting domestic anti-avoidance rules to the task. But a second aspect of Australia’s approach changes the incentives for treaty shopping, with the intended result that the practice becomes largely pointless: it changes the returns, not just the rules. How this occurs is described below.

**AUSTRALIA’S NETWORK OF TAX TREATIES**

By international standards, Australia has a relatively modest network of bilateral income tax treaties. At the time of writing, Australia has only 44 comprehensive income tax treaties, none with any of the notorious tax havens. One reason for the

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5 Velcro Canada Inc. v. The Queen, 2012 TCC 57.
8 There is some pressure for Australia to negotiate a treaty with Hong Kong in light of the recently concluded treaty between Hong Kong and New Zealand. Australia has negotiated 36 tax information exchange agreements with countries such as the British Virgin Islands, the Bahamas, the Cayman Islands, Liechtenstein, Jersey, Guernsey, Vanuatu, the Cook Islands, and Mauritius.
small number of treaties is that Australia, unlike Canada, has no institutionalized mechanism akin to the “exempt surplus” concept that makes the existence of a treaty significant for residents under domestic law. Consequently, Australia can afford to have a small treaty network directed mostly at encouraging inbound investment; a handful of treaties are with developing countries that are trying to attract investment from Australia. Australia’s decision to sign the Convention on Mutual Administrative Assistance in Tax Matters9 also removes some of the pressure for a larger network: this instrument offers a simple and wide-reaching method for securing the exchange of information, a mutual agreement procedure, assistance in the collection of taxes, and other administrative benefits that Australia might once have sought through a bilateral income tax treaty.

It is worth noting that Australia’s recent tax treaties are also relatively consistent. Although some treaties—for example, those with Germany and the Netherlands—are quite old, the recent treaties do not display significant disparities in their major features.10 And in cases where important differences have been identified and exploited, Australia has not been reluctant to enact tax treaty overrides to impose uniformity on non-uniform treaties. This point is discussed further below.

When it comes to treaty shopping, these two features—a relatively small treaty network and a reasonable degree of consistency between the treaties—seem to pull in opposite directions. One might expect that the relatively small number of treaties would lead to many instances of investors from non-treaty countries trying to gain access to a treaty. On the other hand, investors from one treaty country are not likely to be advantaged by trying to shop into a different treaty. As it turns out, Australia has seen some examples of treaty shopping, but they have involved substitutions between treaties.

**EXAMPLES OF TREATY SHOPPING IN AUSTRALIA’S RECENT PAST**

Treaty shopping is not unknown in Australia, though the jurisprudence reveals only a handful of examples. Both the 1997 case of *Lamesa Holdings BV*11 and the Myer transaction in 2009 (described below) involved US private equity firms acquiring and then selling Australian companies through Dutch companies, arguably enlivening the Australia-Netherlands treaty in lieu of the Australia-US treaty. In 1997, the treaty-shopping issue was largely ignored in *Lamesa*; in 2009, it was one of the most important issues on which the Australian Taxation Office (ATO) focused.

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10 There are some differences between Australia’s pre- and post-2000 treaties, but many of the treaties with the major capital-exporting countries were renegotiated or amended after 2000.

11 *Commissioner of Taxation v. Lamesa Holdings BV* (1997), 157 ALR 290 (Full FC).
The structure in Lamesa was comparatively simple. Leonard Green & Associates LP, a US private equity firm, became interested in acquiring the apparently under-valued shares in Arimco and its subsidiaries, which were involved in gold mining in Australia. It formed Green Equity Investors LP with other partners described as “institutional, investment and financial entities resident in the US.” In January 1992, Green Equity Investors acquired all of the shares in an Australian-resident company, Australian Resources Ltd. (“Resources”). Resources then acquired all of the shares in Australian Resources Mining Ltd. (“Mining”).

At this stage, Resources was owned directly from the United States. In early February 1992, however, Green equity Investors acquired the shares in Lamesa, a company incorporated in the Netherlands, and transferred to it the shares in Resources. As a result, Resources was now owned by a resident of the Netherlands, not by a resident of the United States.

In late February 1992, Mining acquired all of the shares in Arimco. In 1994 and 1996, Lamesa sold the shares in Resources (divesting Mining, Arimco, and Arimco’s subsidiaries) in two tranches for a profit of $200 million. The ATO assessed Lamesa on the basis that the profit was ordinary trading income derived from sources in Australia. Lamesa successfully argued that the profit was not liable to tax in Australia under the 1976 Australia-Netherlands treaty. 12 The court concluded that Australia could not retain tax on the profit under either article 7 or article 13. Article 13 of the treaty, as drafted, looked at whether the assets of the company being sold were predominantly real estate. Although it was undoubtedly the case that the main assets of Arimco and its subsidiaries were natural resources in Australia, Lamesa was not selling the shares of those companies; it was selling the shares in Resources.

Australia’s response was to enact a treaty override. 13 If the shortcoming identified in Lamesa existed in article 13 of any of Australia’s other treaties, the defect was now overturned by the unilateral act of Australia’s Parliament.

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12 Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on March 17, 1976. The treaty issue revolved around whether the provisions of article 7 or article 13 should be applied. The parties in Lamesa agreed that if the provisions of article 7 were applied, Australia would not be entitled to sustain the tax assessed because Lamesa did not have a permanent establishment in Australia through which it carried on business. With respect to article 13 the ATO argued that Lamesa was deriving “income from the alienation of real property” when it sold the shares in Resources, so that Australia’s claim to tax could be sustained. The Federal Court disagreed because Lamesa did not itself have “rights to exploit, or to explore for, natural resources,” nor was Lamesa selling “shares . . . in a company, the assets of which consist wholly or principally of” real property or resources in Australia. The only assets of Resources were shares in other companies, and the court was not willing to read the provision as extending to real property held below one corporate tier: Lamesa, supra note 11, at 293-94.

13 Section 3A was inserted into the International Tax Agreements Act 1953 (Cth) in 2000 to apply to Australia’s treaties in force before 1998. The section purported to apply to any treaty that
Would *Lamesa* have been decided differently if it had been analyzed under the terms of the 1982 Australia-US treaty? It is not clear that the result would have changed. Article 7 of the Australia-US treaty was, in this respect, identical to the Dutch treaty, and Australia could not have sustained its claim to tax if article 7 of the US treaty had been applied. Although article 13 was presented slightly differently in the US treaty, the text, which bore on the key issue—namely, whether Lamesa was selling “real property situated in Australia” when it sold the shares in Resources—was identical. This may explain why the treaty-shopping dimension in *Lamesa* was never ventilated in court.

By 2009, however, the ATO was alive to treaty-shopping concerns. The Myer structure was somewhat more complex than that in *Lamesa* but the issue was essentially the same. In June 2006, one of Australia’s largest retailing groups, Coles Myer Ltd., decided to focus on its supermarket operations and sold its department store chain, Myer, to entities connected with Texas Pacific Group for $1.4 billion. An Australian company, Flinders Pty. Ltd. (“Flinders”), acquired Myer. Flinders was owned by a Dutch company, NB Swanston (“Swanston”), which was owned by a Luxembourg company, Nb Queen SaRL (société à responsabilité limitée), which was owned by a Cayman Islands company, TPG Newbridge Myer, which was owned by Texas Pacific entities in the United States and probably by other investors whose residence is not clear.

In 2009, Texas Pacific decided to float Myer on the Australian Stock Exchange. An Australian float vehicle raised funds by issuing shares on market and used the proceeds to buy the shares in Flinders from Swanston. The gain made by Swanston on the sale of its shares was said to be about $1.5 billion. In November 2009, the ATO issued assessments for unpaid tax and penalties against Swanston, relying on Australia’s general anti-avoidance rule (GAAR) to strike down the application of the tax.

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“makes provision in relation to income, profits or gains from the alienation or disposition of shares or comparable interests in companies . . . whose assets consist wholly or principally of real property.” The section provided that the provision “is taken to extend to the alienation or disposition of shares or any other interests in companies . . . the value of whose assets is wholly or principally attributable, whether directly, or indirectly through one or more interposed companies or other entities, to such real property or interests.”


15 Article 13 of the US treaty, ibid., provided that for the purposes of this Article . . . (b) the term “real property,” in the case of Australia, shall have the meaning which it has under the laws in force from time to time in Australia and, without limiting the foregoing, includes: (i) real property referred to in Article 6 [and] (ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia.

The definition of “real property” in article 6 included “rights to exploit or to explore for natural resources.”
Netherlands treaty on the basis of treaty shopping.\textsuperscript{16} Exactly what has happened since those events is unclear—some procedural skirmishes before the courts have been reported,\textsuperscript{17} but the primary issue of Swanston’s liability to Australian tax has not been resolved in a public forum.

The ATO, however, has not remained silent. It issued a series of public taxation rulings in the next year, all directed at the Myer transaction. One ruling declared that the ATO could invoke Australia’s GAAR to strike down an arrangement “designed to alter the intended effect of Australia’s International Tax Agreements network.”\textsuperscript{18} Another ruling declared that the profit made by a private equity firm could be assessed as ordinary trading profits rather than as a capital gain.\textsuperscript{19} A third ruling declared that the source of the profit on the sale of shares in an Australian company was not determined solely by the place where the contract was executed.\textsuperscript{20}

The flurry of rulings was primarily directed at buttressing the elements of the ATO’s substantive argument—that private equity houses earn ordinary income rather than capital gains from their activities; that the source of that income is

\textsuperscript{16} The ATO also sought an order freezing Swanston’s Australian bank account. Swanston apparently collected $3.9 billion on the float of Myer during October and November, but by the time the freezing order was sought the funds had already been remitted offshore and the balance of the bank account was a mere $45. See “ATO Pursues TPG for $452m Tax Bill Related to Myer Float,” News.com.au, November 13, 2008 (news.com.au/finance/ato-pursues -tpg-for-452m-tax-bill-related-to-myer-float/story-e6frfm1i-1225797140510).

\textsuperscript{17} For example, TPG Newbridge Myer Ltd. v. The Deputy Commissioner of Taxation, [2011] FCA 1157, ruling that the ATO could not serve documents affecting the offshore companies on officers of TPG’s Australian subsidiary.


\textsuperscript{19} \textit{Taxation Determination} TD 2010/21, “Income Tax: Can the Profit on the Sale of Shares in a Company Group Acquired in a Leveraged Buyout Be Included in the Assessable Income of the Vendor Under Subsection 6-5(3) of the Income Tax Assessment Act 1997?” December 1, 2010. This ruling is significant principally for its domestic-law effect. The jurisdictional reach of Australia’s capital gains tax is much more limited than the jurisdiction asserted when the amount in question is ordinary trading profits.

\textsuperscript{20} \textit{Taxation Determination} TD 2011/24, “Income Tax: Is an ‘Australian Source’ in Subsection 6-5(3) of the Income Tax Assessment Act 1997 Dependent Solely on Where Purchase and Sale Contracts Are Executed in Respect of the Sale of Shares in an Australian Corporate Group Acquired in a Leveraged Buyout by a Private Equity Fund?” October 26, 2011. A fourth ruling provided that Australia’s treaties could apply to the partners of a foreign limited partnership if the limited partnership was fiscally transparent so that the partners were taxable, provided that the partners were resident in a treaty jurisdiction: \textit{Taxation Determination} TD 2011/25, “Income Tax: Does the Business Profits Article (Article 7) of Australia’s Tax Treaties Apply to Australian Sourced Business Profits of a Foreign Limited Partnership (LP) Where the LP Is Treated as Fiscally Transparent in a Country with Which Australia Has Entered into a Tax Treaty (Tax Treaty Country) and the Partners in the LP Are Residents of That Tax Treaty Country?” October 26, 2011.
Australia; and that, to the extent that a treaty might be relied on to defeat Australia’s claim to tax, the treaty can be ignored if treaty shopping has occurred:

Where an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structuring arrangement, this may be a scheme or a part of a scheme which otherwise satisfies the terms of [Australia’s general anti-avoidance rule] and any tax benefit obtained in relation to such a scheme may be cancelled.21

The obvious question is what happens next. The rulings do not offer a coherent answer. They claim that the benefit of the Australia-Netherlands treaty could be switched off, but they do not substitute the application of the Australia-US treaty, which is presumably available if everything between Australia and the United States is artificial and contrived. Instead, ruling TD 2010-20 disregards two entities, but not three:

In the circumstances discussed above [US investors own a Caymans entity, which owns a Luxembourg entity, which owns a Dutch entity, which sells an Australian company], a scheme involving the mere interposition of holding companies between an entity resident in the Cayman Islands and an Australian holding company of the target assets, may give rise to a tax benefit for the Cayman Islands entity in respect of an otherwise assessable Australian sourced business profit. [The benefit is the non-inclusion in the Cayman resident’s assessable income of the Australian-source business profit].22

The ruling does not explain why the Dutch and Luxembourg companies are disregarded but the Cayman Islands entity is not. The ATO clearly wants to present the structure as abusive, and so it asserts that it involves a non-treaty entity (a Cayman Islands company) shopping into Australia’s treaty network. If the substance of the matter is instead a US entity investing into Australia (relying on the Australia-Netherlands treaty instead of the Australia-US treaty), whether that was abusive would presumably depend on whether the result under the Australia-US treaty involved less Australian tax than the result under the Australia-Netherlands treaty. That is an interesting and complex question which I will not pursue further here. The important point is that none of the rulings asks this question, impliedly insisting that it does not arise.

Lamesa and the Myer transaction are both instructive, but neither grapples with the fundamental concern of treaty shopping—that less tax was paid in Australia because of the decision to apply the Netherlands treaty in lieu of the US treaty. In Lamesa, it is not obvious whether a different outcome would have followed if the US treaty had been applied. In the Myer transaction, the ATO refuses to ask the question by stopping the analysis at the Cayman Islands.

21 TD 2010/20, supra note 18, at paragraph 18.
22 Ibid., at paragraph 19 (emphasis added).
THE POLICY SILENCE ON TREATY SHOPPING

Although the ATO has been particularly exercised about this problem, Australia’s politicians, Treasury officials, and tax policy committees have been remarkably silent. As noted above, Australia’s tax reform projects have all but ignored the problem of treaty shopping. The issue was not mentioned in the 1975 Asprey committee report,23 the 1985 tax reform white paper,24 or the 1998 “New tax system” proposals.25 The 1999 review of business tax considered some international tax issues, but not treaty shopping.26 The 2003 review of international taxation arrangements,27 which was the obvious forum in which to examine treaty shopping, did not mention it. Finally, the 2009 future tax system report28 contained no discussion of international tax.

One might have expected that this silence on treaty shopping in tax policy circles would have been broken with the emergence of the OECD’s BEPS project. The revelations about the tax practices of various multinationals emerging from the UK House of Commons Public Accounts Committee29 and the US Senate Permanent Subcommittee on Investigations30 did not pass unnoticed. Newspaper reports in 2012 drew parallels between the practices being reported offshore and tax outcomes

26 Australia, Review of Business Taxation, A Tax System Redesigned—More Certain, Equitable and Durable (Canberra: Review of Business Taxation, July 1999). The review devoted much attention to transfer pricing and thin capitalization. It included four recommendations with respect to treaties: (1) to reduce withholding tax on non-portfolio investors; (2) to include a non-discrimination article in Australia’s future treaties; (3) to renegotiate some of the older treaties with Australia’s major trading partners; and (4) more generally, to review Australia’s treaty policy “to ensure that it reflects a balanced taxation of international investment and changed investment patterns.”
27 Australia, Board of Taxation, International Taxation: A Report to the Treasurer (Canberra: Board of Taxation, 2003).
in Australia, claiming that Google earned $1 billion from sales in Australia but paid only $780,000 tax there.\textsuperscript{31}

Once tax compliance hit the headlines, politicians began to pay far greater attention to treaty shopping. In November 2012, the assistant treasurer promised “to take action where necessary to ensure the integrity and sustainability of the tax system, including our corporate income tax base.”\textsuperscript{32} He created a specialist group in December 2012,\textsuperscript{33} gave further speeches,\textsuperscript{34} and wrote an opinion piece for the financial press.\textsuperscript{35} Treasury produced an issues paper in May 2013\textsuperscript{36} and a scoping paper in July 2013.\textsuperscript{37}

Yet amid all this activity, the issue of treaty shopping did not warrant a mention. Australian academics and revenue administrators have been puzzling over the problem of treaty shopping, but Australia’s tax policy makers have been, and remain, focused on improving the exchange-of-information regime; curtailing the activities of tax havens; challenging corporate tax compliance culture; pondering the problems of e-commerce and the concept of a permanent establishment as the threshold


requirement for the ability to tax; and handling transfer pricing, especially with respect to intangibles transferred to havens.

AUSTRALIA’S CURRENT TREATY PRACTICE

Australia’s current treaty practice relies on some of the existing provisions in the OECD model but supplements them with a combination of targeted anti-treaty-shopping rules.

OECD Model and Commentary

Australia’s treaties largely follow the OECD model, but with reservations and supplemented by other provisions. Australia’s courts have accepted that the commentary to the OECD model can be consulted in the interpretation of an Australian treaty, and one might expect that an Australian court would be influenced by the discussion in the commentary to article 1 on the improper use of treaties.38 Unlike the United States, Australia does not publish a model treaty. However, the 2009 Australia-New Zealand treaty is generally accepted as a good indicator of Australia’s preferred treaty positions.39

Resident

Article 4 of Australia’s treaties typically follows the OECD model and defines a person as a “resident” for treaty purposes initially by reference to the domestic law of the treaty partner, excluding persons that are liable to tax in a state only on the basis of source.

Australia makes some adjustments to article 4 of the OECD model convention, principally to deal with two peculiarities of the Australian economy—the prominence of trusts in the commercial property and funds management industries, and the existence of significant dual-listed multinational enterprises (BHP Billiton and Rio Tinto) in the mining industry. With regard to trusts, rather than rely simply on the OECD’s partnership report40 to address the question of entitlement to treaty benefits, Australia sometimes elaborates on the definition of “resident” to make explicit the treatment of fiscally transparent entities and to articulate a means of handling disagreements about the transparent status of entities. For example, Australia’s 2008 treaty with Japan contains a complex provision explaining what happens when income is derived by an entity that is established in the other state (or even in a third state) when the income is attributed and taxed in the hands of the investors (or taxed

39 Convention Between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, signed at Paris on June 26, 2009 (herein referred to as “the New Zealand treaty”).
in the hands of the entity). Article 1(2) of the New Zealand treaty is more typical. It provides as follows:

In the case of an item of income (including profits or gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.

Similarly, article 4(7) of the New Zealand treaty confirms that it is the investors in listed publicly traded investment trusts that will enjoy treaty benefits. But article 4(7) tries to do the reverse, presumably as a compliance cost-saving measure—and treat the (transparent) managed investment trust as entitled to the benefits of the treaty if it is listed on a stock exchange and regularly traded and at least 80 percent of the value of units in the trust is owned by Australian residents.

Australia’s treaty practice also attempts to address individuals who are only temporarily resident in Australia. Under Australian domestic law, temporary residents are not taxed on their worldwide income. Instead, most of their foreign-source income and capital gains will be exempt from Australian tax and they will usually be taxed by Australia just on income from performing services in Australia. Australia’s treaty practice provides that any limitation on source country tax that would ordinarily be triggered for the benefit of a resident is not triggered in the case of a temporary resident if the amount is not taxed in Australia.

**Beneficial Ownership**

Articles 10, 11, and 12 of Australia’s treaties typically refer to the requirement for the dividend, interest, or royalty income to be “beneficially owned” by a resident of the other contracting state if the limitation on tax rates is to be triggered. Sometimes a different term (such as “beneficially entitled”) is used, but the requirement appears.

Again, the proliferation of trusts in the Australian economy poses a difficulty that requires a special provision. Under Australian domestic law, if the income derived through a trust is owned by identifiable beneficiaries, the beneficiaries are taxable

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41 Convention Between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Protocol and Exchange of Notes, signed at Tokyo on January 31, 2008, at article 4(5).

42 Supra note 39, at article 1(2).

43 Income Tax Assessment Act 1997 (Cth), at sections 768-910.

44 See, for example, the Convention Between Australia and the Kingdom of Norway for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, signed in Canberra on August 8, 2006, at article 4(5). The provision is expressed to apply in the reverse situation—for example, where a person is temporarily resident in a treaty country and is not taxed in that country because it is a temporary resident, but is claiming relief from Australian tax on the basis that it is a resident.
on that income.45 But if no beneficiary can be identified as the owner of the income by the end of a year, the trustee pays tax on the income.46 It might be argued that if the income is taxed in the hands of the trustee, the “beneficial owner” requirement in articles 10, 11, and 12 is not met. Article 3(4) of the New Zealand treaty is directed at solving that problem and is intended to deliver the benefits of the treaty to the trustee even though the trustee might not be regarded as the “beneficial owner” of the income.

**General Limitation on Benefits**

Australia’s treaty practice does not usually include a general LOB provision, although some exceptions exist. For example, the treaties with the United States and Japan include a general LOB article, presumably because they represent the treaty practice of the other country. In addition, Australia has sometimes insisted on such a clause, apparently for its own purposes. It seems that Australia regards it as important to include a general LOB provision when negotiating with certain countries. The protocol to the 2013 treaty with Switzerland contains a general LOB article that was probably included at Australia’s insistence. Clause 1 of the protocol to the new Swiss treaty provides as follows:

The benefits of this Convention shall not apply if it was one of the principal purposes of any person concerned with the creation or assignment of the property or right in respect of which the income is paid, or if a person has become a resident of a Contracting State, to take advantage of the provisions of the Convention by means of such creation, assignment or residence.47

This is, in effect, a general LOB provision, though one driven by “purpose” rather than by more observable criteria such as ownership structure, listing on a stock exchange, the conduct of an active trade or business, or the leakage of income offshore.

The 2003 treaty with Russia also contains a LOB article, though it is more nuanced than the provision quoted above. It has clearly been drafted to deny treaty benefits to companies that enjoy clandestine tax preferences. Article 23 applies where under the laws or administrative practices of a Contracting State, such income or profits are preferentially taxed and, in relation thereto, information is accorded confidential treatment beyond the usual or general protection of information accorded for tax purposes.48

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46 Ibid., at section 99A.
47 Convention Between Australia and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol, signed at Sydney on July 30, 2013, at protocol clause 1.
The denial of treaty benefits is limited to entities engaged in particular industries—banking; shipping; financing and insurance; Internet activities; headquarters companies; coordination centres; group financing and administrative support; “activities which give rise to passive income, such as dividends, interest and royalties”; and “activities the performance of which do not require substantial presence in the State of source.”49 This LOB article does not depend on findings about purpose.

**Purpose-Based Exclusions**

Australia has an apparent affection for purpose-based LOB provisions. The general denial of benefits contained in the protocol to the Swiss treaty discussed above is one example. A second approach, which is very common, denies access to the limitations on source country taxation in articles 10, 11, and 12. Article 10(9) of the New Zealand treaty, which is typical, provides as follows:

No relief shall be available under this Article if it is the main purpose or one of the main purposes of any person concerned with an assignment of the dividends, or with the creation or assignment of the shares or other rights in respect of which the dividend is paid, or the establishment, acquisition or maintenance of the company that is the beneficial owner of the dividends and the conduct of its operations, to take advantage of this Article. In any case where a Contracting State intends to apply this paragraph, the competent authority of that State shall consult with the competent authority of the other Contracting State.50

Articles 11(9) and 12(7) of the New Zealand treaty are phrased in similar terms. The requirement for a state to consult with the competent authority of the other state prior to denying treaty benefits is a feature of this way of drafting a denial of benefits.

Another example appears in article 4(5) of the 1990 treaty with China. It provides as follows:

If a company has become a resident of a Contracting State for the principal purpose of enjoying benefits under this Agreement, that company shall not be entitled to any of the benefits of Articles 10, 11 and 12.51

Although the article operates on the basis of the definition of “resident,” its effects are limited to denying access to articles 10, 11, and 12. The company remains a resident for the purposes of other articles.

49 Ibid.

50 Ibid., at article 10(9).

Anti-Back-to-Back Provision in the Interest Article

Australia's treaty practice also includes a specific prohibition on treaty benefits in circumstances where conduit financing is involved. Australia's recent treaties eliminate all source country tax when interest is paid to “a financial institution which is unrelated to and dealing wholly independently with the payer,” but a specific limitation is added to prevent exploitation. For example, article 11(4) of the New Zealand treaty provides as follows:

> Notwithstanding paragraph 3, interest referred to in subparagraph (b) of that paragraph may be taxed in the State in which it arises at a rate not exceeding 10 per cent of the gross amount of the interest if . . .
> (b) it is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

The clause is a mixture of an apparently objective criterion (a “back-to-back loan” or an arrangement that is “economically equivalent” to a back-to-back loan) and a purpose-based test (an arrangement that is intended to have a particular effect).

These modifications to the OECD model convention now represent a common constellation of provisions in Australia's recent tax treaties. It seems that Australia adopts both purpose-based rules (to protect the dividends, interest, and royalties articles) and structural rules (to protect the exemption for interest earned by financial institutions). Australia appears to have no appetite for the widespread use of a general LOB article based on the kinds of observable characteristics (set out earlier) seen in the US provision—ownership structure, listing on a stock exchange, the conduct of an active trade or business, or the leakage of income offshore.

Applying the Australian GAAR

Australia’s GAAR is a potential weapon available to be used to combat treaty shopping. Bilateral income tax treaties are given effect in Australian domestic law by the International Tax Agreements Act 1953. Section 5 of that statute provides that a tax treaty “has the force of law according to its tenor” from the date of its entry into force, and section 4(2) gives the treaty superiority over domestic law by providing that the treaty will “have effect notwithstanding anything inconsistent . . . contained in the Assessment Act.” The superiority of the treaty is, qualified, however. Section 4(2) provides that the superiority of the treaty does not extend to superiority over Australia's domestic GAAR. This provision might appear at odds with Australia’s

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52 For example, the New Zealand treaty, supra note 39, at article 11(3)(b).
53 Ibid., at article 11(4)(b).
54 Under the International Tax Agreements Act 1953 (Cth), at section 4AA(2), the superiority of the treaty is also deferred to another anti-avoidance rule in Australia's fringe benefits tax legislation.
obligations under international law to honour its treaty obligations, but its existence is probably tacitly accepted because it has been in the legislation since the introduction of Australia’s revised GAAR in 1981\(^5\) and is presumably the kind of provision that the commentary to the OECD model allows.\(^6\)

**THE SECOND STRING TO THE BOW**

Although Australia has mechanisms in its treaties and in domestic law aimed at preventing treaty abuse, a more interesting strategy for managing treaty shopping emerges from the general domestic tax policy settings that Australia has chosen to implement. As I noted above, so far as Australian residents are concerned, treaties play a minor role in determining their Australian tax liability.\(^5\) The same is true for many non-residents—their Australian tax liabilities are also governed largely by Australian domestic law, applied indifferently to investors from treaty and non-treaty countries alike. Treaties do not often deliver large tax reductions to non-residents. This may be a curious position internationally, but it is undoubtedly the case that non-residents from treaty and non-treaty countries will often end up in the same position because our domestic policy settings are already at a level that is at least as generous as the treaty provisions.

The irrelevance of treaties in determining non-residents’ Australian tax liabilities can be seen in a number of places. For example, Australian domestic law does not impose tax on dividends paid to non-residents if the dividend is paid from the taxed profits of an Australian company.\(^5\) Domestic law does not impose tax on dividends

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\(^5\) The reference to the current version of Australia’s GAAR was added by Income Tax Laws Amendment Act (no. 2) 1981, at section 13.


\(^5\) Non-portfolio dividends from foreign subsidiaries are exempt from Australian tax whether or not the subsidiary is resident in a treaty country: Income Tax Assessment Act 1936 (Cth) section 23AJ. Gains made on the sale of shares in foreign operating subsidiaries are also exempt from Australian tax whether or not the subsidiary is resident in a treaty country: Income Tax Assessment Act 1997 (Cth), division 768-G. Australia’s controlled foreign corporation (CFC) rules do not differentiate between good and bad countries or types of income on the basis of whether or not the CFC is resident in a treaty country: Income Tax Assessment Act 1936 (Cth), part X, division 7. The extent of the attributable income of a CFC depends on whether the CFC is resident in a listed country or an unlisted country. There are only 7 listed countries—Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States. The rest of the world, including the remaining 37 treaties countries, are all viewed as being alike for CFC purposes: Income Tax Regulations 1936, schedule 10. Other types of foreign-source income that have been taxed at source will typically enjoy a foreign tax credit under Australian domestic law: Income Tax Assessment Act 1997 (Cth), division 770. There is no serious suggestion that the credit provided under article 23 of Australia’s treaties is likely to be more generous than that provided under domestic law.

\(^5\) Income Tax Assessment Act 1936 (Cth), at section 128B(3)(ga).
paid to non-residents even from the untaxed profits of an Australian company, if those profits were earned offshore.\textsuperscript{59} Thus, although a treaty might allow Australia to tax dividends at 5, 10, or 15 percent, domestic law does not claim it. The same is true if non-residents sell shares in an Australian company. If the non-resident makes a gain that Australian law regards as a capital gain, Australian domestic law will rarely claim tax.\textsuperscript{60} Indeed, when this rule was announced in May 2005, the justification for the rule was deliberately to align the domestic law with the result that would be reached if a treaty applied.\textsuperscript{61}

The domestic rule has interesting consequences for one of Australia’s treaty curiosities. Article 13 of Australia’s treaties with the United States and the United Kingdom preserves the source country’s right to tax “capital gains in accordance with domestic law” for all residual capital gains. The text departs from article 13(5) of the OECD model convention (which allocates the right to tax residual capital gains exclusively to the residence state) and was drafted at a time when the ATO was very insistent on retaining the right to tax non-residents on gains made on Australian assets. It also departs from the text of some of Australia’s other recent treaties, such as those with South Africa, Japan, and France, all of which give the residence country the right to tax residual capital gains. The irony is that, having ensured that domestic law could operate without restraint on residual capital gains, the domestic law was changed so that it now rarely claims tax on residual capital gains.

A similar alignment occurs for much cross-border interest. Australian domestic law imposes tax at a rate of 10 percent on interest paid to non-residents, but mainly if they are associates of the Australian borrower\textsuperscript{62}—that is, most interest paid to unrelated non-residents is not liable to tax.\textsuperscript{63} Article 11 of Australia’s treaties typically provides for 10 percent tax on interest, and consequently no reduction in tax is to be gained by shopping into or between treaties.\textsuperscript{64}

\textsuperscript{59} Income Tax Assessment Act 1997 (Cth), at section 902-15(1)(b).

\textsuperscript{60} Ibid., at division 768-G. Capital gains made by non-residents on the sale of shares in an Australian company will be liable to tax only if (1) the vendor holds 10 percent or more of the company’s shares and (2) 50 percent or more of the value of the assets of the company is represented by land in Australia.

\textsuperscript{61} “The amendments also align Australia’s domestic law with the approach adopted in Australia’s tax treaties. By aligning our law with Australia’s treaty practice, Australia’s approach to capital gains becomes more consistent.” See Australia, Tax Laws Amendment (2006 Measures No. 4) Bill 2006: Explanatory Memorandum (Canberra: Australian Treasury, 2006), at paragraph 4.7 (austlii.edu.au/au/legis/cth/bill_em/ta2006mn4b2006324/memo_0.html).

\textsuperscript{62} Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 (Cth), at section 7(b).

\textsuperscript{63} Income Tax Assessment Act 1936 (Cth), at section 128F.

\textsuperscript{64} One potential exception is the exclusion of all residence-based tax on interest paid to non-resident financial institutions under article 11 of Australia’s recent treaties. It is worth noting, however, that the domestic-law exception can often be triggered in this situation as well. The main situation in which Australian domestic law retains a tax claim (that is, where the interest is paid to a related entity) also rarely qualifies for the treaty exception.
This alignment of domestic law with treaty outcomes is not universal—the discussion above paints it in very broad strokes—but it occurs often and for situations that are commercially important. Thus, any non-resident that sets up an Australian subsidiary that pays dividends and interest to its non-resident owner is not likely to be advantaged by making that investment through a treaty country or by changing treaties. Similarly, when the non-resident sells the Australian subsidiary, it is not likely to be advantaged by selling while a resident of a treaty country.

There are certainly areas where discrepancies survive. For example, Australian domestic law claims tax at 30 percent on dividends paid from the untaxed profits of an Australian company, but Australia’s recent treaties can reduce this amount to zero if the dividend is paid to a foreign parent. Similarly, domestic law claims tax at the rate of 30 percent on royalties paid to non-residents, but Australia’s modern treaties typically reduce that rate to 15 percent or less and overturn the domestic-law treatment of equipment rentals as royalties, assigning them instead to the business profits article. Non-residents that earn significant amounts of income that Australian domestic law regards as sourced in Australia, but that can do so without maintaining a permanent establishment in Australia (e-commerce businesses are the obvious example) are immune from Australian tax if they reside in a treaty country but liable to tax if they don’t.

I do not suggest that the alignment of domestic policy settings with treaty outcomes was done with treaties and the problem of treaty shopping in mind, although in the case of the jurisdictional claims of the capital gains tax the legislative history shows that this was a factor. For dividends and interest, the more likely explanation is that the policy settings are regarded as appropriate as a matter of domestic tax policy. While Australia has for much of its modern existence been a capital-importing country, investment flows have become more mature over time, and Australia is now both a capital importer and a capital exporter. In consequence, Australia’s 2003 review of international taxation arrangements moved Australia’s tax policy settings away from a preoccupation with maintaining source-based taxation and toward greater residence-based taxation.

One outcome of that change has been a gradual and unilateral reduction in source-based taxes. This reduction has happened because it is regarded as being in Australia’s national interest. It has not been thought necessary—or even sensible—to wait until another country is ready to negotiate a treaty in order to implement reductions that Australia regards as appropriate.

65 Supra note 62, at section 7(a).
66 See, for example, the New Zealand treaty, supra note 39, at article 10(3).
67 Supra note 62, at section 7(c).
68 Australia’s 2003 report on international taxation arrangements recommended “a move towards a more residence-based treaty policy in substitution for based on the source taxation of income.” See supra note 27, at recommendation 3.5.
This position may seem odd to countries that regard treaties as instruments for securing advantages for their residents that invest offshore. Australia does not promise a reciprocal rate reduction, and so at negotiations it appears to have very little to bargain with if it is trying to secure reductions from the other party. This appearance has not passed unnoticed, but the explanatory memorandum that accompanied the 2005 amendments, which wound back the domestic law on capital gains, argued that making the change in domestic law would actually make treaty negotiation easier and more successful:

By bringing Australia more in line with international practice, this will relieve the pressure to compromise other aspects of Australia’s preferred tax treaty practice. This will result in more favourable tax treaty outcomes for Australia.\(^{69}\)

Whether or not that statement is correct, if one believes that lower taxes at source are in the national interest, then waiting until another party is ready to reciprocate would be foolish. And perhaps the treaty negotiators believe that the other party, by insisting on retaining its high withholding rates, will eventually discover that it is harming itself and also decide, unilaterally, to make a similar change.

As I noted above, though these policy settings may have been chosen for entirely self-interested reasons and without much regard to their effects on tax treaties, they may explain why Australia has been uninterested in pursuing treaty shopping. Because treaties often deliver to non-residents little that domestic law does not already offer, no benefits arise from treaty shopping in many common situations. Indeed, one could go further: it is not farfetched to argue that Australia should encourage non-residents to access Australia’s treaties inappropriately. Such a strategy might just prove to be valuable to Australia’s national interest. The current debate about the evils of treaty shopping focuses entirely on its impacts on the distributive rules, which usually operate to reduce the source country’s taxing powers. But treaties also include important administrative provisions, especially provisions dealing with the exchange of information and perhaps assistance in the collection of tax. A non-resident that seeks to access one of Australia’s tax treaties inappropriately may find that it has secured no tax relief beyond what domestic law already allowed, but it has certainly exposed itself to exchange of information and possibly to the collection of Australian taxes. This benefit from treaty shopping should not be ignored in the current efforts to stifle the practice.

\(^{69}\) Supra note 61.
FINANCES OF THE NATION

Vivien Morgan*

SURVEY OF PROVINCIAL AND TERRITORIAL BUDGETS, 2013-14

For almost 60 years, the Canadian Tax Foundation published an annual monograph, Finances of the Nation, and its predecessor, The National Finances. In a change of format, this issue of the Canadian Tax Journal introduces a new Finances of the Nation feature, which will present a series of articles on topical matters relating to taxation and public expenditures in Canada. Each year, one issue of the journal will include in this feature a survey of the provincial and territorial budgets tabled in the preceding year.

This article summarizes revenue and expenditure projections for 2013-14 set out in the budgets and updates issued by Canada’s provinces and territories. It includes tables and charts showing aggregated data for comparative purposes, and comments on discernible patterns and trends. Significant tax changes in each jurisdiction are highlighted and briefly discussed.

KEYWORDS: BUDGETS ■ PROVINCIAL ■ TERRITORIAL ■ GOVERNMENT FINANCE ■ REVENUE ■ EXPENDITURES

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Estate planning offers taxpayers a means of distributing their assets, subsequent to death, in a way that minimizes tax liabilities for both the deceased and their beneficiaries. Serious obstacles can arise if the estate has non-resident beneficiaries and a significant portion of its value is derived from shares of a Canadian investment corporation. The authors of this two-part article examine Canadian and US tax implications for a Canadian resident who wishes to bequeath shares of a Canadian investment corporation to beneficiaries that include both Canadian and US residents. In part 1, the authors reviewed how the residence of an estate is determined pursuant to Canadian rules and US tax rules, the application of US anti-deferral rules, and the resulting unexpected tax liabilities for US-resident beneficiaries. In part 2, they discuss the use of unlimited liability corporations and other planning strategies that may be used to mitigate the overall tax burden on the deceased and their beneficiaries.

**KEYWORDS:** ESTATE PLANNING ■ UNLIMITED LIABILITY CORPORATION ■ NON-RESIDENT ■ BENEFICIARIES ■ DISTRIBUTIONS ■ UNITED STATES

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* Of PricewaterhouseCoopers LLP, Toronto.

** Of PricewaterhouseCoopers LLP, Toronto.

*** Of Bessner Gallay Kreisman LLP, Montreal.
When the sale of a business is contemplated, one possibility is to structure the transaction as a combination of a share sale and a sale of assets. This hybrid form of transaction has proved remarkably useful in bridging the gap between the vendor and the purchaser, particularly when some of the vendor shareholders can claim a capital gains exemption. This situation can arise in the context of a family business corporation where the majority shareholder has previously carried out a freeze in favour of family members, using a family trust, or where there is an unrelated majority shareholder with a number of individual minority shareholders. This article reviews a number of provisions of the Income Tax Act (Canada) that must be considered in using this form of hybrid transaction.

**KEYWORDS:** SALE OF A BUSINESS ■ SHARES ■ HYBRIDS ■ CAPITAL GAINS ■ GOODWILL
Planification fiscale personnelle
Co-rédactrices de chronique: Pearl E. Schusheim* et Gena Katz**

Vente hybride d’actions et d’actifs d’une entreprise

Charles P. Marquette***

Lorsque l’on envisage la vente d’une entreprise, il est possible de structurer l’opération en combinant vente d’actions et vente d’actifs. Cette forme d’opération hybride s’est avérée remarquablement utile en réduisant l’écart entre le vendeur et l’acheteur, en particulier lorsque certains des actionnaires vendeurs peuvent se prévaloir d’une exonération des gains en capital. La situation peut se présenter dans le contexte d’une entreprise familiale quand l’actionnaire majoritaire a déjà procédé à un gel en faveur de membres de sa famille en ayant recours à une fiducie familiale, ou si la société compte un actionnaire majoritaire qui n’est pas lié à un certain nombre d’actionnaires minoritaires qui sont des particuliers. Le présent article examine un certain nombre de dispositions de la Loi de l’impôt sur le revenu dont on doit tenir compte lorsque l’on a recours à cette forme d’opération hybride.

Mots-clés: vente d’entreprise ■ actions ■ hybride ■ gain en capital ■ achalandage

* De Couzin Taylor LLP, Toronto (affilié à Ernst & Young LLP).
** De Ernst & Young LLP, Toronto.
*** De Borden Ladner Gervais s.r.l., s.e.n.c.r.l., Montréal.
Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada* (Toronto: University of Toronto, School of Public Policy & Governance, Mowat Centre, April 2014), 63 pages

The authors of this monograph provide a masterful survey of the fundamental economic issues of the corporate income tax, with particular reference to Canada. Boadway and Tremblay build on their analysis to propose a new type of corporate tax that would have as the tax base economic rents: profits that exceed the normal rate of return in the economy. Numerical examples clearly illustrate the possible versions of this tax.\(^1\)

The advantage of this new form of tax base, according to the authors, is that it is as neutral as possible; firms have no incentive to change their behaviour in response to the tax. Such a tax base contrasts with the present corporate income tax, which is notorious for its encouragement of tax-motivated behaviour.

The authors begin with a review of the purposes of the corporate income tax. Particular attention is given to the backstop argument: a corporate tax is needed to prevent shareholders from accumulating income tax-free in corporations. The authors then review the corporate tax proposals of two UK policy reviews, the Meade report\(^2\) in 1978 and the Mirrlees review\(^3\) in 2011, and discuss who bears the corporate income tax.

The authors then return to the backstop argument, noting that it implies that corporate tax revenues should be interpreted as taxes levied indirectly on shareholders, and hence shareholders should be given credit for taxes paid at the corporate level (through the dividend tax credit). They challenge this sacred cow, noting that

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\(^1\) See Boadway and Tremblay’s appendix 2.


the after-corporate-tax return to shareholder investment is largely determined on a worldwide basis in international capital markets. Thus, there is no need to compensate shareholders for a tax largely borne by others (such as workers, through lower wages). Boadway and Tremblay thus oppose the integration of corporate and personal taxes on the basis that this simply subsidizes savings and lightens the personal taxation of capital income, rather than removing double taxation. Although this material is not new, Boadway and Tremblay display a gift for making these complex arguments understandable.

Boadway and Tremblay conclude that the backstop rationale for the corporate income tax is not a good one, and they propose instead a rent tax rationale, with the main tax policy goal of neutrality. The benefits to be achieved through a rent tax are explained in chapter 6, which sets out in detail the non-neutrality of the present corporate income tax with respect to investment decisions, leverage, profit shifting, and discrimination against new firms and risky firms.

The monograph concludes with a chapter that reviews alternative approaches to reforming corporate taxation, followed by a chapter that sets out recommendations. Boadway and Tremblay propose a combination of corporate tax and personal tax reforms.

Regarding reforms at the corporate level, the authors note that the simplest form of a rent tax is a cash flow tax, but it is administratively and politically unacceptable because it would require refundability of all losses (that is, a system of payments to firms with losses, instead of the present loss carryover system). Thus, they appear to favour a cash flow equivalent tax known as the “allowance for corporate equity” model, which would be similar to the present corporate income tax, except that it would add a deduction for the imputed cost of equity finance. The authors express the hope that this similarity might result in foreign governments continuing to give foreign tax credits to their corporations operating in Canada.

Boadway and Tremblay’s more controversial recommendations, at least among economists, arise at the personal level. Their preferred option is to eliminate both the dividend tax credit and the preferential tax treatment of capital gains (to move to a 100 percent inclusion rate). They considered a special lower inclusion rate for corporate shares to recognize tax paid at the corporate level on retained earnings, but decided against such an exception on several grounds, including fairness and simplicity.

Boadway and Tremblay show their practical side by taking the rare step of estimating the federal revenue implications of their proposals. If the corporate tax rate is kept the same, revenues would decline by 19 percent, or $6 billion. The dividend and capital gains tax changes would each raise about $4 billion, more than making up for the lost revenues at the corporate level.

Two common misconceptions about economists’ policy recommendations are that they are limited to suggesting a reduction in corporate tax rates and that they would reduce the fairness of the tax system. Neither criticism appears to apply to Boadway and Tremblay’s recommendations. The fact that their vision goes beyond simple rate reduction is clear. As for fairness, the authors argue in the monograph’s
final chapter that the reduction in corporate taxes would largely benefit workers because they bear the burden of the present corporate income tax through lower wages. In addition, the reforms to the taxation of dividends and capital gains would make the tax system more progressive, restoring, in their view, some of the fairness that has been eroded in recent years.

A.M.


“The international tax world is facing a defining moment.” The fundamental flaws of the existing system have been known to insiders of the system, such as tax practitioners, tax policy makers, law makers, and tax academics. Thanks to the recent media coverage of the base erosion and profit-shifting (BEPS) project, which is led by the Organisation for Economic Co-operation and Development (OECD) and mandated by the G20, everyone seems to know that the system fails to tax the world’s profitable multinational enterprises (MNEs). Developed economies represented by the OECD, emerging economies such as the BRICS countries (Brazil, Russia, India, China, and South Africa), as well as developing countries, all seem to claim that their tax base has been eroded. MNEs have been pilloried for “artificially” creating “homeless” or “stateless” income and for not paying a “fair” share of taxes in the countries in which their profits were earned. There appears to be a wide consensus that the current international tax regime is irrevocably broken. There is not yet any consensus about how to fix the system.

Each of the four papers reviewed below offers some ideas that are worthy of further exploration. Wells and Lowell suggest a return to the profit split (or formula apportionment) idea considered by the International Chamber of Commerce.

4 Rosenzweig, at 79.

5 For current coverage of the BEPS project, see the OECD website at www.oecd.org/ctp/ieps.htm.
(ICC) before the League of Nations published the 1923 report on double taxation by four economists that laid the foundation for the current system.\(^6\) Avi-Yonah suggests that MNEs should just say no to aggressive tax planning. Rosenzweig suggests establishing an institutional framework to enable one country to retaliate against another country if the latter country does not conform to the new global tax regime. Blair-Stanek ventures outside tax law and introduces an entirely new solution: change intellectual property law to counter BEPS.

Wells and Lowell begin their paper by asking why MNEs are so publicly criticized if they just follow the law. They identify five basic elements (or principles) of tax treaty policy, which can be traced to the work of the League of Nations in the 1920s and 1930s:

1. Source country should tax local operations, including property or other pertinent matters.
2. Residual income should be taxed by the country of residence, which provides the knowledge, capital, and global markets for the business.
3. Presence of an interim holding company should be treated as a residence Country.
4. Subsidiaries should not be treated as a permanent establishment (PE).
5. TP [transfer pricing] is to be evaluated on a separate account basis (i.e., one-sided TP principles).\(^7\)

According to Wells and Lowell, the above principles encourage MNEs to engage in BEPS. What is missing in the current BEPS debate is the fact that no country seems to like the existing treaty rules that guide the allocation of income between countries, but there is no movement to update these fundamental rules to reflect the economy of the 21st century. Therefore, MNEs have simply become the “villains for these failures.”\(^8\) To move forward, Wells and Lowell suggest that the flawed foundational premise must be addressed to meet the needs of both countries with divergent interest and MNEs. They maintain that the original ICC recommendation should be given fair consideration.

The ICC draft 1923 resolution contains the following principles:

- If a company does business in more than one country, the profits should be taxed in each country in proportion to the profit realized therein.
- If the countries cannot agree, then the allocation is presumed to be proportional to sales (turnover).

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\(^7\) Wells and Lowell, at 27.

\(^8\) Ibid., at 5.
These proportions cannot exceed the total fixed by the “competent authority in the country of domicile.”  

The ICC proposal was rejected by the League of Nations economic experts’ report on the ground that “the methodology has no fundamental basis in economic theory which is capable of easy application.”

Wells and Lowell did an excellent job in documenting the work of the ICC and the League of Nations that planted the seeds of the modern international tax system. They remind readers how little has changed in international tax thinking in the face of dramatic changes in world politics, economics, and business practices. To solve the problems of the 21st century, however, it may be wise to review history, which has taught us that tax revenues will follow treaty policy design. To redesign treaty policy, the residence country paradigm may need to be replaced with a profit split (formulary apportionment) paradigm.

In *Just Say No: Corporate Taxation and Corporate Social Responsibility*, Avi-Yonah describes the Caterpillar profit-shifting strategy, discusses why shy corporations should pay tax, and examines the three main views on corporations and their implications for corporate social responsibility (CSR) and corporate tax.

The Caterpillar profit-shifting strategy involves “artificially” relocating approximately $2.4 billion in profits from the United States to Switzerland through the use of a hybrid entity in Switzerland (an entity treated as a corporation for Swiss tax purposes but as a partnership for US tax purposes), and creating a “virtual inventory,” which has no resemblance to the physical movement of any product sold by Caterpillar. The tax plan was proposed by one of the big four accounting firms. Avi-Yonah considers the plan to have no economic substance because the profits would have been earned without the transactions.

Assuming that governments want to tax corporations, for whatever reasons, Avi-Yonah discusses whether corporations should cooperate and pay the tax, or engage in “strategic” tax behaviour designed to minimize or eliminate their corporate tax burden. He summarizes the debates on CSR and concludes that the scope of CSR depends on one’s view of the corporation. One view is that a corporation is an “artificial entity,” which is primarily a creature of the state. Another view is that a corporation is a “real entity,” separate from both the state and from its shareholders. A third view is that a corporation is an “aggregate” or “nexus of contracts,” which is merely an aggregate of its individuals members or shareholders. Each of the views has different implications for the payment of tax and CSR. Under the artificial entity view, engaging in some forms of CSR is part of the corporation’s mission, and paying corporate tax is one way of fulfilling the corporation’s CSR obligations. Under the

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10 Supra note 6, at 46, quoted in Wells and Lowell, at 22.
real entity view, the corporation is similar to an individual citizen, is legally required
to pay taxes, and is expected not to engage in overly aggressive tax planning to mini-
mize its tax obligations. Under the aggregate view, which dominates contemporary
CSR scholarship, CSR is an illegitimate attempt by managers to tax shareholders
without their consent, and managers have an obligation to maximize shareholder
profits by minimizing corporate taxes. Avi-Yonah argues that the last view, when
taken to its extreme, is misguided and self-defeating because “it could mean that
neither corporations nor the government can fulfill their responsibilities to soci-
ety.”\(^{11}\) He concludes that “strategic tax behaviour seems to be inconsistent with any
view of the corporation.”\(^{12}\)

Avi-Yonah also addresses the competitiveness argument often used by corpora-
tions: “everyone does it, especially our foreign competitors.”\(^{13}\) He points out that
US corporations were competitive until the 1990s, when they did not engage in
aggressive tax strategies. Today, it is rare to find a US-based multinational that does
not declare on its website that it is committed to CSR. In the end, he believes that
the only real solution is to change the attitude of US corporations. A tax director of
a major corporation, when presented with an aggressive tax plan, should just say no.

In “An Antigua Gambling Model for the International Tax Regime,” Rosenzweig
investigates a “sticky” problem in international tax law: the lack of a mechanism for
resolving policy differences among countries. This type of dispute differs from the
disputes between taxpayers and governments, which are currently resolved through
mutual agreement procedures. He imagines that the problem of intercountry tax
policy disputes will worsen in any new multinational framework emerging from
BEPS or similar projects. Without a workable institutional mechanism for resolving
these disputes, it would be difficult to implement the new multilateral framework or
norms. He suggests that the recent experience of the World Trade Organization
(WTO) in the Antigua Gambling case\(^{14}\) can be used as a model for the new inter-
national tax regime.

In the Antigua Gambling case, the dispute was between Antigua and Barbuda, the
smallest member country of the WTO, and the United States. Antigua and Barbuda
hosted popular online gambling sites directed primarily at US gamblers. In 2006,
the United States enacted a law that makes it illegal to offer online gambling in the
United States. Antigua and Barbuda brought a claim in the WTO that the United
States was impermissibly restraining international trade in services in violation of the
general agreement on trade in services (GATS). It won the case. The typical remedy
for a violation of GATS is permitting the aggrieved country (Antigua and Barbuda)
to retaliate by enacting restraints or tariffs on services from the other country.

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\(^{11}\) Avi-Yonah, at 12.
\(^{12}\) Ibid., at 30 (emphasis in original).
\(^{13}\) Ibid., at 32.
\(^{14}\) United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services,
WT/DS285/AB/R.
However, since there were virtually no services provided by the United States in Antigua and Barbuda, the usual remedy was meaningless. Antigua and Barbuda was permitted by the WTO to retaliate against the United States, not under GATS, but under another WTO agreement: the agreement on trade-related aspects of intellectual property rights. In July 2013, Antigua and Barbuda declared its intention to begin selling copyrighted songs, movies, and other material directly to US consumers, without paying royalties.

What are the implications of the *Antigua Gambling* model for international tax law? One idea is to build a dispute settlement mechanism into the BEPS project that permits a form of cross-retaliation, such as that used in the WTO. This matter is important because there are disparate incentives between some developed and developing countries that have led to a breakdown in the international tax order (for example, some countries choose to be tax havens, and other countries enact unilateral laws against tax havens). There is no direct retaliation possible in the tax system. If the WTO-style cross-retaliation were introduced, it would increase the cost of non-compliance because the “aggrieved” country can use tax or non-tax measures to retaliate against the other country.

Rosenzweig suggests several interesting alternatives for translating the *Antigua Gambling* model for international tax law, including incorporating BEPS into the WTO. He raises an important issue and provides some interesting ideas about tackling it.

In “Intellectual Property Law Solutions to Tax Avoidance,” Blair-Stanek suggests an intellectual property (IP) law solution to the problem of BEPS. He recognizes the fact that MNEs’ tax-avoidance strategies rely on undervaluing their IP. He proposes IP law reforms to make it harder for MNEs to litigate or to license the IP if they use low valuations in transferring the IP to an offshore entity. For example, transferring a patent for a low price to a subsidiary in a tax haven should make it harder for an MNE to demonstrate the patent’s validity (to qualify for patent registration), a competitor’s infringement, or entitlement to any injunctions. The low transfer price may also be used in determining the amount of damages. Blair-Stanek suggests that these adverse impacts under IP law would deter multinationals from using IP to avoid taxes.

J.L.


MNEs, such as Apple and Google, have been labelled as “US” corporations in the recent BEPS debates. Scanchirico seeks to investigate the ownership nationality of corporations. He poses and attempts to answer a simple question: “When we speak
of ‘US multinationals,’ what do we mean by ‘US’? More specifically, to what extent are these ‘US’ corporations owned by non-US investors?”

According to the author, this question plays an important role in the current policy discussion regarding the taxation of large US MNEs. It relates, for example, to such concerns as whether the tax benefits now available to large US multinationals should be retained, enhanced, or limited; the competitiveness of US businesses; and the propriety of offering a tax holiday for “repatriated profits.”

The author first examines the literature on “home country bias” in equity ownership (that is, investors holding a disproportionate share of their equity portfolio in home country stocks). He finds that the literature does not separate large US MNEs from other companies and does not help answer the question posed earlier. Scanchirico then looks at the data on cross-border securities holdings, including foreign holdings of US stocks in the Treasury International Capital system, reporting on “institutional investment managers” under the Securities Exchange Act, disclosures under the Investment Company Act and the Investment Advisers Act, reporting related to US withholding tax, and the companies themselves. The preliminary conclusion is that data are not available to answer the question.

However, the author reports some interesting findings. For example, the percentage of foreign ownership of US equity increased from less than 4 percent in 1974 to about 5 percent in 1984 and over 13.5 percent in 2012. It is not possible to determine who owns Google because of reporting gaps and opacity of intermediaries and institutional investors, even though the data indicate that its shareholders include FMR LLC, the American arm of the Fidelity investment management complex; The Vanguard Group, Inc.; State Street Corporation; Barclays Global Investors UK Holdings Limited; JPMorgan Chase & Co.; Capital World Investors; Capital Research Global Investors; The Bank of New York Mellon Corporation; and Invesco Ltd. Data concerning US withholding tax show that the percentage of US corporations’ dividends paid to foreign payees (as reported on forms 1042-S, 2011) is 4 percent in Australia, Cayman Islands, and Switzerland respectively; 8 percent in Canada; and 16 percent in the United Kingdom.

In conclusion, the author notes that the existing constellation of disclosures and reports about the ownership of US equity reveals almost nothing about the foreign ownership share of large US MNEs. Therefore, “in the current debate over how large US multinationals are taxed—based as it must be on the current state of knowledge—assertions that rest, explicitly or implicitly, on the supposition of US ownership, rest on very little indeed.”

J.L.

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15 At 4.
16 Ibid., at 22.
17 These data do not seem to support the widespread use of treaty shopping involving the outbound payments of dividends.
18 At 58.


In these two papers, the authors discuss the treatment of gains from indirect transfers. The notion of “indirect transfers” refers to the transfers of shares of an offshore company whose value is derived directly or indirectly from the value of shares of an onshore company. Often, the transferor and transferee are both non-residents of the country in which the onshore company is located. A well-known example is the transaction in the Indian *Vodafone* case.19 In this case, a Dutch subsidiary of Vodafone (a UK-based multinational telecommunications company) acquired the shares of a Cayman Island’s company from Hutchinson (a company based in Hong Kong) for the purpose of acquiring the Indian telecommunications businesses indirectly owned by the Cayman Islands company. The gains from the sale of the Cayman Islands company shares were considered not to be taxable in India under the existing Indian legislation, which has since been amended to tax these gains.

In “The Relationship Between China’s Tax Treaties and Indirect Transfer Antiavoidance Rules,” Zhou investigates whether the position articulated in circular 698 issued by the Chinese state tax administration (SAT)20 is consistent with China’s treaty obligations. Under Chinese tax law,21 gains realized by a non-resident from the transfer of shares or other equity interest in a Chinese-resident company are sourced in China, and thus subject to a 10 percent withholding tax. The Chinese general anti-avoidance rule (GAAR) empowers the tax administration to reassess transactions that lack any reasonable commercial purpose. Circular 698 states that pursuant to GAAR, SAT will disregard the offshore company and redetermine the facts as the transfer of shares in a Chinese-resident company if the arrangement lacks reasonable commercial purpose or economic substance.

The author provides a good overview of the approaches to interpreting tax treaties. Many Chinese tax treaties contain article 13(5) of the United Nations model convention,22 which allows the source country (that is, the residence country of the

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19 *Vodafone International Holdings BV v. Union of India & Anr.* (2012), 14 ITLR 431 (India SC).
company whose assets give rise to the value of the offshore company shares that are transferred) to gain from indirect transfers. A small number of Chinese treaties contain a general anti-abuse rule and explicitly permit the application of the domestic GAAR to treaties. After discussing the general principles of treaty interpretation under Chinese domestic law and the Vienna Convention on the Law of Treaties, the author concludes that in the event of a conflict between China's treaty obligations and circular 698, the treaty provisions should prevail.

The relationship between circular 698 and China's treaty obligations is discussed separately, depending on whether a treaty contains UN model article 13(5). The author does not discuss the application of the domestic GAAR or whether a treaty explicitly incorporates the domestic GAAR. Zhou draws two conclusions. First, SAT’s substance-over-form approach to characterizing transactions is incompatible with the form-over-substance approach that should be applied in interpreting article 13(5). Second, when a treaty contains a general anti-abuse rule or allows the application of the domestic GAAR, such as the China-Hong Kong Arrangement, “Circular 698 is arguably in line with the arrangement [or treaty].”

In “T axing Indirect T ransfers: Improving an Instrument for Stemming T ax and Legal Base Erosion,” Cui argues that taxing gains from indirect transfers can have vital policy significance in countries where foreign inbound investments are actively traded in offshore markets, such as China and India. This taxation not only protects the tax base but also protects the “legal base” of these countries by discouraging offshore transfers, thereby encouraging the use of legal mechanisms in onshore markets. However, after reviewing the existing instruments for taxing indirect transfers, including those adopted by countries with otherwise sophisticated tax and legal systems, such as Canada and the United States, the author concludes that the instruments remain “remarkably crude.” Cui classifies the instruments as “ex ante” rules (such as the charging rule under paragraph 2(3)(c) and the definition of “taxable Canadian property” under subsection 248(1) of the Canadian Income T ax Act) and “ex post” rules (such as GAAR). Cui proposes to improve the taxation of indirect transfers by striking a better balance between ex ante and ex post law-making, and consistently treating taxable indirect transfers as sales of underlying target companies (by allowing conforming adjustments in tax basis).

23 As of May 2014, 13 Chinese tax treaties explicitly allow the application of the domestic GAAR. These are treaties with Mexico (2005), Hong Kong (2006), Singapore (2007), the Czech Republic (2009), Belgium (2009), Malta (2010), the United Kingdom (2011), Botswana (2012), Denmark (2012), the Netherlands (2013), France (2013), Switzerland (2013), and Germany (2014).


25 Zhou, at 563.

26 Cui, at 652.

27 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).
The author provides an interesting discussion about why the issue of indirect transfers does not arise more often, suggesting that possible explanations include enforcement difficulty and the fact that many countries do not tax foreign investors on capital gains from direct transfers. In terms of tax policy, however, the author maintains that there is no reason why indirect transfers should not be taxed. Such taxation can be justified as the taxation of economic rent. In many developing countries, “the appreciation of foreigners’ investments in domestic companies has to do with special opportunities in the local economy,” and thus taxing the gains from indirect transfers can be justified as taxing “location-specific rent.”

Why do indirect transfers for tax-avoidance purposes occur? Cui suggests that the answer may not be tax rules, but rather other factors. In the case of China, these factors may be “unfriendly (and easily avoidable) domestic regulatory regimes and undeveloped law for M&A [mergers and acquisitions], as well as comparatively lower quantities of domestic parties in the onshore M&A market.” According to Cui, the US Foreign Investment in Real Property Tax Act rules do not tax indirect transfers, but an offshore market for equity interest in US real estate companies is nearly non-existent as a result of US tax and non-tax regimes. Cui notes, without commenting, that Australia, Canada, and Japan, which have a similar level of sophistication in tax administration, have enacted rules for taxing indirect transfers of real property. However, China has active offshore markets for equity investments in Chinese companies and is currently trying to tax indirect transfers through GAAR.

As for the design of the appropriate instrument for taxing indirect transfers, Cui suggests that ex ante, more specific rules, and ex post standards (such as GAAR) are necessary to encourage voluntary compliance while preventing abuse. Existing ex ante rules, such as those in Canada and article 13(5) of the UN model convention are, in essence, “source rules” because they regard any capital gain from the indirect transfers as having a domestic source. The ex post rule adopted in China’s circular 698 adopts a lookthrough approach, under which indirect transfers are not taxable per se. What is taxable per se is the direct transfer of shares of resident companies because Chinese tax law does not specifically speak to indirect transfers. Indirect transfers become taxable only after they have been determined by the tax authorities to be, in economic substance, direct transfers under GAAR. Cui suggests that well-designed ex ante lookthrough rules (with basis adjustments) can better target tax avoidance, provide certainty for taxpayers, and generate market incentives that facilitate compliance.

J.L.

28 Cui, at 659.
29 Ibid., at 666.

Kahng claims that this paper is the first to analyze and assess the taxation of intellectual capital within a broad interdisciplinary landscape that includes knowledge management, financial accounting, and national accounting. Kahng defines “intellectual capital” to include non-physical sources of value, such as patents and copyrights, computer software, organizational processes, and knowhow. She notes that after a long history of being undervalued and excluded from measures of economic productivity and wealth, intellectual capital has finally gained wide recognition as being of central significance in economic productivity and growth. For example, in 2013, the US Bureau of Economic Analysis included for the first time research and development (R & D) as well as artistic creations, such as films, music, and books, in its measures of national economic productivity and wealth, adding $569 billion to the size of the US economy.31

Kahng provides an excellent review of intellectual capital research, findings, and reform proposals in the fields of knowledge management, financial accounting, and national accounting. She observes that scholars in these fields make a theoretically persuasive claim that intellectual capital results in economic productivity, which has been poorly understood and inaccurately measured. These scholars also have developed new methodologies for identifying and measuring intellectual capital. Kahng argues that advances in these fields have major implications for the tax treatment of intellectual capital.

Currently, intellectual capital is generally deducted rather than capitalized. Therefore, the tax system incorrectly measures the income from intellectual capital. Kahng claims that the current deduction “has the effect of imposing a zero rate of tax [on] the returns on intellectual capital,”32 which amounts to undertaxation of income from intellectual capital. This undertaxation “results in an enormous loss of tax revenues” and “creates an incentive to overinvest in intellectual capital relative to other types of capital, which results in the misallocation of economic resources.”33

Drawing on research in other fields, Kahng argues that the deduction system is flawed and should be reformed. She proposes to capitalize and amortize over five years a broad array of intellectual capital investments, including R & D, advertising, worker training, and strategic planning. It is too early to say if such a proposal will receive much attention in the United States. The idea of capitalizing capital expenditures makes perfect sense. The challenge remains in defining what these expenditures are.

J.L.

31 At 6.
32 Ibid., at 41.
33 Ibid.
J. Scott Wilkie, “Intangibles and Location Benefits (Customer Base)”

The debates on BEPS and transfer pricing presuppose that the “source” of profit may reliably be determined. “Routine” profits earned by MNEs can be sourced to the place of economic activities with a reasonable level of certainty. However, the source of income attributable to “intangibles” (or super profit) is elusive. There is no consensus on what intangibles mean beyond the scope of intellectual property, such as patents, copyrights, and trademarks. The OECD intangibles report (2013) suggests that intangibles include something of value that can be controlled or owned for use in commercial activities.34 China and India suggest that intangibles may include something of value that cannot be owned or controlled by any specific corporation, such as country-specific advantages—namely, location savings or market premium.35 In this article, Wilkie provides an interesting way of thinking about intangibles in the context of transfer pricing and BEPS.

Wilkie suggests that the letter “i” in intangibles can be “i” or “I.” “I”ntangibles are things of value and capable of being the objects of transactions (that is, capable of being owned and transferred), whereas “i”ntangibles have a much broader meaning. “Location benefits” are not “I”ntangibles, but can be considered as “i”ntangibles. Location benefits include location savings and “other benefits arising from purposely and purposefully organizing business operations in a particular territory.”36 Customer base or local market features are not seen by the OECD as “I”ntangibles, but should be treated as “i”ntangibles. Wilkie makes the following insightful observation:

[A]side from considerations associated with discernible features of “ownership” and “control” that are hallmarks of “I”ntangibles, it might be asked why these “intangibles” are any less significant than “I”ntangibles for measuring and sharing the relative advantage and opportunities multinational or global businesses seek to capture by exploiting their unique features and opportunities and that are not available or sustainable in an uncontrolled setting. A functional analysis based on facts and circumstances would seem to be appropriate for these intangible features of business as well as “I”ntangibles.37

Further, Wilkie notes that “I”ntangibles and “i”ntangibles converge in contributing to the profit of global businesses. In transfer-pricing analysis, finding reliable comparators for either type of intangibles may be difficult. Therefore, the result may inevitably be a profit-oriented approach.

36 At 355.
37 Ibid., at 357.
Wilkie also discusses the challenges in achieving the objectives of BEPS action 8, such as the recognition of intangibles in private law and/or tax law and the legal significance of the OECD transfer-pricing guidelines and BEPS measures. He suggests that a constructive, reliable, and sustainable response to BEPS action 8 should avoid approaches that require changes to law, avoid creating parallel quasi-transactional regimes for “intangibles” that are not property in the legal sense but effectively operate as if they were, and

[adopt an approach that recognizes and can use, in the relevant analysis, the possible depth and textures of “global” business, informed possibly by a more expansive economic analysis that takes account of considerations enlightened by an awareness of the study of economic geography, but is not constrained by any particular inferred quasi-legal or accounting constructs.]

J.L.


The authors review four 2012 tax decisions of the Supreme Court of Canada: Canada v. Craig,39 Fundy Settlement v. Canada (also known as “Garron Family Trust”),40 Canada v. GlaxoSmithKline Inc.,41 and Calgary (City) v. Canada.42 They render their verdict on these decisions at the beginning of the article:

[W]e take the position that over the years the Court has done a disservice to the aspirations of our tax system in its interpretation of the Act and other tax legislation. There is little question, in our view, that the Canadian income tax system is less fair, more distortionary, more complex and more incoherent than it ought to be because of the Court’s tax decisions and because of the approach it has taken to tax cases. . . .

By engaging in and encouraging a most arid legal formalism when dealing with tax cases, the Supreme Court has made it almost impossible for the others involved in the tax law-making process to compensate for its uninspired performance.43

In addition, they reiterate their praise of Bowman CJ’s approach:

He did not purport to deduce answers to complex cases based on the supposed plain meaning of words or phrases. He stated goals, weighed consequences, and chose appropriate results based on notions of policy, common sense, professional values, and

38 Ibid., at 359.
39 2012 SCC 43.
40 2012 SCC 14.
41 2012 SCC 52.
42 2012 SCC 20.
43 At 267-68 and 269.
sensitivity to relevant tax principles. . . . He always tried hard to reach the best results as he understood them.44

After mounting a forceful argument about the role of courts in the development of tax law and a failure of leadership on the part of the Supreme Court of Canada, the authors review each of the four cases to illustrate how the court still holds doggedly to a formalistic approach. They have refused to take seriously the purposes of the provisions they are interpreting, the consequences of their decisions in terms of tax principles, or the most sensible and appropriate result among the alternative interpretations that were open to them.45

According to the authors, Canada v. Craig reflects the staggering failure of the court’s formalism. The court reached a “perverse” result that effectively read a longstanding section (section 31) out of the Act, even though the section reflects sound tax policy principles and important tax expenditure considerations. The court’s interpretation of section 31 ignores the purpose of the provision, is based on a misreading of the history of the provision, and is contrary to the court’s own stated approach to statutory interpretation (that is, textual, contextual, and purposive). Further, the Supreme Court overruled a unanimous decision that it had handed down over 35 years earlier (in Moldowan v. The Queen46 on the ground that the earlier court had not followed the plain meaning of the words in section 31. To demonstrate how miserably the Supreme Court failed in interpreting the purpose of section 31, the authors provide an excellent overview of the purposes and history of this provision.

The Fundy Settlement v. Canada decision is “short and adds nothing to the analysis in the lower courts.”47 It held that the corporate test for the location of central management and control was the appropriate test for trusts for essentially the same two reasons given by Woods J in the Tax Court: (1) trusts and corporations are similar in many respects; and (2) adopting the same test would promote consistency, predictability, and fairness in the application of the tax law. The authors are disappointed with the Supreme Court’s decision:

Instead of assuming the role of pragmatic tax policy analysts and formulating a residency test that would preserve the purpose that residency requirements serve in an income tax system by, for example, making tax avoidance more difficult, the Court resolved the issue formally by resorting to an argument by analogy with corporations.48

45 At 272.
47 At 299.
48 Ibid., at 273.
In the authors’ view, “Fundy represents a missed opportunity to develop a test for the residency of trusts based on the legal, political and economic benefits the trust might be deriving from Canada and on the need to have tax rules that are difficult to manipulate.”

The GlaxoSmithKline decision is the Supreme Court of Canada’s first case on transfer pricing. According to the authors, transfer pricing provides a striking example of what is wrong with the tax rules that apply to MNEs. The facts of this case vividly illustrate how transfer pricing offers no answer to the problem of fairly allocating multinationals’ profits to the countries in which they operate. In fact, the decision makes things worse. The court did not settle any general proposition of law in this case. In applying the comparable uncontrolled price method under the arm’s-length principle, it is indisputable that all economically relevant circumstances must be considered in ensuring that the comparator arm’s-length transaction is sufficiently comparable to the contested non-arm’s-length transaction. The authors maintain that the judgment can be read as suggesting that in almost all cases the business and economic circumstances surrounding a taxpayer that is a member of an MNE group distinguishes its transactions with related corporations from arm’s-length transfers. If this is the case, they argue that it would be almost impossible for tax departments to regulate transfer prices.

More specifically, the authors believe that the ruling (that the licence agreement with Glaxo Canada’s parent corporation and the supply agreement with its sister corporation were relevant in arriving at a realistic picture of the profits of Glaxo Canada) cannot be correct for several reasons. For example, the two agreements exist between different corporations in two different countries. Why would the payments for intangibles owned by the parent corporation be made to the sister corporation? Whether the licensing agreement was a relevant consideration in determining the reasonableness of the transfer price that Glaxo Canada paid to the sister corporation is a factual question that requires a careful review of all the facts and circumstances. Rip ACJ of the Tax Court (as he then was) carefully and exhaustively reviewed all of the facts and circumstances of the case. Instead of finding that the licence agreement was not relevant, Rip ACJ stated that he was bound by Singleton and did not consider the licence agreement. The Supreme Court found that by relying on Singleton he committed an error in law. The authors regard this error to be “beside the point” in light of the general findings by Rip ACJ. In their view, “[i]n sending the matter back to the trial court for a redetermination of the reasonableness of the taxpayer’s transfer prices, the Court imposed a test of reasonableness that will make it even easier for multinationals to manipulate their transfer prices to avoid tax.”

49 Ibid., at 304.
51 At 273.
Calgary (City) v. Canada does not illustrate the Supreme Court’s formalism because it did not raise any interpretive issues. The authors wonder why the court granted leave to appeal in this case.

With the typical forcefulness and intellectual rigour that distinguish Brooks’s writings, this article exposes the court’s failure to follow its own textual, contextual, and purposive approach to statutory interpretation. The authors argue that the court did “not even allude to the purpose of the legislation or the consequences of alternative holdings, let alone take these matters seriously or struggle explicitly with them.”52 They urge the court to play a positive role in developing tax law and make a concession to common sense.

J.L.


The author of this article, which is part of a book on the charitable and not-for-profit sector, has two goals: (1) to assess alternative rationales for tax recognition of charitable gifts and the forms of incentives that flow from each and (2) to assess the Canadian experience in light of these rationales.

Duff begins by reviewing the arguments that charitable gifts should be deductible on the basis that they reduce the ability to pay and calls them a poor rationale for tax recognition. Duff then turns to the arguments that charitable gifts should be subsidized, and finds them to have more substance, but notes that they support a tax credit that does not vary according to the donor’s level of income and that is refundable if the donor’s income is low enough to exempt the donor from paying tax.

Duff analyzes the aggregate data on donations by individuals and concludes that total donation amounts are quite responsive to incentives. In particular, the 1987 change from a deduction to a two-tiered tax credit achieved its goal of shifting the distribution of charitable giving to include more low-income donors. Similarly, the movements since 2006 to reduce (and now delete) the capital gain on donations of certain appreciated capital property have partially undone the effects of the switch to a credit and tilted donations toward upper-income donors. Duff expresses his concern about this trend. He also notes that neither reform addresses the long-term decline in the percentage of taxpayers in all income classes who report contributions to charitable organizations.

A.M.

52 Ibid., at 325.
The authors of this paper report on the results of a set of semistructured in-person interviews with experts on the taxation of capital gains in Canada, Australia, and the United States. Two issues concerning capital gains for individual taxpayers were addressed: (1) the advantages and disadvantages of having an inclusion rate of less than 100 percent, and (2) the general question concerning how to reform this part of the tax system in the country in which the interviewee is based. There were 24 interviewees, including 8 from Canada. Interviewees from each country were selected in geographical clusters (for example, the Toronto area) to minimize travel costs. Two-thirds of the interviewees were from academia, and the remainder were divided evenly between tax practice and “government advisory type” roles.

The article contains many direct quotes and paraphrases from the responses of the individual participants, which is quite helpful in demonstrating the diversity of opinion in this controversial area. Nevertheless, there were two areas of consensus (but not unanimity): an accrual-based capital gains tax is not feasible, and a 100 percent inclusion rate is preferred.

For each country, the authors separately report the responses to the questions about the needed reforms to the taxation of capital gains in that country. Two pages are devoted to Canada. The Canadian respondents appear to have been more inclined than respondents from other countries to mention problems with the borderline between income and capital.

Another interesting part of the paper is the comparative description of the taxation of capital gains in the three jurisdictions. Canada is unique among the jurisdictions in allowing the carryback of capital losses. Australia is notable for the fact that when it introduced the taxation of capital gains in 1985, it did not use a valuation day; instead, gains from assets held before September 20, 1985 were exempted forever (although future budgets could change that).

A.M.


With the high level of attention currently paid to whether or not corporations are obliged to pay a “responsible” amount of tax (rather than the minimum required), the auditor general’s report on aggressive tax planning is well timed. The auditor general also has the advantage of being able to get officials to answer questions that are inconvenient for the government. The Canada Revenue Agency (CRA) appears to have been cooperative, while the Department of Finance often insisted that the information sought could not be released because it was a Cabinet confidence.

53 At 204-5.
The four specific aggressive tax plans investigated by the auditor general are offshore insurance, registered retirement savings plan (RRSP) strips, stock dividend value shifts, and the inappropriate use of losses through “tech wrecks.” None of these plans is still operative (at least in its previous form) as a result of adverse Federal Court of Appeal decisions regarding the stock dividend planning and legislative amendments concerning the other three plans. Although the report does not focus on this point, the time required is notably long. For example, the CRA first identified RRSP strips in the late 1990s, but a business case concerning the nature and magnitude of the issue was not submitted to the Department of Finance until 10 years later, in September 2009; the 2011 budget stopped the use of these plans. Similarly, the CRA contacted the Department of Finance about tech wrecks in 2001, 2004, and 2006, but corrective budget proposals were not made until 2013. One should not conclude from this that the answers were simple and obvious but bureaucrats dragged their feet; rather, the persistence of these issues indicates the difficulties surrounding this policy area.

The report is quite specific in discussing the process within the CRA of addressing aggressive tax plans, including the operation of the GAAR committee, the national risk assessment model, the training of auditors, the application of third-party penalties, and the CRA’s methods of measuring its own success in dealing with aggressive tax planning.

A.M.


Frequent flyer points earned through business expenses incurred by employees (and later reimbursed by employers) may be redeemed by employees for personal travel. There is little doubt that tax policy goals dictate that these points form part of the economic income of employees, even though the governments of the United States, Canada, and Australia have made little attempt to find a practical way to tax them. Zelenak finds this to be strange because the amount of forgone revenue is significant—he estimates it to be approximately $1.5 billion annually in the United States.

Zelenak canvasses each country’s tax history concerning this fringe benefit, finding little that deserves praise: “After more than three decades, the results could hardly be more discouraging. Virtually no tax on frequent flyer benefits is collected anywhere, and respect for the rule of law (on the part of both taxpayers and the agencies themselves) has been eroded.”

Zelenak appears to believe that points (rather than the rewards actually received) should be taxed and subject to information reporting, but he is uncertain whether

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54 At 3.
the information-reporting obligation should be placed on employers or airlines (or other sponsors of loyalty programs, of which frequent flyer points are just one type). The twin advantages of placing the reporting obligation on employers are that withholding from salary becomes possible, and points earned personally could be excluded from the calculation. The advantage of placing the reporting obligation on airlines is that reporting would be less onerous because airlines possess all the information needed to comply. In the end, Zelenak concludes that the better approach is to place the burden on airlines and other issuers, both to minimize the number of businesses required to report and to avoid requiring employers to obtain points information from their employees.

Applying Zelenak’s idea about airline reporting would be significantly less practical in Canada than in the United States. Canadians book many flights on foreign airlines, and inducing these airlines to comply with Canadian information-reporting laws might be difficult. Zelenak does not consider this issue.

A.M.