A Few Thoughts on Treaty Shopping

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PRÉCIS
L’auteur fournit quelques brèves réactions immédiates au document de consultation sur le chalandage fiscal du ministère des Finances. Elles portent sur certaines questions de politique fiscale : la quantification d’une perte de revenu, qui suppose certaines hypothèses normatives; la pertinence de la résidence du propriétaire pour les demandes relatives aux avantages découlant d’une convention par une société; le rôle de la « substance » d’entreprise; et la distinction entre les structures de conduit adossées et d’autres formes possibles d’abus d’une convention. L’auteur conclut que les décideurs devraient prêter une attention plus particulière aux principes de base relatifs aux questions de ce type avant de se pencher sur les mécanismes d’une solution.

ABSTRACT
The author provides some brief and immediate reactions to the Department of Finance’s consultation paper on treaty shopping. These concern certain tax policy issues: the quantification of revenue loss, which implies some normative assumptions; the relevance of the residence of the owner to claims of treaty benefits by a corporation; the role of corporate “substance”; and the distinction between back-to-back conduit arrangements and other possible forms of treaty abuse. The author concludes that policy makers should pay closer attention to the basic principles relating to issues such as these before they focus on the mechanics of a solution.

KEYWORDS: TREATY SHOPPING ■ POLICY ■ TAX LAW

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INTRODUCTION
Canada’s Department of Finance has released a consultation paper (herein referred to as “the paper”) posing seven questions about a possible response to treaty shopping. Those questions raise many interesting structural issues. Should an anti-treaty-shopping rule be general or specific, put into domestic law or into treaties? How does such a rule avoid being underinclusive or overinclusive? How can it be integrated with existing treaty provisions? In order to examine the remedy, however, one must first identify the mischief. The paper therefore begins with a discussion on the “problem” of treaty shopping.

To my aging eyes, the policy discussion is not as sharp as it should be. Fuzziness is endemic in treaty-shopping rhetoric. Commentators do not always mean the same thing and may have different agendas. I am not heartened by the repeated appeals to an international consensus; consensus-driven decisions often sacrifice clarity on the altar of mutual agreement.

In this brief note, I would like to step farther back than the starting point of the paper and raise a few basic policy questions in the hope of stimulating some useful conversation. My comments are selective; there are many more questions to ask. For simplicity I will use the expression “treaty shopping” as if we had a common understanding of what it meant.

DATA
How important is treaty shopping? The Organisation for Economic Co-operation and Development (OECD) conceded in its initial publication on base erosion and profit shifting (BEPS) that data demonstrating the extent of these phenomena in general are unavailable, and the same is true for treaty shopping in particular. The paper remarks that the tax at issue in two beneficial ownership cases, Canada v. Prévost Car Inc. and Velcro Canada Inc. v. The Queen, was “significant.” Citing, in addition, the “experience of CRA [Canada Revenue Agency] auditors” and foreign

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2 This is apparent in many documents issued by the Organisation for Economic Co-operation and Development (OECD), and perhaps explains their length.
4 2009 FCA 57; aff’g. 2008 TCC 231.
5 2012 TCC 57.
6 In Prévost Car, the dividends paid over 4 years (1996-1999) totalled $67 million. The withholding tax at stake (resulting from the difference between the applicable rates under the Canada-Sweden and the Canada-UK treaties and the rate in the Canada-Netherlands treaty) was highest in 1997, at about $2 million, and dropped thereafter when the treaty rate with Sweden was reduced to 5 percent. The figure in Velcro was $8.6 million, covering 10 years.
direct investment (FDI) statistics, the paper concludes that “treaty shopping has a significant role in inbound direct investment in Canada.”

FDI statistics do suggest, unsurprisingly, that many apparent direct investors are probably acting as intermediaries, although not necessarily (or likely) for the purpose of treaty shopping. The Netherlands, Switzerland, and Luxembourg are singled out for suspicion on the basis of a discrepancy between their rankings as FDI investors into Canada and as trading partners (set out in table 2 of the paper). The missing fact is where the funding originates. Some undoubtedly comes from local residents, and most of the rest probably represents capital invested by residents of other treaty countries, since the only significant pools of investor capital outside Canada’s treaty network are in the Middle East. I would hazard that the lion’s share of these intermediaries serve to support tax-efficient financing and repatriation strategies, sometimes avoidance or deferral of residence-country taxation, and perhaps non-tax purposes, but not treaty shopping.

As a footnote to the rankings in table 2, it should be noted that Switzerland makes the blacklist because it is 4th in FDI but only 15th in trade—yet no one suggests that Brazil (5th in FDI and 13th in trade) is used for treaty shopping. This might suggest some caution about the methodology.

The paper fails to clarify what should be the normative assumption concerning the “right” amount of tax. In Velcro, for example, the CRA assessed on the basis that royalties paid to a Netherlands company were beneficially owned by its Netherlands Antilles parent, the owner of the intellectual property. I have no personal knowledge of the group, but I suspect that this “parent” was itself part of a global tax plan; if the elimination of treaty shopping means looking through the intermediaries to the owners of the capital, or to the highest legal entity in the chain with an active and substantial business operation (the derivative benefits concept), then there may well have been no treaty shopping in Velcro. From this perspective, and taking into account the breadth of Canada’s treaty network and the high degree of consistency in its stipulated withholding rates, one wonders how large the leakage could possibly be.7 Many arrangements labelled as treaty shopping are more correctly regarded as financing or holding structures primarily benefiting group companies in other jurisdictions. Anti-treaty-shopping provisions would make such planning more difficult or more expensive. This may be a desirable international goal, and Canada may even collect more tax if the structures are still efficient enough to be retained, but the issues should be made explicit.

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7 Thinking back to Prévost Car, almost all of Canada’s treaties with likely investor countries (including Sweden and the United Kingdom) now have a 5 percent rate on dividends paid to a company holding a prescribed percentage of the shares. During the years under litigation, the majority of the shares of Velcro Industries NV were owned by a BVI company the ownership of which is not public. Based on what one can find on the Web, it probably traces back to the United Kingdom. Most of the remaining, publicly traded, shares were held in the United States. The Antilles company was not owned by Antilles residents who were “treaty shopping” through the Netherlands.
RESIDENCE OF THE OWNER

The “lookthrough” approach described in the paper (whether stand-alone or incorporated into the four-step proposal outlined in section 7.2 of the paper) presupposes that a company should not be entitled to treaty benefits if its owners reside in a different jurisdiction, or at least not unless those owners would themselves be entitled to equivalent benefits. Three reasons are listed (although they really amount to three versions of one reason): benefits should be denied in such circumstances to prevent the one-way flow of treaty benefits, support the negotiation of reciprocal benefits, and preserve the bilateral character of tax conventions. I am not unalterably opposed to governments’ using either tax treaties or domestic law for international fiscal extortion in a good cause. Canada’s exempt surplus system proved quite successful in convincing countries in the 1970s and 1980s to enter into bilateral tax treaties, and now it serves well as a carrot to promote tax information exchange agreements. It does not, however, follow that international tax rules should always demand reciprocity. The main reason for lower withholding rates and exemptions in bilateral treaties is not to obtain a quid pro quo but to promote trade and investment and facilitate commerce. The reduction in Canadian withholding tax benefits Canada. This is why there is no tax on arm’s-length interest payments, wherever the payee may reside.

Not only is the relevance of absentee ownership to the granting of treaty benefits far from self-evident, it is also contrary to the practice in other spheres. The North American Free Trade Agreement (NAFTA), for example, provides protection to “investors of a Party,” defined to include corporations incorporated under the laws of a party and carrying out business activities there, with no reference to share ownership. Nor do domestic corporate income tax systems generally pay attention to shareholder residence. In Canada, it is relevant in only a few limited contexts, each with its own peculiar policy rationale, like the Canadian-controlled private corporation provisions designed to aid local entrepreneurship, and section 19 of the Income Tax Act meant to protect Canadian print media. These provisions would not survive the “national treatment” non-discrimination provision in article 24(5) of the OECD model, and that is why our treaties replace it with a “most-favoured nation” rule. The domestic provisions meet that test for all non-residents, whether or not resident in a treaty country.

8 Definitions for the investment chapter of NAFTA are in article 1139: see www.nafta-sec-alena.org/Default.aspx?tabid=97&language=en-US.

9 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

The limitation-on-benefits (LOB) juggernaut loosed by the United States in 1981 will be difficult to stop, but if treaty shopping is to receive serious consideration, the relevance of shareholder residence should be opened for discussion.

**ECONOMIC SUBSTANCE**

“Economic substance,” or at least some kind of substance, seems intuitively relevant to a claim for treaty benefits, and without regard to the location of ownership. Indeed, one might think that substance should be a requirement for any tax rule, not just treaties, but this is not the case. The thinnest nexus is generally sufficient to support the imposition of tax. Canada happily taxes the world income of every corporation incorporated in Canada, exempts qualifying (exempt surplus) dividends that those corporations receive, and collects part XIII tax on non-residents to whom they make prescribed payments. Substance has nothing to do with it. The general practice of imposing tax without any substance requirement is important in considering treaty shopping. The OECD raised the problem of international coordination in its BEPS report. Serious distortions will arise if all countries adopt a substance rule that applies only to non-resident companies.

Defining “substance” is very difficult; Canadian judicial conceptions of sham and agency presumably set too high a standard for these purposes. One basic question is: What does a substance requirement apply to? The paper, like most treaty-shopping discussions, focuses on substance of the entity, and this is reflected in a common exemption within LOB provisions. But why should a corporation escape an anti-treaty-shopping rule just because it has substance? One might have thought substance should be required for the investment or transaction, not just the entity. One is reminded of the “more closely connected business activities” rule in subsection 212.3(16) of the foreign affiliate dumping provisions.

I am not advocating this position, just pointing out the logical problem. The practical consequences appear to be daunting.

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11 Suppose that companies A and B are article 4 residents in country X and each has a Canadian subsidiary. A is owned by an individual resident in country X; B is owned by an individual resident in country Y. The Canadian treaties with countries X and Y provide 5 percent withholding tax on dividends from a Canadian company to a parent in the respective country, and 15 percent to anyone else. If companies A and B both lack substance, the perceived abuse should be the same: substitution of 5 percent for 15 percent withholding tax. However, the LOB approach only reaches the dividends paid to company B because only it is owned by a third-country resident.

12 Discussions of treaty shopping often imply that a few nasty countries allow companies to sneak into their article 4 “liable to tax” definition without a substantial nexus with the jurisdiction. In Organisation for Economic Co-operation and Development, Harmful Tax Competition: An Emerging Global Issue (Paris: OECD, 1998), at 22-23, the OECD identified the lack of a requirement that activity be substantial as one of the secondary hallmarks of a tax haven.

13 Supra note 3, at 7-8.
Conduits

Targeted anti-conduit measures are described in the paper as the “channel” approach, but in most cases they are really a subset of the “subject-to-tax” approach, which effectively adds to the entity-level “liable to tax” rule in treaty article 4 an analogous requirement attaching to specific items of income. This would not be acceptable as a general rule because it is far too restrictive of fiscal sovereignty. A country that retains jurisdiction to tax may decide not to exercise it for domestic policy reasons.

In the usual conduit case, the income received by the intermediary company would have been subject to tax but for an offsetting deductible payment. Applying the undifferentiated notion of “treaty shopping” to these arrangements along with problems involving lack of substance and claims about the importance of the location of ownership is unhelpful. Contrary to what seems to be the usual view (as reflected, for example, in the paper), it should be irrelevant in such conduit arrangements who owns the entity or even whether it has substance. A company that has significant business activity and is owned entirely by local residents can still make back-to-back deductible payments to a related company in another jurisdiction, raising the same tax policy issue.

The obvious solution would be to replace the ineffective (and poorly labelled) “beneficial ownership” rule with something more explicit. One is reminded of sub-section 18(6) of the Act. In practice, such a rule can raise thorny problems of tracing, purpose, and so on. In addition, the same issue raised above regarding normative assumptions applies. Many or even most conduit arrangements are not meant primarily to save Canadian withholding tax but rather to avoid increasing that tax as a result of the interposition of an intermediary company that serves some other tax, or non-tax, purpose.

Conclusion

In the case of treaty shopping, the devil lies not only in the details but also in basic principles of international taxation, in the role of tax treaties in promoting trade, investment, and commerce, and in a proper scrutiny of the extent and character of the activity in question. Finance’s seven questions presuppose that there is a “problem” and that it is fiscally “significant.” They could be right, but I for one would like to see a more thorough and open consideration of the issues.

14 An exception concerns dividends, the subject of the Prévost Car case and not usually considered in this context.

15 Elements of this approach already exist in some treaties. For example, a trust is resident in a contracting state under article IV(1) of the Canada-US treaty “only to the extent that income derived by the estate or trust is liable to tax in that State”: 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.

16 Or even an unrelated company, in an arrangement whereby the intermediary “rents” its treaty status.