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The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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May 16, 2014

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Ms. MacLean:

The federal budget of February 11, 2014 ("Budget 2014") included a description of the main elements of a proposed rule (the "Proposed Rule") intended to address "treaty shopping" (as defined in Budget 2014) as well as an invitation to provide comments on the Proposed Rule. In response to this invitation, following are our comments in respect of the Proposed Rule.

We have divided our comments into three sections being, in general terms, (i) comments on the ambit of the substantive aspects of the Proposed Rule and, in particular, comments on the examples that accompanied the description of the Proposed Rule in Budget 2014, (ii) comments on the transition rules for the introduction of the Proposed Rule, and (iii) comments on the impact of the Proposed Rule on taxpayers making payments to non-residents of Canada that are or may be subject to tax withholding obligations under the *Income Tax Act* (Canada) (the "ITA"). Our comments build upon the very helpful discussions held by telephone with you and your colleagues on March 28, 2014 for which we thank you.

Although we have chosen to limit our comments to the three general areas described above, we would like to note that this should not be interpreted as indicating that we are in agreement that a treaty shopping rule of any sort is necessary or appropriate for the best overall functioning of the Canadian tax system. The fact that we have so limited our comments should similarly not be interpreted as indicating that if such a rule is to be introduced into the Canadian tax system, that the proposed form of the rule is the most appropriate. It is a matter of public record that the very concept of a "main purpose" provision is considered inappropriate by representatives of some jurisdictions, including the United States. Nevertheless, in this submission we have refrained from wading into the broader policy issue of whether or not a domestic main purpose test is appropriate. Instead, we have targeted our comments at the points raised in Budget 2014 and the specific issues arising from the proposed design of the rule. In our submission of December 12, 2013, which responded to the August 12, 2013 Consultation Paper, we provided broader comments on the topic of a domestic treaty shopping rule, including a "main purpose" rule.

Summary of our Comments

Our comments can effectively be summarized in the following manner.

First, consistent with the comments in our December 12, 2013 submission, we suggest that the Proposed Rule must be considered in the context of international developments, particularly the OECD's initiative on "Base Erosion and Profit Shifting". In this regard, in particular, we note the recently released OECD discussion draft entitled "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" in which the need for protection of non-abusive transactions from the denial of treaty benefits is acknowledged. In particular, the discussion draft states that access to treaty benefits is not to be denied where "it is established that granting that benefit in the circumstances would be in accordance with the object and purpose of the relevant provisions" of the relevant treaty. We note that the Proposed Rule does not contain a similar exception for non-abusive transactions and we strongly recommend that this exclusion be carefully re-considered having regard to the OECD discussion draft.

Secondly, because the Proposed Rule takes a "general approach" as opposed to a "specific approach", as described in Budget 2014, it is imperative that the Department provide as much guidance as to its possible application or non-application as possible. It is only through such guidance that the high level of uncertainty inherent in a general rule can be reduced. The examples provided in Budget 2014 are helpful in this regard, but they should be expanded and further examples given. In particular, specific guidance in relation to what factors are relevant or determinative in different examples should be provided. This concern extends to the relief that is to be provided by allowing treaty benefits "to the extent … reasonable having regard to all the circumstances". As noted in our submissions, reasonableness is in the eye of the beholder. Guidance on what is "reasonable" in different circumstances is imperative.

Thirdly, we comment on the need for an appropriate transition period for any new rule. Taxpayers have established their relationships and structures in reliance on current law and such reliance should be honoured. As well, it is often not as simple as it might seem to restructure existing relationships, including "internal" group structures, as they often involve arm's length commitments and obligations. We also suggest that a form of "step-up" or valuation-day protection to protect gains accrued prior to the effective date of any new rule, in order to avoid retroactive taxation of such gains, would be appropriate. This would be consistent with the approach taken in several of Canada's bi-lateral treaties, as we note below.

Finally, we suggest that payors of amounts to non-residents of Canada that are subject to Canadian withholding tax obligations should be provided with some form of protection from liability in circumstances in which treaty benefits are denied or reduced by reason of the Proposed Rule. As we note, it will not always be obvious to such payors that the Proposed Rule will be applicable in a particular set of circumstances, including in cases in which the payors actions are reasonable and prudent. Such payors should not be prejudiced.

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

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

Yours very truly,

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Consultations on Treaty Shopping
Submission by the Joint Committee on Taxation
May 16, 2014

Background

The federal budget of February 11, 2014 ("Budget 2014") included a description of the main elements of a proposed rule (the "Proposed Rule") intended to address "treaty shopping" (as defined in Budget 2014) as well as an invitation to provide comments on the Proposed Rule. In response to this invitation, following are our comments in respect of the Proposed Rule.

Our submission is organized as follows. The comments below address three main areas – substantive aspects of the Proposed Rule; transition; and protection for payors. In Appendix I, we expand on our discussion of substantive aspects of the Proposed Rule through comments on several examples. In Appendix II, we discuss a specific issue upon which you sought our comments, namely the appropriateness of granting "derivative benefits" in a variety of situations, including in the context of one of the examples in the OECD Discussion Draft (referred to below).

One of the key themes of our comments relates to the need for the legislators and policy makers to provide as much guidance for taxpayers and their advisers on the intended ambit and application of the Proposed Rule as can be achieved. As you can appreciate, while there are many advantages and disadvantages to adopting a rule of more general application, such as the Proposed Rule, clearly one of the advantages to all stakeholders of a detailed and more specific rule limiting access to treaty benefits (Article XXIX-A of the Canada-US Tax Convention (1980) (the "Canada-US Convention") leaps to mind as being such a rule) is that it is much more helpful to taxpayers and their advisers (as well as the Canada Revenue Agency - "CRA") in terms of providing certainty of ambit and application than is a more general rule such as the Proposed Rule.

The Joint Committee has previously expressed the view to the Department of Finance (the "Department") that, in the Canadian legal and tax system, law is far more appropriate and preferable to administrative discretion or explanatory notes. Nevertheless, the Department should be commended for recognizing, in the context of a general rule such as the Proposed Rule, the need to provide guidance and amplification in Budget 2014 in respect of the Proposed Rule, particularly in providing the five examples that were included in Budget 2014. We know, and the inclusion in Budget 2014 of these example evidences the fact, that officials within the Department are well aware of the need to provide taxpayers and their advisers, as well as the CRA, with as much guidance on the intended ambit and application of tax rules such as the Proposed Rule as can be achieved.

Consistency with International Initiatives

Consistent with the comments in our December 12, 2013 submission, we suggest that the Proposed Rule must be considered in the context of international developments, particularly the OECD's initiative on "Base Erosion and Profit Shifting" (the "BEPS Initiative"). On March 14, 2014, the OECD released a

Discussion Draft entitled "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (the "Discussion Draft").

The focus of the Discussion Draft is on treaty-based solutions as opposed to domestic law overrides of treaties, a position that we put forward in our submission of last December. The Discussion Draft also suggests the adoption of a form of "main purpose" test for treaties, which suggests that the concept of a "main purpose" test could meet with some international acceptance, although clearly not universal acceptance as we note that it is a matter of public record that the very concept of a "main purpose" provision is considered inappropriate by the OECD representatives of some jurisdictions, including the United States.

Against this background, we note that there are several important differences between the version of the rule described in the Discussion Draft and the Proposed Rule:

- The Discussion Draft's "main purpose" rule is intended as a supplement to a US-style "limitation on benefits" ("LOB") test rather than being a stand-alone rule;

- The Discussion Draft's "main purpose" rule is intended to be a feature of bilateral tax treaties rather than being imposed unilaterally by any particular state; and

- Of perhaps greatest significance, the Discussion Draft's "main purpose" rule has an exception for non-abusive transactions. Specifically, access to treaty benefits is not to be denied under the Discussion Draft's version where "it is established that granting that benefit in the circumstances would be in accordance with the object and purpose of the relevant provisions" of the treaty.

While we acknowledge that the exclusion of an exception for non-abusive transactions in the Proposed Rule may have been intentional, we nonetheless would recommend that this exclusion be carefully re-considered having regard to the Discussion Draft. Without such an exception, the Proposed Rule could apply to ordinary commercial transactions, contrary to what is in fact intended. This is illustrated in our discussion below and in our commentary on the examples in Appendix I.

Finally, we must express our surprise that Canada would act unilaterally, proposing a domestic rule that is not aligned in form or, at least in some significant respects in substance, to the approaches in the Discussion Draft, particularly given that Canada has been such an active participant in the OECD activities. This is not to say that the form of the rule proposed in the Discussion Draft does not present its own challenges. However, one can reasonably assume that whatever rule is ultimately recommended by the OECD will become the "new norm" in treaty negotiations involving OECD member countries, which makes it that much more surprising that the Department would consider such a dramatically divergent approach to treaty shopping concerns. This divergence also raises questions in respect of what the Canadian position will be in any future treaty negotiations if there is a domestic rule that could override whatever terms are negotiated, not to mention the uncertainties it raises in respect of existing treaties that already have some form of LOB or other treaty shopping rule.

Substantive Aspects of the Proposed Rule

"Reasonable", "Ordinary", "Improper"

We acknowledge the stated desire in Budget 2014 to "ensure that treaty benefits are provided with respect to ordinary commercial transactions". While this objective is appropriate and commendable, we have some concerns regarding the inherent vagueness of this objective as well as the extent to which it is actually implemented in the text of the Proposed Rule.

Words such as "reasonable, "ordinary" and "improper" most often provide the user of those words, or the reader, or both with an unwarranted sense of comfort. For example, parties may agree that one should behave "reasonably" without realizing that they have fundamentally different views of what is reasonable and, therefore, that they have not agreed at all. These are words that are often put forward as reasons for a conclusion, but they are in fact conclusions themselves based upon analyses and factors that the user imports into his or her analysis, whether consciously or unconsciously. In fact, it is not enough for one to say something is "reasonable" without saying why it is reasonable.[1]

The Joint Committee recognizes that words such as "reasonable", "ordinary" and "improper", all of which appear in either the Proposed Rule or in the Budget 2014 description and background to the Proposed Rule, or both, are words widely used in both judicial decisions and in legislative drafting and are often necessary and practical approaches to judicial decisions and legislative drafting as a form of "shorthand". However, the Joint Committee is also confident that the officials of the Department recognize that these words introduce a significant element of uncertainty in any legislated rule, at least when first introduced and until the rule has been judicially considered and the courts have given some guidance on their actual meaning in the particular circumstances (which meaning, we note, can change over time with subsequent judicial decisions, often reflecting changes in societal or legal views of the issues in question). There is a risk that this very uncertainty undermines one of the purposes of tax treaties, because risk-averse potential investors may "assume the worst" and refrain from investing if expected returns, computed on the assumption treaty benefits will be denied, are inadequate.

We note that the OECD's Discussion Draft suffers from a similar problem, which is best illustrated by reference to paragraph 32 of that document:

> 32. A purpose will not be a main purpose when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was not a main consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is

[1] The Federal Court of Appeal has very recently addressed these issues in its decision in the case of *Canada* v. *Lehigh Cement Limited*, 2014 FCA 103, in which the Court stated (at paragraph 64) that "[u]nacceptability is in the eye of the beholder. It can shift depending on one's subjective judgment and mood at the time. Using it, as the Crown suggests, to restrain the indiscriminate use of paragraph 95(6)(b) creates the spectre of similarly-situated taxpayers being treated differently for no objective reason", and (at paragraph 66) "[a] standard of unacceptability, even if it were open to us to invent it and insert it into paragraph 95(6)(b), is in itself unacceptable, as I have explained."

> inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its main purpose will be considered to be the obtaining of that benefit.

Respectfully, we submit that it is not acceptable that there should be uncertainty with regard to eligibility for treaty benefits in the context of an arrangement that is "inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit". It should not merely be "unlikely" that treaty benefits would be denied in such a case; it should be crystal clear that benefits should be available in such a case.

This is a further reason that the Joint Committee believes that it is imperative that the Department expand upon the examples given in Budget 2014. Clear indications in supplementary materials may mitigate, at least to some degree, the chilling effect on inbound investment of a broadly worded and vague anti-treaty shopping rule such as the Proposed Rule. We also continue to believe that there is a very real risk of such a "chilling effect" and that a careful impact assessment should be undertaken by the Department to properly estimate the likely effects of the Proposed Rule on inbound capital flows.

US Hybrids – What is "reasonable", "ordinary" or "improper" – Reasonable Transition

Experience in respect of entities that receive hybrid treatment in terms of their characterization for US and Canadian tax purposes is illustrative of a number of concerns that arise in respect of the Proposed Rule. Examples include the denial of benefits rules in paragraph 7(b) of Article IV of the Canada-US Convention and the "self-help" solutions which the CRA has indicated, prior to the announcement of the Proposed Rule, would be acceptable to it (such as the "two step" approach to dividend distributions, or the interposition of a third-country entity between a Canadian hybrid unlimited liability company or corporation and its US shareholders).[2] In the absence of specific CRA guidance in which the CRA indicates that such self-help solutions are acceptable to the CRA, taxpayers would be subject to considerable uncertainty and risk that the CRA could assert that such self-help solutions were not "reasonable" and "ordinary" and were "improper".

These examples also illustrate the need for appropriate transition to the Proposed Rule. In particular, if a taxpayer has engaged in such a self-help solution to the inappropriate application of an existing treaty rule, which self-help solution was specifically condoned by the CRA, the application of the Proposed Rule arguably is not appropriate to such taxpayer at any time or, at the very least, should be deferred at least until the CRA has publicly indicated (or has had a reasonable period of time in which to analyze these circumstances and publicly indicate) whether the past self-help solutions would continue to be acceptable under the Proposed Rule, and if they would not be acceptable, then what alternative forms of self-help would be acceptable. The application of the Proposed Rule should be further delayed to permit affected taxpayers, who relied in good faith upon the CRA pronouncements that such self-help solutions were acceptable, sufficient time to adapt to whatever impact the Proposed Rule may have on them. We provide further comments with respect to transition below.

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[2] We understand that the CRA developed its positions in these situations after consulting fully with the Department.

Scope of the Conduit Presumption

Under the Proposed Rule, it would be presumed, in the absence of proof to the contrary, that one of the main purposes of a transaction or step in a series of transactions was to obtain a treaty benefit "if the relevant treaty income is primarily used to pay, distribute or otherwise transfer, directly or indirectly, at any time, or in any form, an amount to another person or persons that would not have been entitled to an equivalent or more favourable benefit had the other person or persons received the relevant treaty income directly".

We are deeply concerned that this sweeping rule will lead to unreasonable degrees of uncertainty for many taxpayers who should be entitled to know that treaty benefits are available to them, including benefits that were intended to be conferred by the signatories to the relevant treaty. We are also concerned that, due to the "directly or indirectly" language, and the absence of any time limit on payments out of the "conduit", the extent of the application of the Proposed Rule will not be known or even discoverable for years to come.

The premise of this rule seems to be that the mere remittance of money to another person, no matter when it occurs or how tenuously connected it might be to the income in question, and irrespective of whether or not it is a deductible payment, is enough to raise a presumption that treaty benefits should be denied. With respect, we believe this rule is so broad that it will create a dramatically high degree of uncertainty and, in the extreme, could be read to deny the availability of treaty benefits in connection with many ordinary commercial transactions.

For instance, suppose a foreign company that is a resident of State R invests in securities issued by a Canadian company. Suppose the foreign company itself has some – or even a majority – of its investors resident in jurisdictions other than State R. Suppose the foreign company reinvests Canadian source income earned on the securities, but years later, liquidates the property into which it has reinvested and uses the proceeds – traceable to the Canadian source income – to make a dividend distribution.

Continuing the previous example, would the result be different depending on whether the company has, or might be expected to have, reliable information on the actual treaty status of its shareholders so may not be able to confidently conclude that the shareholders qualify for equivalent benefits opposite Canada? Such information is almost impossible for a public corporation to obtain.

What if, instead, the foreign company that is a resident of State R, and having shareholders only resident in State R, invests in securities issued by a Canadian company. Suppose the foreign company, in the ordinary course of its business, engages in commercial transactions with persons who are not resident in State R. For example, assume that the foreign company receives a dividend from the Canadian company, and uses the proceeds of that dividend to purchase additional securities of the Canadian company, or securities of another Canadian or foreign company, from a seller that is not a resident of State R. Would this trigger the conduit presumption, simply because the cash proceeds of the Canadian dividend were paid to a vendor that is not resident in State R, even though the economic value of the dividend remains within the foreign company?

It seems the broad wording of the conduit presumption (which includes, as noted above, the words "directly or indirectly" but does not include any time limitation) could be interpreted so as to apply in each of these situations, which seems completely inappropriate.

We also note that, as drafted, the conduit presumption is paramount over the safe harbours for active business, companies controlled by equivalent beneficiaries and public companies. This seems to us to tip the balance too far toward the denial of treaty benefits. If investors are to actually rely on the safe harbours, we submit they should not be neutralized by too broad a conduit presumption (this point is discussed further below).

We would suggest the Department seriously consider narrowing the conduit presumption to address the following points:

- Consider eliminating the phrase "directly or indirectly, at any time or in any form" to better target the provision at true conduit situations;

- Consider a specific exception for transactions undertaken in the ordinary course of the business of the taxpayer;

- Consider eliminating the paramountcy of the conduit presumption over the safe harbours.

Safe Harbours

The Proposed Rule contemplates three "safe harbour presumptions" under which, subject to the conduit presumption, and absent proof to the contrary, treaty benefits would not be denied to a person resident in a treaty country, being if:

(a) the person carries on an "active business" in that country (other than a business of managing investments);

(b) the person is not controlled, directly or indirectly, in any manner whatever, by another person (or persons) that would not have been entitled to equivalent or more favourable treaty benefits had they received the relevant treaty income directly; or

(c) the person is a corporation or trust the shares or units of which are regularly traded on a recognized stock exchange.

We have several comments on this aspect of the Proposed Rule:

- As noted above, we are concerned that these safe harbours are neutralized by making them "subject to" the conduit presumption. For instance, if the State R company referred to above is a dividend paying public company, it would seem that any deployment at any future time of the cash arising from Canadian source payments to fund dividends could jeopardize the availability of treaty benefits on such payments, so the company would not really have a certain outcome even though it is a public company.

- A true safe harbour should in our view be absolute; if its specified conditions are met, it should simply apply. The potential advantages of certainty and predictability are undermined not only by the fact that the safe harbours as drafted are subordinated to the conduit presumption, but also by the fact that the potential application of a safe harbour can be nullified by "proof to the contrary".

- It is unclear why the business of managing investments should be ineligible to qualify for the "active business" safe harbour. To the extent this criterion is intended to measure the degree of connection of an entity to its country of residence, why should it matter whether that connection is established through a business of making widgets or managing investments? It seems that many otherwise qualifying bona fide financial institutions will be excluded from the safe harbour no matter how active their activities in their country of residence may be, and this seems to us to draw an arbitrary distinction. We respectfully suggest the Department at least consider an exception for regulated financial institutions engaged in an active business conducted principally with arm's length persons.

- The application of the "control" safe harbour in situations involving a multiplicity of shareholders is unclear. A more objective "votes and value" test, similar to the derivative benefits provision mentioned in the OECD Discussion Draft, would at least be clearer, i.e., the safe harbour would apply where persons entitled to equivalent treaty benefits own at least 50% of total voting power and value of all shares. In fact, we would suggest that a test based solely on value would be even more appropriate (as in the case of the definition of a partnership or trust as a "financial institution" in subsection 142.2(1) of the ITA).

- Consideration should be given to including collective investment vehicles, properly defined, as entities entitled to safe harbour protection. The OECD commentary includes recently added provisions detailing the policy reasons for extending benefits to such entities in appropriate cases.

- A "same country" subsidiary of a public company should also be able to claim the safe harbour to which its parent would be entitled (for example, a Belgian holding company owned by a Belgian resident public company).

Collective Investment and Aggregation Vehicles

Many of our comments on the Proposed Rule as they relate to collective investment and aggregation vehicles ("Investment Vehicles"[3]) are to be found in Appendix I and, in particular, our comments on

[3] Please note that when we refer to "Investment Vehicles" we intend to refer not only to widely held vehicles such as mutual funds, master limited partnerships or private equity or hedge funds, but also to more closely held vehicles used for so-called "club

example 4. However, we felt it was necessary to provide some general background comments on Investment Vehicles.

It is fairly clear to most observers that the global economy has become more integrated over the past several decades. This has been caused by many factors, but among them has been a reduction in barriers to entry into national economies for foreign investors. At the same time, large pools of capital, including various superannuation and sovereign wealth funds, as well as individual investors, have increasingly sought investment opportunities outside their home jurisdictions. Canadian pension funds have been world leaders in this regard. However, not all of these investors have the size and, therefore, the resources of the largest pension funds which resources are necessary to be able to find, investigate and monitor a variety of international investments, particularly across different geographic and industry sectors. The ability to participate in different investment funds and to seek out investment managers with geographic and industry sector or other specialized knowledge, allows such investors not only to diversify their investments and seek out greater returns than would be the case if they were restricted to their home jurisdiction, but also provides broader, more competitive and, therefore, less expensive sources of capital for businesses around the globe.

It is not unusual for an investment fund to have investors from many different countries and to have investments in many different countries. A "western European infrastructure fund" may have dozens of global investors and a dozen investments in different countries. An emerging markets mutual fund or hedge fund may similarly have a diverse investor and investment base.

The use of an Investment Vehicle through which both investors and investments can be aggregated is desired by both investment managers and investors. Investment Vehicles can take the form of corporations, partnerships or trusts. The choice of the appropriate form of Investment Vehicle will depend upon the particular circumstances, and will reflect a number of considerations of which tax is a significant, and may in some cases be the most significant, consideration. However, it is important to note that the incidence of tax is not the only tax consideration. Other significant tax considerations include tax reporting obligations and preservation of advantageous tax status.

For example, it is usual for investors to extract from investment managers undertakings to take steps to ensure that the investor will not have any foreign tax filing obligations as a result of investing in the investment manager's fund (the Department will be familiar with this concern which was a recurring one expressed to the Department in the context of representations made by various investment industry organizations in respect of the definition of "taxable Canadian property" and section 116 obligations prior to the changes made in the 2010 budget). In the case of an Investment Vehicle that takes the form of a partnership, it is usual for an investment manager to be obligated to insert a "corporate blocker" in a fund structure where that is necessary to avoid foreign tax filing obligations for the ultimate investors.

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deals" in which the investors may number fewer than 20, as well as vehicles the holders of which may number only a very few. As we are sure the Department knows, the reasons for parties aggregating their interests in particular investments can be many and are more often than not unrelated to tax. In fact, rather than aggregating for the purpose of reducing tax, most often parties aggregate for non-tax reasons and then seek to minimize the potential tax costs of such aggregation.

Similarly, certain sovereign funds are entitled to so-called “892” tax status for US tax purposes. However, in general terms, under existing US tax rules that status can be jeopardized if the sovereign fund earns income from a commercial activity. As a result, similar to the discussion in the previous paragraph, it is usual for an investment manager to be obligated to insert a “corporate blocker” in a fund structure where that is necessary to avoid income from a commercial activity from accruing to an “892 investor”.

These examples are provided to illustrate that the use of Investment Vehicles to aggregate investors, often from many different jurisdictions, and investments, again often from many different jurisdictions, is ordinary and usual, and that often considerations far removed from treaty shopping are the ones motivating an investment manager to establish other entities, such as “blocker corporations”, in a fund structure. These issues are discussed in greater detail in our comments to example 4 in Appendix I.

Relieving Provisions

As drafted, if the Proposed Rule applies to a particular circumstance, then the relief is to be provided by allowing treaty benefits “to the extent … reasonable having regard to all the circumstances”. The precise relief to be provided in any given case is therefore inherently vague.

We believe that prudent investors considering an investment into Canada will simply “assume the worst” when their advisors tell them that the treaty shopping rule may apply if one of their main purposes in structuring an investment into Canada was to obtain a treaty benefit, and that the result of that will either be denial of all treaty benefits or some other less harsh remedy as is “reasonable”. Prospective investors, acting prudently, may be expected to simply discount any prospect of obtaining any treaty benefits since the “reasonable in the circumstances” standard is so inherently vague.

This aspect of the Proposed Rule is, in our view, most in need of additional background and examples in order to provide some degree of clarity and certainty to taxpayers and their advisers.

Examples

In addition to the above comments, we have considered the five examples from Budget 2014. In Appendix I, we discuss and expand upon these examples, the intent being for the expanded examples to provide more guidance to taxpayers and their advisers through additional or different facts compared to those in the examples. We also comment on some other examples which illustrate the need for more guidance on the scope of the Proposed Rule.

Transition

Budget 2014 indicates that the Proposed Rule, if adopted, would apply to taxation years that commence after the enactment of the rule into Canadian law. As discussed in our telephone call of March 28, 2014, we strongly feel that this would not be adequate time for taxpayers to be able to adapt to the potential impact of the Proposed Rule. For example, it would be highly unusual for a taxpayer to take any action to restructure its investment into Canada based upon a proposed rule. Given that taxation years of different taxpayers can commence at any time, it is certain that under the transition proposed in Budget 2014 the Proposed Rule would be applicable to some taxpayers the day after enactment.

We would note that even for circumstances involving affiliated or non-arm's length parties, the affected taxpayers and affiliated or non-arm's length parties normally have obligations under various related agreements with arm's length parties which often make it difficult or impossible to restructure on little or no notice. Such taxpayers should be provided with sufficient time to amend or otherwise address such matters before the Proposed Rule would apply to such an existing structure.

We therefore suggest that a period of perhaps two years, but in any case no less than a year, before the Proposed Rule would have impact on existing situations would be more appropriate. For example, if the Proposed Rule were to be included in the second budget implementation act for Budget 2014, then an effective date of January 1, 2017 or 2016 would be more appropriate.

As well, in the case of capital gains accrued prior to the effective date of any new rule, a complete lack of grandfathering is inappropriate. There will be many situations in which a taxpayer has relied in good faith upon the current state of Canadian tax law and its tax treaties to structure the taxpayer's investment or investments into Canada. It is our view that grandfathering protection from taxation for gains that have accrued before the change in law should be granted.

This treatment would not be without precedent. In our telephone call of March 28, 2014 we discussed the elective means by which taxpayers could "step up" their tax cost of capital property at the time of the withdrawal of the general capital gains exemption. However, we would also note the grandfathering of gains accrued before changes to particular bilateral tax treaties, such as is found in paragraph 9 of Article XIII of the Canada-US Convention, or paragraph 5 of Article 13 of the Convention Between Canada and the Kingdom of the Netherlands. In both of these cases, the amount of the gain which is liable to tax is to be reduced based on the proportion of the gain attributable (on a monthly basis), or such greater portion of the gain as is shown to the satisfaction of the competent authority of the other State to be reasonably attributable, to the period ending on 31 December of the year in which the particular convention entered into force.

Protection for Payors

As discussed in our telephone call of March 28, 2014, we strongly submit that some form of due diligence or similar protection should be provided to a payor of amounts subject to withholding under Canadian domestic law, but which withholding obligation the payor reasonably believed was reduced by reason of the application of an applicable tax treaty. As discussed, Part XIII of the ITA does not expressly provide for such protection but, rather, purports to impose absolute liability on a payor that fails to withhold and remit amounts required to be withheld and remitted under that Part. It is debatable whether such absolute liability was ever appropriate in respect of tax withholding obligations on payments to non-residents, particularly where treaty benefits reasonably appear to be available to the payee, but this is even more the case if treaty benefits can be denied as a result of difficult interpretive issues as could arise if the Proposed Rule is adopted. A form of due diligence defence or reasonableness protection would seem clearly to be appropriate, particularly in the case of payments made by arm's length parties. This seems to have been recognized with the introduction of a similar form of defence into the section 116 withholding regime some six years ago. Another example is provided in the definition of "Canadian investor" in subsection 115.2(1) of the ITA.

These points are strongly and clearly illustrated in Example 4 of the Budget 2014 description of the Proposed Rule. The illustration in that example of the non-application of the Proposed Rule to the collective investment vehicle, B-trust, is helpful in terms of the exposure of B-trust and its investors. However, in the absence of a form of due diligence protection and clear statements by the Department that the Proposed Rule should not apply to most collective investment vehicles (this is discussed further in the appendix to this letter) an arm's length payor of amounts to B-trust will be reluctant to withhold at less than the full Canadian domestic withholding rate of 25% if the payor knows that there is a collection of diverse investors from various different jurisdictions in the collective investment vehicle.

The fact that such "over-withholding" may be recoverable from the CRA does not seem to be an answer. This is illustrated by the reaction of foreign investment funds (particularly US based venture capital funds) to the pre-2010 section 116 and taxable Canadian property regime. It is also illustrated in the context of Canadian collective investment vehicles structured as partnerships and that will earn Canadian sourced investment income. Many Canadian tax-exempt investors insist that such partnerships be structured to qualify as "Canadian partnerships" Such investors require this in order to ensure that the partnership is not subject to Part XIII withholding and remittance, even though such tax-exempt investors could apply for and ultimately receive refunds of their portions of such withheld and remitted amounts. These investors do not want to suffer the significant impact that such withholding can have on the cash flow generated from these investments nor the administrative and other costs of seeking refunds of tax.

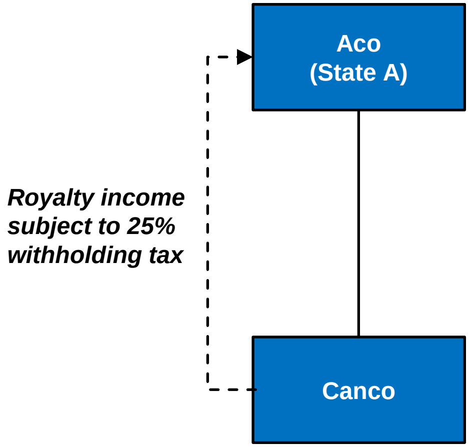
We would note in particular the circumstances that will be faced by Canadian public companies in the absence of a due diligence defence. In order to avoid jeopardizing access to capital by Canadian public companies that pay regular dividends, and which generally are in no position to evaluate the purposes underlying a particular foreign holder's structure, we suggest it is appropriate to simply exempt those situations from the ambit of the Proposed Rule.

We note that CRA forms NR301-NR303 do not provide a taxpayer with protection from penalties, even in circumstances in which the taxpayer has acted reasonably (an unfortunate circumstance that the CRA has readily admitted). Amendments to the form NR301-303 regime, with protections to payors who have acted reasonably, would seem to be eminently reasonable and appropriate.

Appendix I to Joint Committee on Taxation Submissions of May 16, 2014 on Budget 2014 Treaty Shopping Proposals

Consultation on Treaty Shopping
Example 1 – Assignment of Income

BEFORE



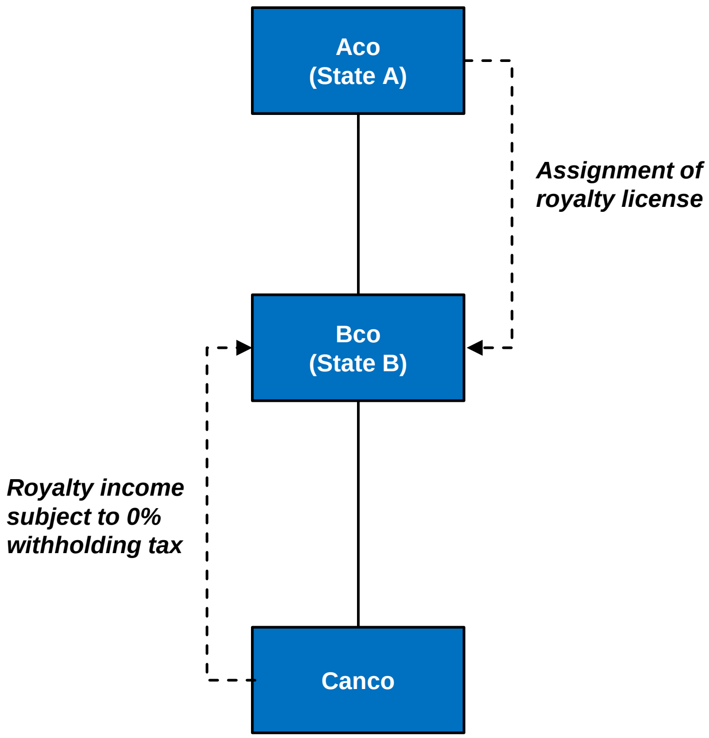
Example 1 – Assignment of Income

Facts presented in Budget 2014 – "before" situation:

- Aco is resident in State A, a non-treaty country.
- Aco owns IP used by its subsidiary, Canco.
- Royalties paid by Canco to Aco would be subject to 25% withholding tax.

Consultation on Treaty Shopping
Example 1 – Assignment of Income

AFTER



Example 1 – Assignment of Income

Facts presented in Budget 2014 – "after" situation:

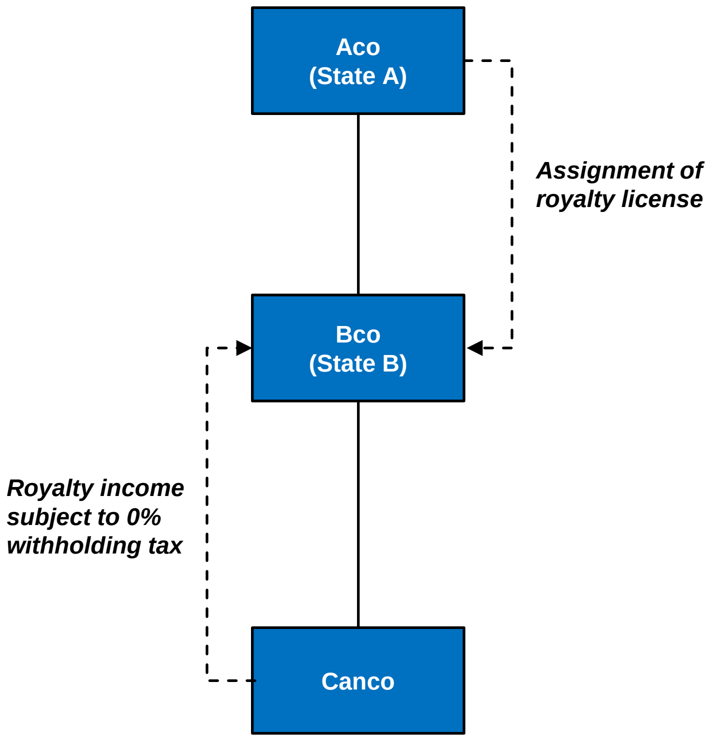
- Aco incorporates Bco in State B, a treaty country.
- Aco assigns to Bco the right to receive royalty payments from Canco.
- In exchange for this right, Bco agrees to pay 80% of the royalties received to Aco within 30 days.
- No withholding tax on royalties paid by Canco to Bco under the treaty.
- No withholding tax on royalties paid by Bco to Aco under the domestic laws of State B.

Analysis in Budget 2014

- Royalties received by Bco from Canco are primarily used to pay an amount to Aco.
- Under conduit presumption, it is presumed, in the absence of proof to the contrary, that one of the main purposes for the assignment of the royalties is to obtain the reduced withholding tax rate under the treaty with State B.
- If only 45% of Bco's royalties received were used to pay an amount to Aco, then the conduit presumption would not apply, but the main purpose test could still apply.

Consultation on Treaty Shopping
Example 1 – Assignment of Income

AFTER



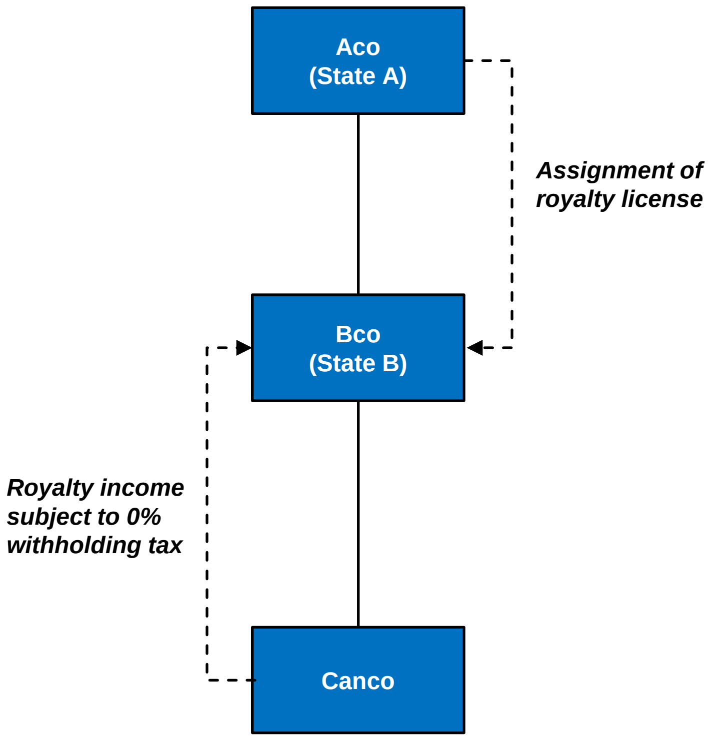
Comments / Questions on Example 1

- Budget 2014 provides as follows in respect of the Conduit Presumption (emphasis added):

  Conduit presumption: it would be presumed, in the absence of proof to the contrary, that one of the main purposes for undertaking a transaction that results in a benefit under a tax treaty (or that is part of a series of transactions or events that results in the benefit) was for a person to obtain the benefit if the relevant treaty income is primarily used to pay, distribute or otherwise transfer, directly or indirectly, at any time or in any form, an amount to another person or persons that would not have been entitled to an equivalent or more favourable benefit had the other person or persons received the relevant treaty income directly.

Consultation on Treaty Shopping
Example 1 – Assignment of Income

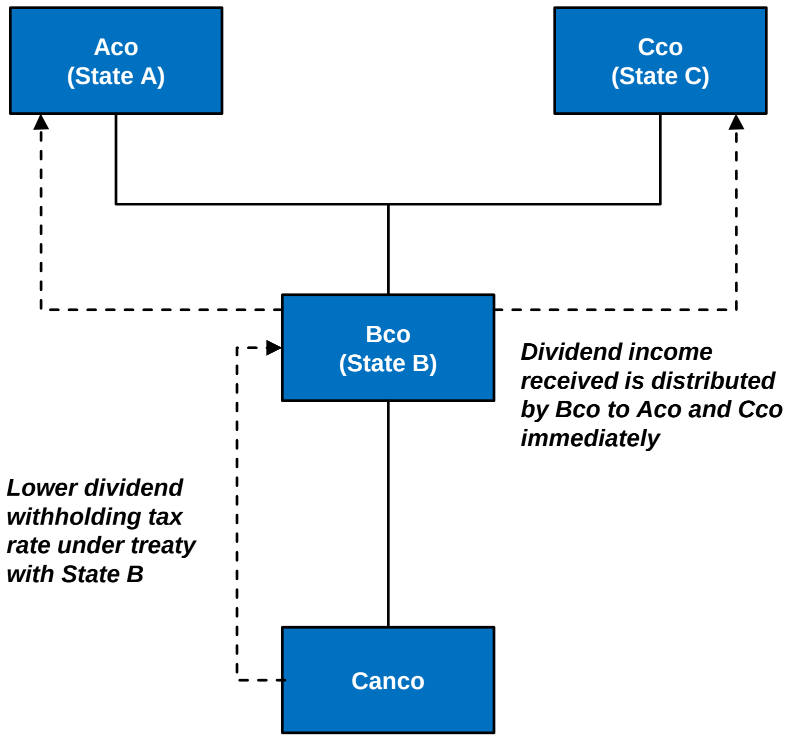
AFTER



Comments / Questions on Example 1

- The Joint Committee suggests that the examples should only include facts relevant to the analysis to avoid confusion regarding the ambit of the proposals.
- For example, it is not clear that it is relevant that Bco pays the royalty income to Aco within 30 days of its receipt. Would the conclusion be different if the royalty income were to be paid within 6 months or 1 year or even 3 years? Or would the conclusion be different if no agreement were in place?
- It would be more helpful if the example stated that "Bco agrees to remit a substantial percentage (*e.g.,* 80%) of its royalty income to Aco within a short period of time (*e.g.,* 30 days)."
- The Joint Committee recommends that a time frame or limit be built into the conduit presumption. The Joint Committee recognizes that the Department of Finance (the "Department") may be reluctant to build in a specific time limitation into the Conduit Presumption. As an alternative, a "series of transactions" concept could be used . The jurisprudence relating to "series of transactions" (notably the Supreme court of Canada decision in *Copthorne*) has determined that a "series of transactions" can be quite broad. However, it should provide taxpayers and their advisors comfort and certainty that only payments under arrangements that have a sufficient nexus to the treaty protected income would be taken into account in assessing the conduit presumption.
- Examples that would provide guidance on when and to what extent the relieving provision would apply would also be helpful.

Consultation on Treaty Shopping
Example 2 – Payment of Dividends



Example 2 – Payment of Dividends

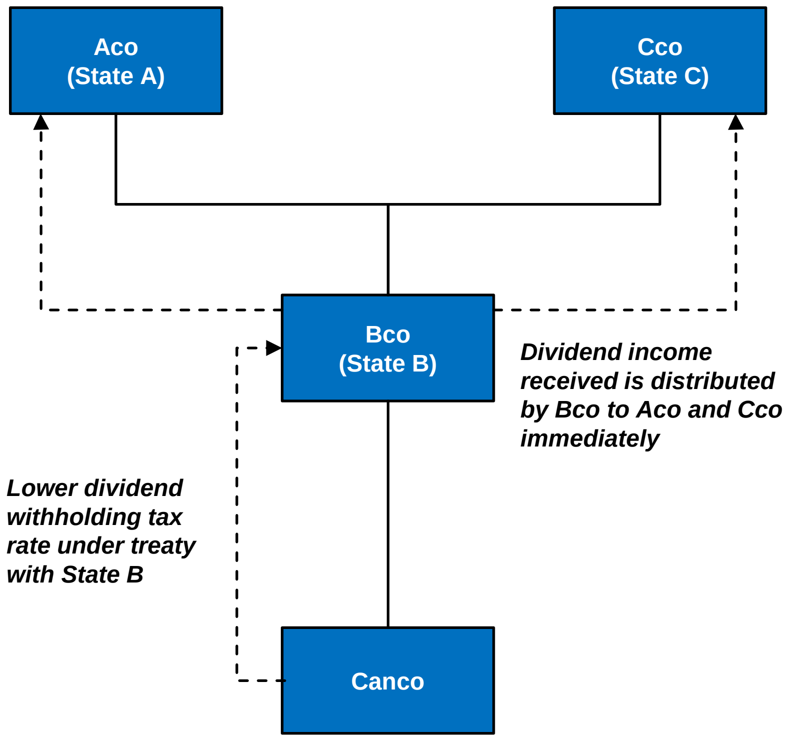
Facts presented in Budget 2014

- Aco and Cco are residents of State A and State C, respectively.
- Aco and Cco established Bco in State B.
- Bco owns the shares of Canco.
- Canada has a treaty with States A, B and C, however, dividend withholding tax rate is higher under treaty with States A and C.
- Under shareholders' agreement between Aco and Cco, Bco is required to distribute any dividends received from Canco to Aco and Cco almost immediately.
- Under the domestic laws of State A and State C, dividends received from foreign corporations are subject to tax.

Analysis in Budget 2014

- Dividends received by Bco are used to make immediate distributions to Aco and Cco.
- Under conduit presumption, it is presumed, in the absence of proof to the contrary, that one of the main purposes for the establishment of Bco is to obtain the reduced withholding tax under the tax treaty with State B.
- Treaty benefits may still be available under the relieving provision. For instance, treaty benefits may be available if Aco and Cco are taxable in State A and State C on the dividends they received from Bco.

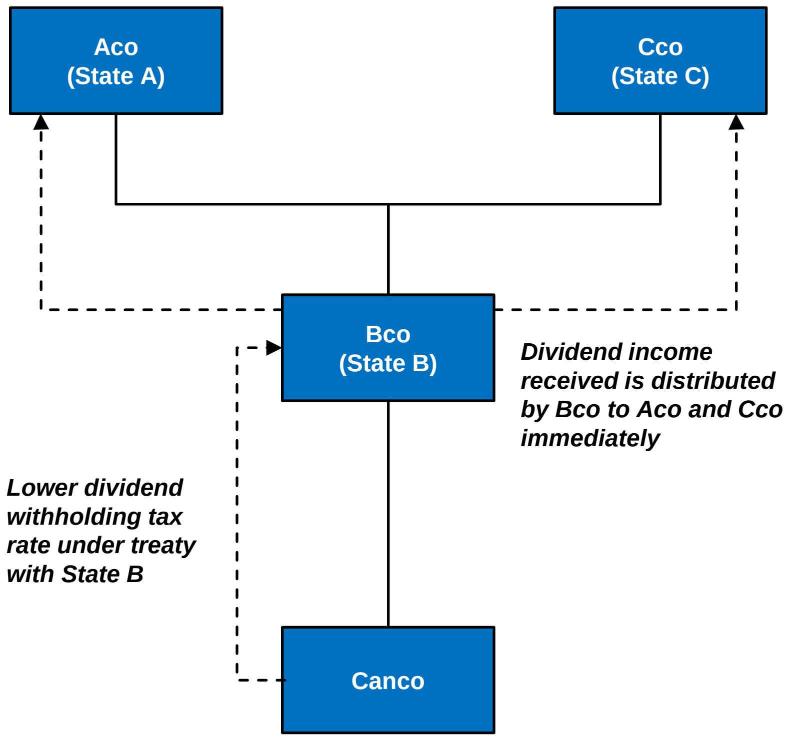
Consultation on Treaty Shopping
Example 2 – Payment of Dividends



Comments / Questions on Example 2 (1)

- It not clear why the tax treatment in States A and C of the dividends received by Aco or Cco is relevant in determining what is reasonable treaty relief.
  - In the absence of further comment or guidance, this statement could be interpreted by taxpayers, their advisors or a court that it would not be reasonable to provide treaty relief where Aco and Bco are not taxable on the dividends.
  - In light of the fact that both Canada and most of its treaty partners operate an exemption system for dividends, the focus should not be on the taxation of the dividends but rather whether the ultimate recipient would be entitled to any form of treaty reduced rate.

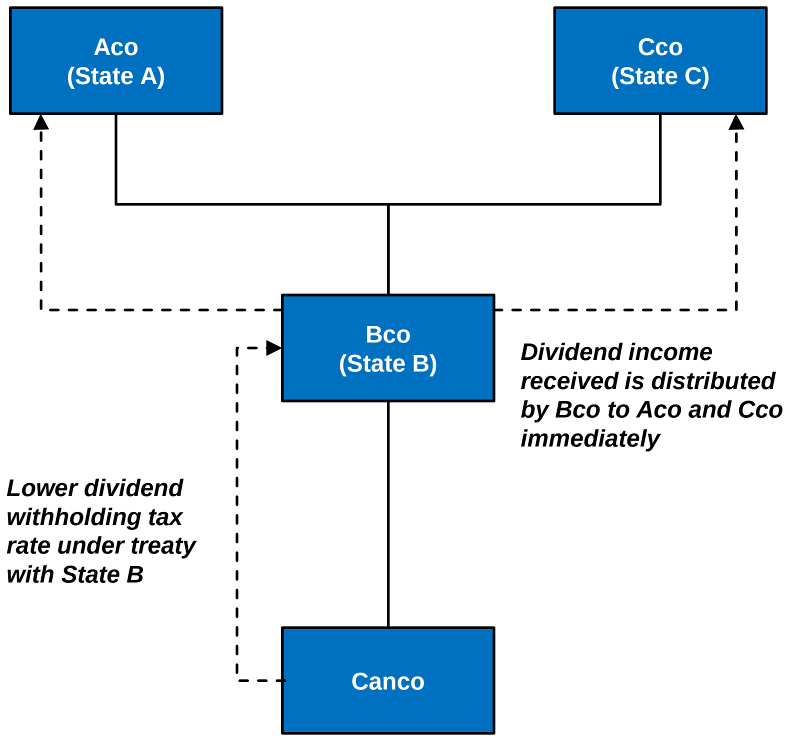
Consultation on Treaty Shopping
Example 2 – Payment of Dividends



Comments / Questions on Example 2 (2)

- It is often the case that arm's length parties come together for particular projects or investments. The "home" jurisdictions of such parties are often different. Such parties will often wish to create an aggregation vehicle through which to undertake their joint projects.
- In circumstances such as this it will often be the case that Aco does not wish to be subjected to the tax regime of State C (even if there were to be a minimum of "tax leakage" through State C, compliance obligations and the potential for tax audits and reviews can be sufficient to drive this behaviour – an example is a foreign joint venturer partnering with a Canadian corporation – the prospect of having to comply with Canada's exempt surplus and FAPI regimes can be enough to drive foreign joint venturers away from agreeing to establish Bco in Canada, even where Cco is in Canada). The same will often be the case for Cco viz. State A.
- Accordingly, a "safe" third jurisdiction is often sought. The safe harbour presumption would address this situation provided that it is not subject to the conduit presumption.

Consultation on Treaty Shopping
Example 2 – Payment of Dividends

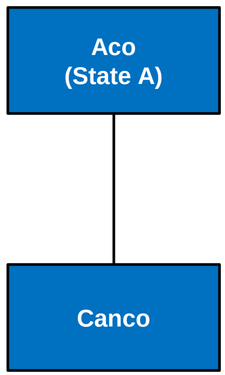


Comments / Questions on Example 2 (2 continued)

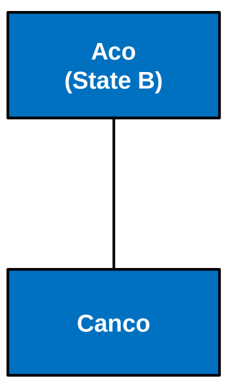
- The Joint Committee recommends that the safe harbour presumption not be subject to the conduit presumption, but that the two operate in parallel.
- In the case of Aco and Cco in this example, the Joint Committee suggests that the Department include in the examples, either as a separate example or as commentary on example 2, commentary confirming that the establishment of an aggregation vehicle in a third country for the purpose of avoiding the tax compliance obligations and risks of either joint venturer being exposed to the tax regime of the other joint venturer's "home" jurisdiction is a valid and proper consideration and should be relevant in determining the main purpose of the parties and whether the safe harbour or conduit presumptions have application in the circumstances.

Consultation on Treaty Shopping
Example 3 – Change of Residence

BEFORE



AFTER



Aco migrates from State A to State B and then disposes of Canco's shares

Example 3 – Change of Residence

Facts presented in Budget 2014

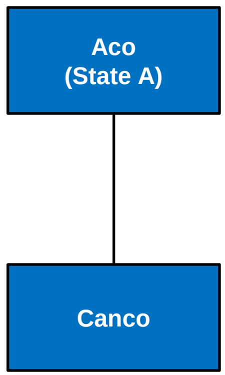
- Aco is resident in State A, a non-treaty country.
- Aco owns the shares of Canco and is contemplating their sale.
- Sale of Canco would trigger a capital gain that would be taxable in Canada.
- Shortly before the sale, Aco is continued into, and becomes a resident of State B, a state that does not impose tax on capital gains.
- Treaty between State B and Canada provides taxing rights to State B.
- Aco sells Canco without any Canadian tax implications and retains the proceeds of disposition.

Analysis in Budget 2014

- As disposal proceeds are retained by Aco, the conduit presumption does not apply.
- Main purpose provision would still apply (in absence of other circumstances).
- If Aco was already a resident of State B on initial acquisition of Canco, it would need to be determined whether one of the main purposes of the establishment of Aco in State B was to obtain the capital gains tax exemption under the treaty with State B.

Consultation on Treaty Shopping
Example 3 – Change of Residence

BEFORE



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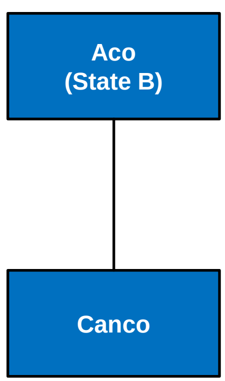
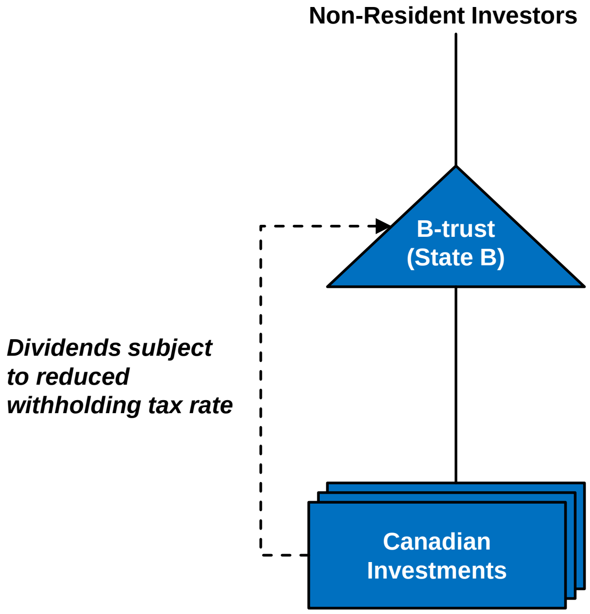


Comments / Questions on Example 3

- Additional guidance should be provided on when it may be acceptable for Aco to be already a resident of State B at the time of the initial acquisition of Canco.
- Would the treaty-shopping rules apply where an individual migrates to another country before disposing of the shares of Canco? It would be much more difficult / unusual for an individual to change their residence for the purposes of mitigating a capital gain on the disposal of Canco shares.

Consultation on Treaty Shopping
Example 4 – *Bona Fide* Investments

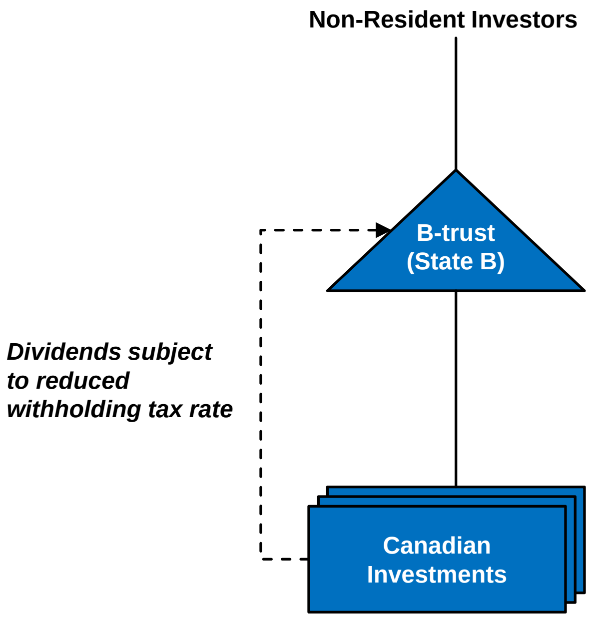


Example 4 – *Bona Fide* Investments

Facts presented in Budget 2014

- B-trust is a widely held trust that is resident in State B, a treaty country.
- B-trust manages a diversified portfolio of investments in the international market. B-trust holds 10% of its portfolio in shares in Canadian corporation and receives annual dividends from its Canadian investments.
- Tax treaty between State B and Canada reduces the withholding tax on dividends to 15%. Several investors in B-trust are resident in State B, but a majority of investors are residents of states with no treaty with Canada.
- Investors in B-trust seek to optimise their investment and rely on B-trust's management to make optimal investment decisions. B-trust annually distributes all of its income to its investors.

Consultation on Treaty Shopping
Example 4 – *Bona Fide* Investments

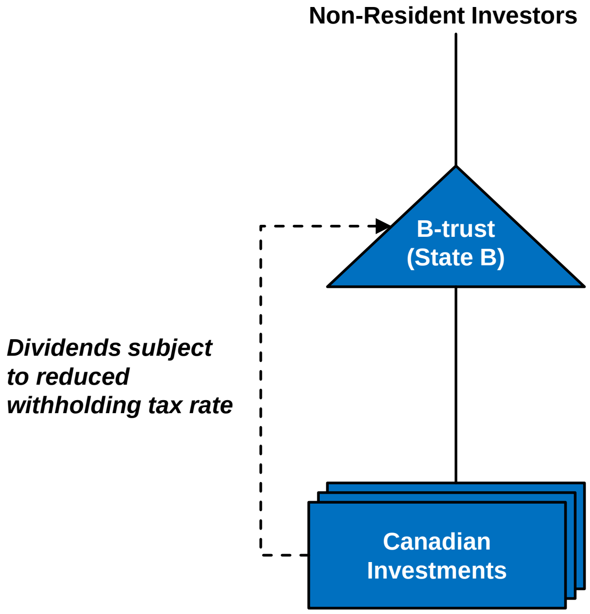


Example 4 – *Bona Fide* Investments

Analysis in Budget 2014

- Dividends received by B-trust from Canadian corporations are primarily used to distribute income to persons in non-treaty countries.
- Under conduit presumption, it is presumed, in the absence of proof to the contrary, that one of the main purposes for B-trust to invest in Canadian corporations and for third state investors to invest in B-trust is to obtain the reduced withholding tax rate under the treaty with State B.
- However, investors' decisions to invest in B-trust is not driven by any particular investments made by B-trust, and B-trust's investment strategy is not driven by tax position of investors.
- According to the Budget document, there should be sufficient facts to rebut the conduit presumption, and the main purpose would not apply.

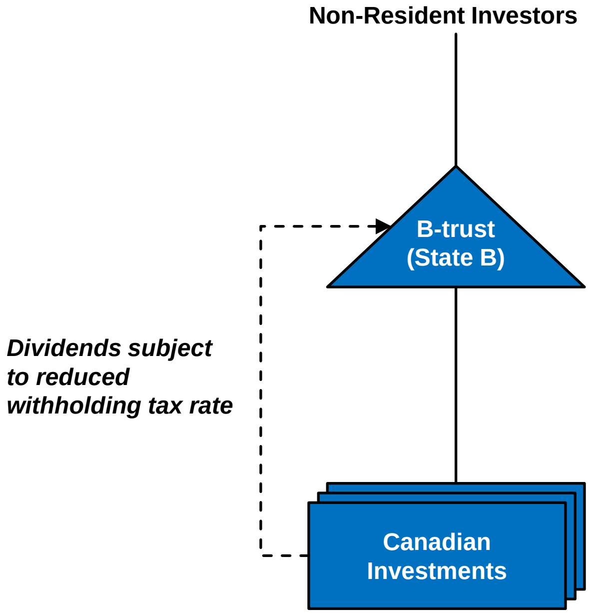
Consultation on Treaty Shopping
Example 4 – *Bona Fide* Investments



Comments / Questions

- This is example is very helpful, as far as it goes. However, a number of the background facts limit the extent to which investors and sponsors of collective investment vehicles (in particular, typical private equity or hedge funds and US Master Limited Partnerships) can take comfort from this example.
- It is often the case that investment funds carry on business in jurisdictions (such as the US or UK) that impose significant tax costs, including compliance costs, on taxpayers carrying on business in the jurisdiction, and that investors require that fund entities be structured such that they (the investors) do not have liability for taxes nor for tax compliance and filings (and all the costs and risks that can entail). As well, for funds that anticipate having investors from multiple jurisdictions, or investments in multiple jurisdictions, or both, it is imperative, in terms of minimizing the potential for multiple layers of tax liability and tax compliance, to seek out a "tax neutral" jurisdiction in which to establish the fund aggregation vehicle or vehicles – we say "vehicles" because the diverse nature of a particular funds investors or investments can be such that several different aggregation vehicles may be necessary in order to achieve maximum minimization of tax risks. In such a case:
  - Would the conclusion be different if the fund sponsor or manager was resident in a jurisdiction other than State B?
  - Would the conclusion be different if the fund sponsor formed the fund in State B specifically because State B has a favourable domestic tax regime and treaty network (such that the treaty with Canada was only one factor relevant to the choice of jurisdiction for the aggregation vehicle)?
  - Would the conclusion be different if fund investors considered the treaty network of State B in making their decision to invest in the fund?

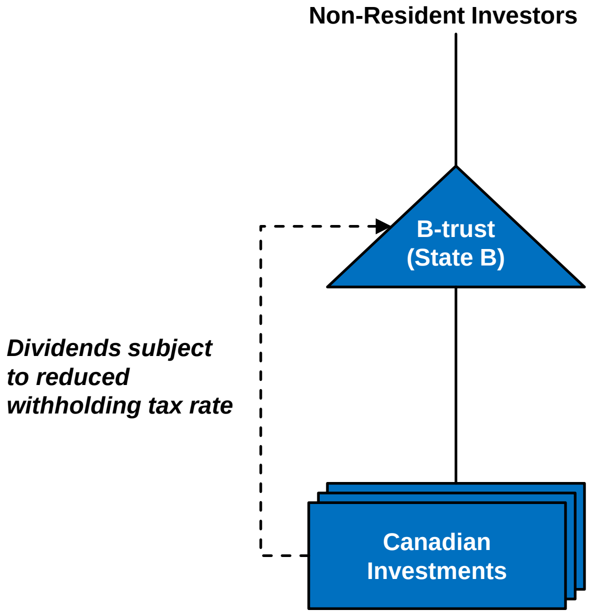
Consultation on Treaty Shopping
Example 4 – *Bona Fide* Investments



Comments / Questions

- Why is it stated that "it would have to be clearly established" that none of the main purposes was to obtain a treaty benefit? What is meant by "clearly established"? The standard of proof should presumably be the normal civil standard of "balance of probabilities". It is not clear whether or not the phrase used by Finance suggests some higher onus.
- In developing the non-resident trust ("NRT") rules, notably the definition of "exempt foreign trust", the Department took the approach that this definition should provide an "easy out" for foreign collective investment vehicles in which the Department could have a very high level of comfort that the particular vehicles were established for 'legitimate" commercial reasons and had not been established for the purpose of avoiding the NRT rules (see paragraph (h) of that definition). The Joint Committee recommends that the Department take a similar approach to the Proposed Rule, either directly in the rule itself or, more likely (given the approach that the Department has adopted), in the commentary to example 4. We have added, on the next slide, some suggested comments to the final paragraph of example 4 in Budget 2014.
- The Joint Committee also recommends a specific carve-out for collective investment vehicles that are regulated. See the additional comments on the next slide.
- However, the rules could still provide that collective investment vehicles that interpose intermediary entities for the sole purpose of lowering withholding tax rates from Canada should still be caught by the treaty shopping rules.

Consultation on Treaty Shopping
Example 4 – *Bona Fide* Investments



Comments / Questions

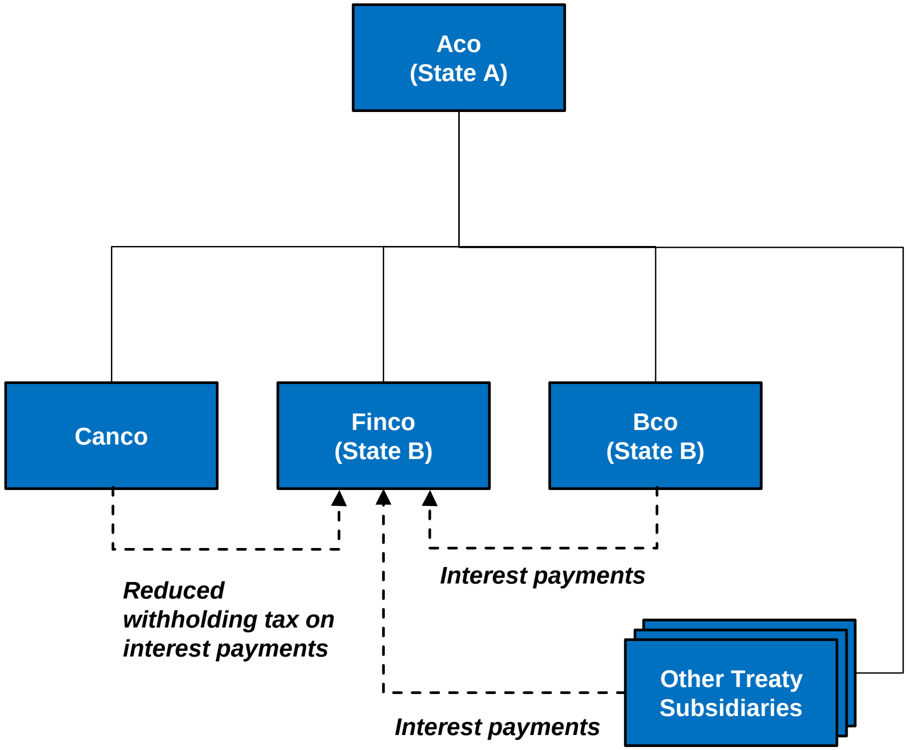
- The Joint Committee recommends that in addition to the following comments taken directly from Budget 2014, the sentences in bold italics that follow be added.

To rebut this presumption, it would have to be clearly established that none of the main purposes for undertaking these investments, either alone or as part of a series of transactions, was to obtain the benefit of the tax treaty between Canada and State B. Investors' decisions to invest in B-trust are not driven by any particular investments made by B-trust, and B-trust's investment strategy is not driven by the tax position of its investors. In this example, and in the absence of other circumstances, there would be sufficient facts to rebut the above presumptions. It follows that the main purpose provision would not apply to deny the tax treaty benefit. ***This should be the case whether or not the investment manager for B-trust is also resident or carries on business in State B.***

It would be expected that there would similarly be sufficient facts to rebut the above presumptions in circumstances in which B-trust is less widely held but has a number of investors from different jurisdictions or has a number of investments in different jurisdictions, of which Canada is only one.

As noted in our letter, in the absence of very clear statements about the availability of treaty protection to collective investment vehicles in circumstances such as these, as well as some form of protection from the potential application of the Proposed Rule for payors of amounts to such vehicles who have acted reasonably, payors will be reluctant to withhold at less than the full Canadian domestic rate of 25%.

Consultation on Treaty Shopping
Example 5 – Safe Harbour (Active Business)



Example 5 – Safe Harbour (Active Business)

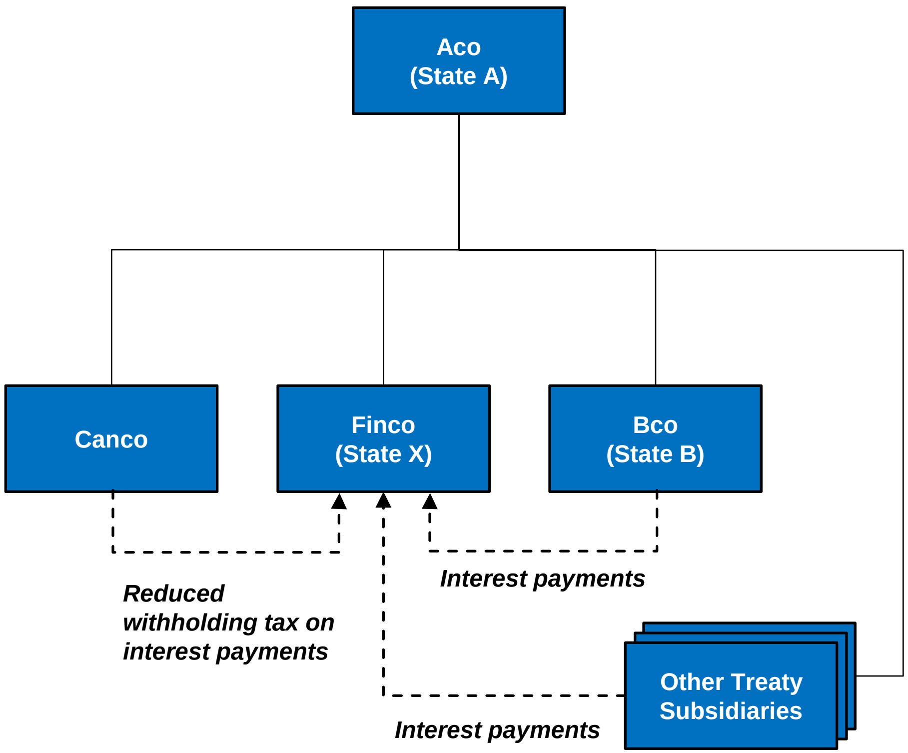
Facts presented in Budget 2014

- Aco is resident in State A, a non-treaty country.
- Aco owns all the shares of Finco that is resident in State B, a treaty country. Finco acts as a financing company for Aco's wholly owned subsidiaries, including Canco and Bco (also resident in State B).
- Bco carries on an active business in State B and that business is substantial compared to Canco's activities.
- All Aco's subsidiaries are resident in countries that have tax treaties with Canada that provide equivalent treaty benefits for interest payments as the treaty between State B and Canada.
- Finco receives interest from Aco's subsidiaries and reinvests its profits.

Analysis in Budget 2014

- As the interest received by Finco from Canco is used to pay an amount to persons that would be entitled to equivalent treaty benefits had they received the interest directly from Canco, the conduit presumption would not apply.
- As Bco carries on a substantial active business in State B and is related to Finco, it would be presumed under the safe harbour presumption that none of the main purposes for Finco to provide financing to Canada was to obtain benefits under the treaty between Canada and State B.
- To rebut the presumption, it would have to be "clearly established" that one of the main purposes of the financing from Finco was to obtain benefits under the treaty.

Consultation on Treaty Shopping
Example 5 (Expanded) – Global Cash Pooling



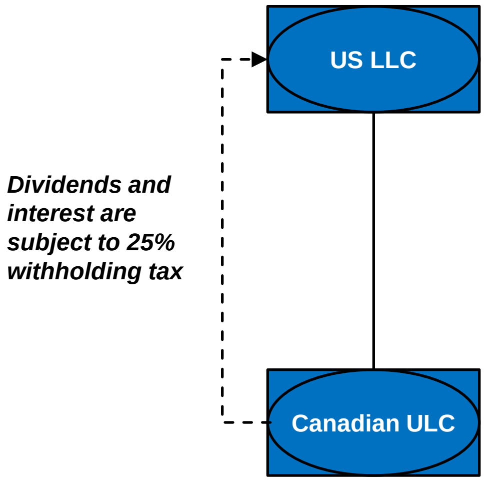
Example 5.1

- Global cash pooling of the sort illustrated by example 5 is commonly undertaken by multinational groups and, although tax structuring is an important consideration, as it is for any commercial transaction, global cash pooling is never undertaken to achieve tax benefits.
- Global cash pooling will also generally involve all members of a global group, some of which will be resident in and operate in relatively high tax rate jurisdictions, and some of which will be resident in and operate in relatively low tax rate jurisdictions.
- The comments in example 5 are helpful as far as they go. However, it is not clear why these comments could not go further. For example, it is not clear why the presence of Bco in the structure and the fact that it carries on a substantial business should be relevant to the analysis - which illustrates why the safe harbour should not be subject to the conduit principle.
- Similarly, it is not clear why it should be relevant that "Bco carries on a substantial active business in State B" (other than to establish the basis for the safe harbour exception). It is also not clear why it should be relevant that "Aco's other subsidiaries are residents of other states with which Canada has tax treaties which provide tax treaty benefits on payments of interest that are equivalent to those provided under the tax treaty between Canada and State B." Perhaps the Department could add a further example in which Finco is a resident of State X in which the global group does not otherwise have a presence, and that a number of group corporations are in states that do not have treaties as favourable as that between Canada and State X, but provide comfort that the Proposed Rule would not apply where the global cash pooling arrangement is established principally to permit the global group companies to pool their cash resources.

Other Examples

Consultation on Treaty Shopping
Example 6 – Canada/US Protocol

BEFORE

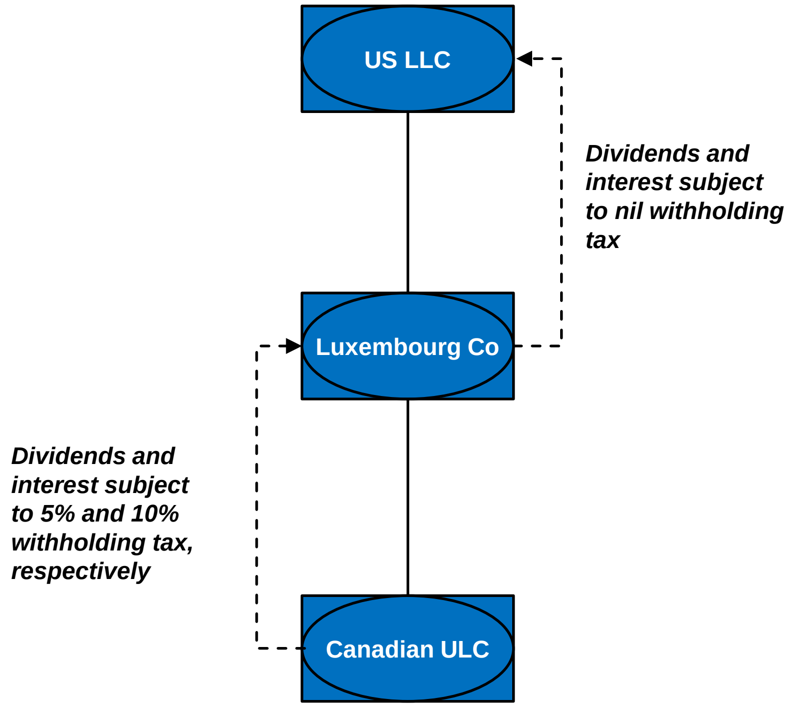


Example 6 – Canada/US Protocol

- US LLC is a disregarded entity for US tax purposes.
- Canadian ULC is also a disregarded entity for US tax purposes.
- Under Article IV:7 of the Canada-US tax treaty, dividends and interest paid by Canadian ULC to US LLC would be denied treaty benefits. As such, dividends and interest would be subject to 25% withholding tax.
- If instead the US investor was a fully taxable US C-corp or S-corp, the CRA has accepted a two-step approach for obtaining treaty benefits on dividends:
    i. Canadian ULC converts its retained earnings to paid-up capital, which is liable to 5% dividend withholding tax.
    ii. Canadian ULC distributes paid-up capital to US LLC without any domestic Canadian withholding tax.

Consultation on Treaty Shopping
Example 6 – Canada/US Protocol

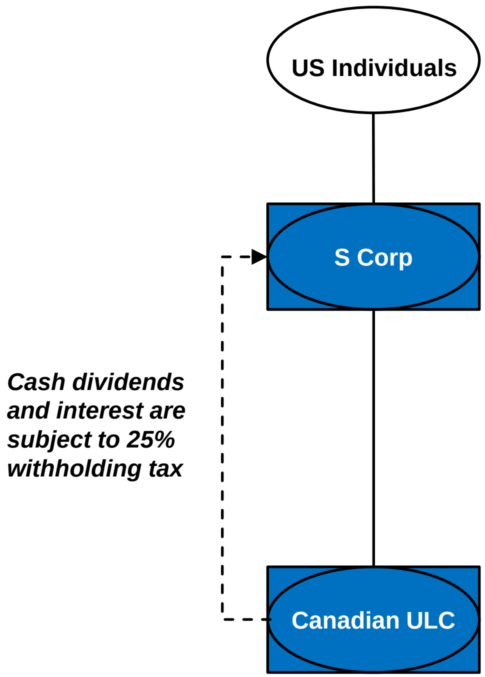
AFTER



Example 6 - Canada/US Protocol

- Many existing inbound investments have been structured through Lux/Dutch entities to deal with the adverse issues brought about by the breadth of the hybrid entity rules under the Canada/US treaty protocol.
- In response to concerns over these issues in the past, the CRA indicated that investing through an intermediary to obtain the 5% withholding tax rate on dividends and 10% withholding tax rate on interest (rather than 25%) was acceptable where no "double-dip" was involved.
- Under the one of the main purposes test, the avoidance of Article IV(7) would be one of the purposes for the structure (even though they could have gone with other structures to avoid that provision that would not involve a third country).
- It seems that the treaty shopping proposals will prevent the use of the intermediary to solve the treaty protocol concerns.
- If this structure is caught by the proposed treaty shopping rule and since many of these structures were established in response to the CRA acceptance of these structures in the context of the treaty protocol issue, it would be appropriate to provide a complete grandfathering rule or a transitional period of 5 /10 years to unwind the structure.

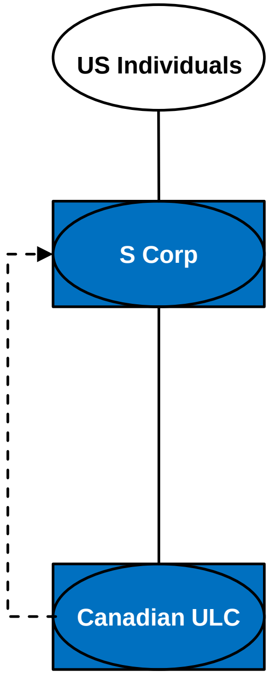
Consultation on Treaty Shopping
Example 7 – Canada/US Protocol



Example 7 – Canada/US Protocol

- S Corp is a US resident corporation that is owned 100% by U.S. resident individuals.
- S Corp has an operating business based in the U.S.
- S Corp owns 100% of Canadian ULC, which operates a similar business in Canada as S Corp operates in the U.S.. Canadian ULC is a disregarded entity for US tax purposes.
- Under Article IV:7 of the Canada-US tax treaty, dividends and interest paid by Canadian ULC to S Corp would be denied treaty benefits. As such, dividends and interest would be subject to 25% withholding tax.
- The CRA has accepted a two-step approach for obtaining treaty benefits on dividends:
  i. Canadian ULC converts its retained earnings to paid-up capital, which is liable to 5% dividend withholding tax.
  ii. Canadian ULC distributes paid-up capital to S Corp without any domestic Canadian withholding tax.

Consultation on Treaty Shopping
Example 7 – Canada/US Protocol



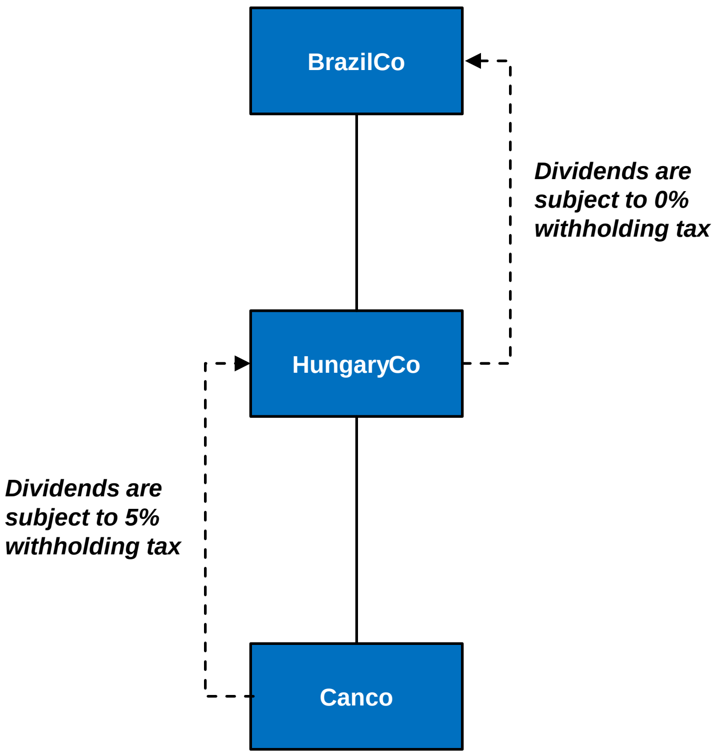
Cash dividends and interest are subject to 25% withholding tax

Example 7 – Canada/US Protocol

Analysis/Comments

- It's clear that a main purpose, if not the principal purpose, of these steps is to access the treaty rate on dividends because without these steps a distribution by ULC would attract 25% withholding tax.
- The conduit presumption appears to apply, because (i) S Corp will likely use the return of stated capital to make a distribution to its shareholders and (ii) if the US resident individuals were to have received the deemed dividend they would be subject to a 15% rate
- The first prong of the safe harbour rule probably applies, but since this is subject to the conduit presumption, it does not appear a taxpayer could rely on its application.
- Is this a situation where it would, nevertheless, be reasonable to allow the treaty 5% rate?

Consultation on Treaty Shopping
Example 8 – Active Business



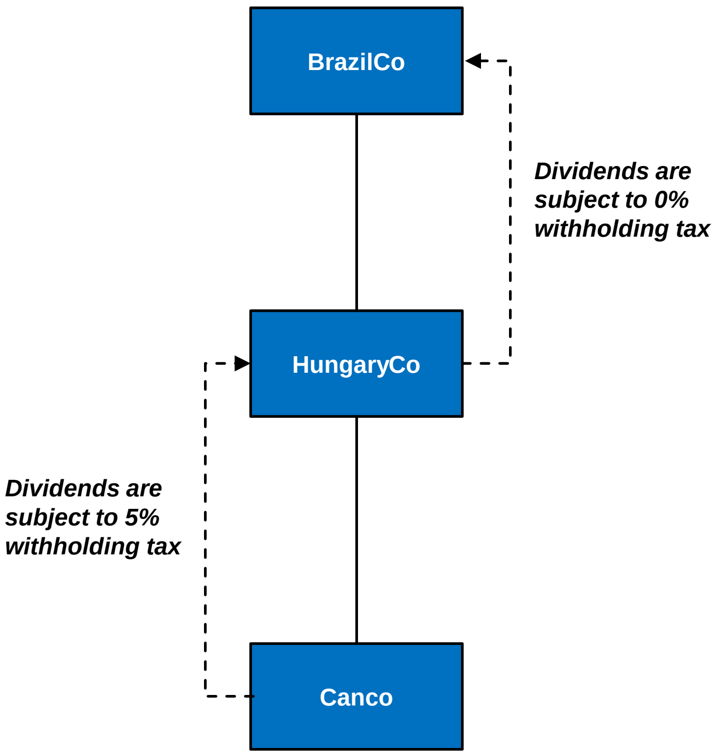
Example 8 – Active Business

- BrazilCo owns a company in Hungary ("**HungaryCo**") that is a manufacturing company.
- The group decides to expand its manufacturing business into Canada.
- If BrazilCo owns Canco directly, dividends paid by Canco to BrazilCo would be subject to 15% withholding tax.
- Whereas, if HungaryCo owns Canco, dividends paid by Canco to HungaryCo would be subject to 5% withholding tax.
- HungaryCo has sufficient cash generated by its active business to acquire Canco and HungaryCo is not established for the purpose of investing into Canada.
- More than 50% of the dividends received by HungaryCo are distributed to BrazilCo.

Analysis

- Under the conduit presumption, it is presumed, in the absence of proof to the contrary, that one of the main purposes for HungaryCo to invest into Canco is for HungaryCo to obtain a benefit under the Hungary-Canada tax treaty.

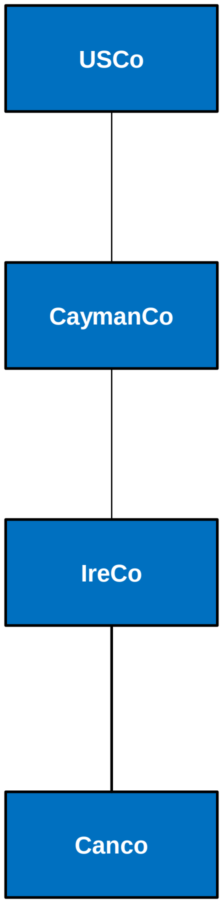
Consultation on Treaty Shopping
Example 8 – Active Business



Example 8 - Questions / Comments

- This example illustrates an instance of a non-abusive transaction.
- Availability of treaty benefits is only one of the considerations for HungaryCo's investment in Canco.
- How could HungaryCo evidence its subjective intentions for investing into Canco?

Consultation on Treaty Shopping
Example 9 – Multiple Tiers



Example 9 – Multiple Tiers

- Assume that Canco is directly owned by a company resident in Ireland, IreCo.
- IreCo is directly owned by a company resident in the Cayman Islands, CaymanCo.
- CaymanCo is directly owned by a company resident in USCo.
- Assume conduit presumption applies to this example.

Questions / Comments

- The safe harbour rules would not apply because Canco is controlled indirectly in any manner whatever by CaymanCo, which would not be entitled to any treaty benefits if it held Canco directly.
- Should the treaty shopping rules still apply even where the ultimate parent company is resident in a treaty country, and dividends paid by Canco to USCo would be subject to 5% withholding tax (being the same withholding tax rate applicable to dividends paid by Canco to IreCo)?

Appendix II to the Submissions of the Joint Committee on Taxation

Dated May 16, 2014

Further to our general submissions in respect of the proposed rule relating to "treaty shopping" as described in Budget 2014, following are our submissions on the issue of granting derivative benefits in the context of any measure aimed at counteracting treaty shopping. We begin with a discussion of the relationship between certain of the features of the measure described in Budget 2014 (the "Proposed Rule"), and then proceed to a more general discussion.

Proposed Rule

The Proposed Rule would provide for the following features:

- Main purpose provision: This provision would incorporate the core of the test, which would be satisfied where "it is reasonable to conclude" that "one of the main purposes" for undertaking a transaction (alone or as part of a series) was for a relevant person to obtain a treaty benefit. This test would be regulated but not displaced by two rebuttable presumptions, and separately subject to a relieving provision. A distinction is also drawn in the explanatory materials released as part of Budget 2014 (the "Explanatory Materials") between a "purpose" and a "consideration".[1]
    - Conduit presumption: it would be presumed, in the absence of proof to the contrary, that the "one of the main purposes test" is satisfied if the relevant treaty income is "primarily used" to pay (directly or indirectly, at any time or in any form) an amount to another person that would not have been entitled to an equivalent or more favourable treaty benefit (under the same or any other tax treaty).[2]
    - Safe harbour presumption: subject to the conduit presumption, it would be presumed, in the absence of proof to the contrary, that the "one of the main purposes test" is not satisfied if the relevant person meets any of three alternative conditions with respect to its status or activities – in brief, a "substantial active business activities test", a "not controlled by lesser beneficiaries test", or a "regularly traded test".[3]
- Relieving provision: This provision would specifically override the main purpose provision. In other words, it would apply to grant treaty benefits in whole or in part "to the extent that it is

[1] See page 352.

[2] Here the taxpayer would have the burden to establish proof to the contrary, unless it could establish that the basic conditions for the "primarily used test" have not been satisfied as the Crown would normally have assumed (or will have had to prove in the absence of an assumption to that effect underlying the assessment).

[3] Here the Crown would have the burden to establish proof to the contrary, after the taxpayer establishes (or the Crown concedes) that it meets any of the three alternative conditions.

reasonable having regard to all the circumstances" where it has first been determined (or presumed and not rebutted) that it is reasonable to conclude that one of the main purposes for undertaking a transaction that results in a treaty benefit was for the relevant person to obtain the benefit.

Thus, the Proposed Rule would contemplate the possibility of granting derivative benefits under the relieving provision, as suggested by Example 2 in the Explanatory Materials.[4]

In that example, one factor that is mentioned, in relation to the "reasonable in the circumstances" issue, is whether or not "Aco and Cco are taxable in State A and State C respectively on the dividend they received from Bco". The reference to this factor raises a variety of issues – including the specter of mixing source country (i.e., Canadian) treaty shopping issues with residence country non-treaty taxation issues.

This mixing of issues is also reflected in the OECD's recent Public Discussion Draft on *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (the "OECD Treaty Discussion Draft").[5] The OECD Treaty Discussion Draft notes that the extension of derivative benefits was considered by its focus group and that the group invites comments in that regard. The OECD Treaty Discussion Draft also includes the following observations:

> 14. The Group recognised that the inclusion of such a provision would be an appropriate way of dealing with cases where taxation of an item of income in the two Contracting States is comparable to the taxation of the same item of income if it had been received directly by the shareholders of the company that received that item of income. Since many States do not effectively tax dividends received by a resident parent from its foreign subsidiaries, that situation will often arise in the case of dividends, where the tax levied by the State of source will be the only tax levied by the two Contracting States.[6]

[4] Example 1 also contemplates the possibility of granting partial benefits to the intermediary entity to the extent that its income is not paid to third-country residents. Examples 3-5 do not discuss the possibility of granting derivative benefits. This is not relevant in Examples 4 and 5 because the premise there is that the "one of the main purposes test" would not be satisfied. Example 3 involves the taxation of gains, which is binary, so the context is slightly different, although derivative benefits can also be relevant in relation to gains.

[5] March 14, 2014.

[6] It is interesting to note the contrast in the underlying assumptions in paragraph 14 of the OECD Treaty Discussion Draft, that the ultimate residence country would not tax direct dividends in any event, and those in Example 2 in the Explanatory Materials in Budget 2014, that the residence country would tax dividends from the intermediary entity. The implication from the assumption in paragraph 14 of the OECD Treaty Discussion Draft is that there are no "BEPS concerns" where the residence country would not tax direct dividends in any event, whereas the implication from the assumption in Example 2 in the Explanatory Materials seems to be that this can give rise to "BEPS concerns". There is an obvious inconsistency here, but what is common to both examples is the more general implication that the tax treatment of the income in the intermediary country or in the ultimate residence country (directly or indirectly) could condition the availability of derivative benefits. This is also the implication of the royalty income example in the OECD Treaty Discussion Draft, as discussed below.

> 15. The Group also noted, however, that such a provision could result in the granting of treaty benefits in the case of base eroding payments in situations that have given rise to BEPS concerns. […]

The OECD Treaty Discussion Draft then provides an example of such "BEPS concerns", featuring the establishment of an intermediary entity in a country that also has a treaty with the source country, and that provides for identical treatment as that provided for under the treaty with the ultimate residence country – being an exemption for royalty income from the source country – but taxes the royalty income "at a preferential rate",[7] whereas the ultimate residence country "taxes royalties at the normal corporate rate".[8]

As discussed below in greater detail, whether or not the tax treatment of the income in the intermediary country or in the ultimate residence country gives rise to other "BEPS concerns", it is our view that treaty benefits should not be denied under any measure aimed at counteracting treaty shopping to the extent that treaty benefits would be available on a direct receipt of the income, and thus either that any such measure should not in the first place apply in such circumstances (because such circumstances should fail to meet the "one of the main purposes test") or that derivative benefits should be provided for in any event (either automatically or on the basis that this would be "reasonable in the circumstances" that should be considered to be relevant to such a measure).

<u>The Case for Scheme Integrity</u>

Scheme Integrity in General

Maintaining scheme integrity (and avoiding scheme confusion) is an important goal of tax system design, whether the particular system is intended to be prescriptive or discretionary. Scheme integrity contributes to the process of textual, contextual and purposive interpretation, as well as to the process of determining whether or not abusive tax avoidance may be present in particular circumstances, as contemplated by the general anti-avoidance rule ("GAAR").[9] It also contributes to clarity and certainty, which enable discretionary powers to be exercised in a manner that is less arbitrary, and permit taxpayers to anticipate their obligations with more predictability.

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[7] Presumably, on this logic, "BEPS concerns" may also arise where the intermediary country does not tax the royalty income, or taxes it more favourably, because it grants a deduction to the intermediary entity under a hybrid instrument that does not give rise to a taxable inclusion in the residence country, or even where the tax rate in the intermediary country is not "preferential" but simply substantially lower than the rate that would be applicable to royalty income in the residence country.

[8] Although it does not explicitly state that the residence country's normal corporate rate is higher than the intermediary country's preferential rate, that seems to be implied. The example also does not address the potential application of withholding taxes in the intermediary country, nor the potential application of any CFC rules in the residence country.

[9] Section 245 of the federal *Income Tax Act* (the "Act"). The courts have held that the "abuse" element under the GAAR must be established by the Crown rather than by the taxpayer. See, for example, The Queen v Canada Trustco Mortgage Company, 2005 DTC 5523 (SCC).

Counteracting Arrangements One of the Main Purposes of Which is to Obtain Treaty Benefits

In the context of the approach described in the Proposed Rule, what is particularly interesting about the OECD Treaty Discussion Draft is that the question of whether derivative benefits should be granted in relation to their royalty income example is raised just before moving on to the section of that draft under the heading *Rules aimed at arrangements one of the main purposes of which is to obtain treaty benefits*. This suggests to some extent an acknowledgement that their royalty income example is not really an example of arrangements one of the main purposes of which is to obtain treaty benefits.[10] We would agree with this suggestion, on the basis that the exact same treaty benefits would arise if the income was earned directly, so it is illogical to posit that any of the purposes of earning the income through the intermediary entity is to obtain any advantage with respect to treaty benefits. At most, in that example, the treaty benefits available to the intermediary entity should be regarded as a consideration, but not a purpose.

It is also interesting to note that the facts posited in the OECD's royalty income example would seem to not meet the conditions to trigger the conduit presumption described in the Proposed Rule, since even if all the royalty income were paid or distributed to the ultimate residence country entity that would not be a payment to a "person that would not have been entitled to an equivalent or more favourable treaty benefit". Moreover, these facts would also seem to meet the conditions for the application of the safe harbor presumption, since the intermediary entity would not be controlled by a "person that would not have been entitled to an equivalent or more favourable benefit". Thus, it would be the Crown that would have to rebut the safe harbor presumption by establishing that the "one of the main purposes test" was satisfied. The question of derivative benefits would arise only if the Crown could establish this proposition.[11] It would seem to be odd to suggest that the safe harbor presumption could be rebutted in a circumstance such as that posited in the OECD's royalty income example by reference to any difference between the tax treatment of the income under the laws of the intermediary country *versus* the tax treatment of the income under the laws of the ultimate parent country, since that factor simply does not involve any difference with regard to treaty benefits.

In contrast, if the treaty benefits otherwise available to the intermediary entity are more favourable than the treaty benefits that would have been available had the income been earned directly, then it is of course conceivable that the "one of the main purposes test" could be satisfied, subject to the safe harbor presumption, which would in turn be subject to the conduit presumption. In such a case, however, we submit that it should always be considered to be reasonable, in the context of an anti-treaty shopping measure, to grant treaty benefits to the same extent that they would be granted if the income were earned directly. Such an approach would not only keep the focus of the Proposed Rule

[10] The same suggestion arises to some extent from the separation of the treaty shopping consultation from the broader BEPS consultation as described in Budget 2014.

[11] However, the establishment of this proposition would not suggest that the availability of derivative benefits under the relieving provision should be denied because the relieving measure would be intended to grant treaty benefits precisely where it has been established (or presumed and not rebutted) that the "one of the main purposes test" was satisfied.

targeted on treaty shopping, but it would also be more consistent with other features of the Act and of the various income tax treaties that Canada has entered into.

For example, where the GAAR is applicable in particular circumstances involving abusive tax avoidance, the tax consequences to a person must be determined as is reasonable in the circumstances in order to deny the relevant tax benefit. The GAAR does not confer on the Crown or the courts any broad discretion to grant or deny favourable tax consequences in general, nor in order to indirectly penalize the taxpayer, but only to deny the relevant tax benefit. If the GAAR were applicable in a treaty shopping case, it is our view that its effect should be limited to a denial of the reduction of Canadian tax payable that is attributable to the enhanced treaty benefits available to the intermediary entity relative to the treaty benefits that would have been available had the income been earned directly. This would be consistent with the Crown's position, and with the Court's determination, in the RMM case, where the Minister assessed non-resident withholding tax of 10%.[12]

This would also be consistent with the Crown's position in both *Prévost Car* and *Velcro*,[13] which were not challenged under the GAAR but rather on the theory that the intermediary entity was not the "beneficial owner" of the income in question. In both cases, the Crown's position was that treaty benefits should be granted to the extent that they would have been available had the income been earned directly.

Similarly, under the proposed "back-to-back loan" rule for withholding taxes announced in Budget 2014, subsection 212(3.2) would not apply unless "if the particular amount were paid or credited to the non-resident person rather than the intermediary, the tax that would be payable under this Part is greater than the tax payable under this Part … in respect of the particular amount". Moreover, where this is the case, the effect of subsection 212(3.2) would be to produce a deemed interest payment that would result in additional withholding tax in an amount equal to the tax that would be payable if the particular amount were paid or credited to the non-resident person rather than the intermediary, minus the tax already payable in respect of the particular amount paid to the intermediary. This approach completely neutralizes any enhanced treaty benefits that would otherwise result from certain forms of treaty shopping (i.e., through back-to-back loan arrangements), but does so in a manner that produces consequences including automatic derivative benefits that are very clear, not discretionary or arbitrary, and not dependent on unspecified extraneous factors.

Counteracting Treaty Shopping vs. Other Concerns

The royalty income example in the OECD Treaty Discussion Draft is very similar to the example that has been contained in the Commentaries to Article 12(1) of the OECD Model Tax Convention (the "OECD Model") since the 1960s.[14] This example sets out what could be viewed as a caveat to the general

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[12] See *RMM Canadian Enterprises Inc et al v The Queen*, 97 DTC 302 (TCC).

[13] See, respectively, *Prévost Car Inc. v The Queen*, 2008 DTC 3080 (TCC), aff'd 2009 DTC 5053 (FCA), and *Velcro Canada Inc. v The Queen*, 2012 DTC 1100 (TCC).

[14] This example was included in the Commentaries to the 1963 OECD Model Tax Convention. See Report of the Fiscal Committee on the Draft Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital Among the Member Countries of the O.E.C.D., July 6, 1963, Part I and Part II (C(63)87 Part I and

expectation of the OECD Model that no withholding tax should be imposed by source states on royalty income, without any particular expectation with regard to the tax treatment of the income to the recipient. The current version reads as follows:

> 6. The paragraph does not specify whether or not the exemption in the State of source should be conditional upon the royalties being subject to tax in the State of residence. This question can be settled by bilateral negotiations.
>
> 7. Attention is drawn generally to the following case: the beneficial owner of royalties arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the royalties the tax exemption which is provided in paragraph 1. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.

However, it is important to understand the context of this example. In particular, this example is premised on the understanding that the treatment by a source country of dividends, interest and royalties should in general be consistent with what has been viewed as an overall compromise between competing considerations, and the competing interests of source countries and residence countries. These are discussed below in greater detail.

Clearly, it is important to balance the interests of source countries to impose taxation with respect to income that arises within their jurisdiction with the interests of residence countries to impose taxation in accordance with their sovereignty. Residence countries should be free, under the principles of sovereignty, to impose taxation on various items of income as they may deem appropriate or expedient, in order to advance economic and social policy objectives. Thus, in general, the exemption from source country taxation contemplated by Article 12(1) of the OECD Model does not specify whether or not the royalties should be subject to tax in the residence country. That is a matter for the residence country to determine – both in terms of whether or not to impose taxation on that income and in terms of whether any relief from such taxation should be delivered through a direct exemption or through an indirect exemption that operates under that country's CFC rules.

Many countries nominally impose taxation on their residents on a worldwide basis, but indirectly operate territorial systems of taxation by providing for a participation exemption in respect of the income of and from the CFCs of their residents. Thus, in order to access such relief, multinational enterprises based in such countries often hold intangibles through their CFCs. This is the case for Canada and for Canadian-based multinational enterprises. Increasingly, however, many countries are

Part II), available at www.taxtreatieshistory.org. See also Recommendation of the Council Concerning the Avoidance of Double Taxation, November 19, 1963 (C(63)113).

coming to the realization that a more direct form of territoriality and similar relief may be preferable for a variety of reasons. Thus, countries are increasingly adopting "patent box" regimes and other forms of direct territoriality or partial territoriality. This is the case for the United Kingdom, to mention just one important example.

Territoriality with respect to the imposition of the corporate income tax is an important element of an international tax policy that seeks to align the location of taxation with the location of value creation. Moreover, such territoriality is an important element of an international tax policy that seeks to avoid the effective taxation of non-residents in respect of foreign source income. Where the ultimate individual stakeholders of a multinational enterprise are resident in countries other than where the enterprise is based, the country in which the enterprise is based would effectively be taxing non-residents in respect of foreign source income if it seeks to impose its corporate income tax on a worldwide basis. This is undesirable as a matter of principle, and is an increasingly important consideration given the globalization of capital markets.

Furthermore, it is important to note that the imposition of source country taxation on a gross basis can result in an inordinate and destructive degree of taxation, given that taxation may be imposed in circumstances where the ultimate taxpayers have not earned any net income. This has also been recognized at least since the 1960s, and to a significant extent explains the overall compromise reflected in the OECD Model. For example, in 1961, when the maximum rates of source country taxation on dividends, interest and royalties were being discussed among the members of the Organization for European Economic Co-Operation (the "OEEC"), which preceded the OECD, it was being posited that "the maximum rate of 5 per cent proposed for taxation of royalties by the country of source …. was often equivalent to a tax of over 20 per cent on the net amount of the royalties and should be regarded as an absolute maximum for the country of source".[15] As we know, it was ultimately agreed that the overall compromise position would be source country taxation limited to 15% for portfolio dividends (and 5% for direct dividends), 10% for interest income and 0% for royalty income (recognizing, and expecting, that interest and royalties paid to non-residents would be deductible in computing the payer entity's net income). The imposition of greater source country taxation would undermine this compromise, and would allow source countries to impose an inordinate amount of taxation, thereby taking up an inordinate share of the overall tax base, in turn leading to destructive double taxation (either immediately or ultimately) or at a minimum leading to an unfair deprivation of residence country tax revenues or sovereignty with reference to tax policy.

Against that background, it is not surprising that the OEEC and the OECD approached the question of base companies with great caution, suggesting that the question be settled by bilateral negotiations and dealt with through special exceptions to the general approach. However, there was no suggestion that this matter should be left to the discretion of the source country, to be exercised based on unspecified standards that could change from time to time.

[15] See, for example, Fiscal Committee, Minutes of the 22nd Session held at the Château de la Muette, Paris, on Tuesday 17th, Wednesday 18th, Thursday 19th and Friday, 20th January, 1961 (FC/M(61)1).

Conclusions

In brief, it is our view that derivative benefits should be extended automatically under any measure that is intended to address treaty shopping concerns, without regard to the treatment of the income under the tax laws of the intermediary country or the treatment of the income under the CFC rules of the country where the stakeholders of the intermediary entity may be resident, subject of course to any special exceptions that may be negotiated on a bilateral basis.

For Canada to unilaterally deny derivative benefits under a treaty shopping measure on the basis that the income enjoys a lower rate of taxation under the laws of the intermediary country than would be applicable under the laws of the country where the stakeholders of the intermediary entity may be resident, even if no enhanced treaty benefits arise in the circumstances, would be equivalent to Canada asserting unilaterally that the country where the stakeholders of the intermediary entity may be resident cannot adopt a "patent box" regime. We submit that this would be an unwarranted interference with the fiscal sovereignty of our trading partners. Many of Canada's current income tax conventions provide for the exclusion from treaty benefits of entities that enjoy preferential treatment, but these are special exceptions adopted through bilateral negotiations, and are thus consistent with long-standing international standards in this regard, as reflected in the Commentaries to the OECD Model discussed above.

Moreover, such a position being taken by Canada would be equivalent to Canada asserting that Canadian-based multinational enterprises should not enjoy derivative benefits with reference to foreign-source income earned by their CFCs. Such a position would undoubtedly compromise the international competitiveness of Canadian-based multinational enterprises, and would undermine Canada's attractiveness as a location for the establishment of multinational enterprises that reach into global capital markets. Canada should neither actively seek to, nor unwittingly be forced to, tax foreign source income that ultimately belongs to non-resident stakeholders under the guise of addressing treaty shopping or any other BEPS concern.

BEPS concerns arise in a variety of situations and for a variety of reasons. However, it is important to distinguish between appearances and reality. There are many situations in which BEPS concerns do not really arise when all relevant facts and circumstances are taken into consideration even though they may appear to arise at a more superficial level of analysis. Included herewith is a set of examples intended to illustrate the range of considerations that are relevant in the context of such determinations, with a view to demonstrating the reasons why derivative benefits should be granted in such circumstances. This set of examples also demonstrates how unmanageably broad the range of considerations can become if the focus is shifted beyond the question of whether the intermediary entity obtains better treaty benefits than would be available to its ultimate stakeholders. For this reason, among others, we believe that derivative benefits should be granted purely as a function of a comparison between the benefits claimed by the intermediary entity and the benefits that would be available to its ultimate stakeholders, consistent with the approach reflected in proposed subsection 212(3.2).[16]

Derivative Benefits Scenario Examples

Paragraph 17 of the *Public Discussion Draft on BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (the "Discussion Draft") invites comments on the situation described in paragraphs 15 and 16 of the Discussion Draft and on possible ways of addressing such cases if a "derivative benefits" provision were included in the limitation-on-benefits rule described in the Discussion Draft. It also invites examples of situations which should be covered by a "derivative benefits" provision.

The situation described in paragraphs 15 and 16 of the Discussion Draft posits an example where a company resident of State T[17] (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

It is stated in paragraph 15 of the Discussion Draft that the granting of treaty benefits in such a situation has given rise to BEPS concerns. The question is whether derivative benefits should be granted in such a situation, as well as in a variety of more or less similar situations.

The comments below are intended to highlight a number of important considerations that should be taken into account in relation to this question.

1. As acknowledged in the Action Plan, BEPS concerns arise in a variety of situations and for a variety of different reasons, including but not limited to the application of tax treaties. Various working parties have been tasked to develop solutions that relate to each of the specific Actions and the specific areas of concern that they reflect. It is undesirable to confound treaty shopping considerations with different considerations. This can give rise to inordinate complexity, inordinate uncertainty, and results that fail to fairly align tax base allocation with value creation, or produce double taxation or otherwise excessive taxation, and would thus be inconsistent with the fundamental objectives of the BEPS Project.

2. There is a wide spectrum of circumstances in which the issue of granting of treaty benefits by source countries can arise. The situation described in paragraphs 15 and 16 of the Discussion Draft is only one example, and does not set out a complete picture of the tax considerations

[16] [16] This set of examples begins with the example featured in the OECD's discussion draft, but goes beyond that example to consider the issues that arise in a broader range of factual circumstances.

[17] Paragraph 16 of the Discussion Draft refers to State R as the residence of Parent but this appears to be a typo.

arising in the circumstances. For example, it does not specify whether State T would tax the income of Opco 2 under State T's CFC rules, or whether State T already taxed Parent in respect of the present value of the income from the intangible property on the transfer to Opco 2, or whether other aspects of the tax laws of State T would neutralize any BEPS concerns. CFC considerations are mentioned in the Discussion Draft, but not with reference to treaty shopping.[18]

3. Paragraph 15 of the Discussion Draft focusses on "the granting of treaty benefits in the case of base eroding payments". It is important to be clear in this regard. There is a significant difference between questionable "base erosion" and what may be referred to as "base delimitation". One of the purposes of tax treaties is to reduce the prevalence of double taxation and the excessive taxation of cross-border payments through gross-basis withholding taxes. Where cross-border payments are not excessive in light of the economic realities of the situation, the fact that they are deductible in computing the income of the payer does not constitute the questionable erosion of the tax base of the payer's jurisdiction. Rather, granting the deduction is an appropriate way of properly determining the amount of the income of the payer, and should reflect the degree to which the payer has created value in that jurisdiction. To deny a deduction in such circumstances, or to deny treaty benefits that would otherwise be applicable to such payments, would result in "base inflation" for the source country, and actual "base erosion" for the residence country (and other interested countries), that is not in accordance with the location of value creation.

4. Below we set out a number of additional examples that should be taken into account.

    a. Tax on Transfer of IP:

        i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

        ii. Tax Analysis: State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. State T imposed taxation at the normal corporate rate on Parent in respect of the present value of the future income from the intangible property at the time of the transfer to Opco 2 (and there is no dispute between Parent and State T with respect to valuation).

[18] In contrast, the *Public Discussion Draft on BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* does try to integrate CFC considerations into the analysis of whether there is an inclusion that corresponds to a deduction.

iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T has imposed taxation on the present value of the future income from the intangible property at the time of the transfer to Opco 2. Double non-taxation does not arise. Indeed, the taxation of the income from the intangible property has been taxed by State T *in advance* of its actual realization.

b. CFC Considerations (normal rate):

   i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

   ii. Tax Analysis: State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. Under its CFC rules, State T imposes taxation at the normal corporate rate on Parent in respect of the income of Opco 2 from the intangible property.

   iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T continues to tax the income from the intangible property. Thus, double non-taxation does not arise.

c. CFC Considerations (reduced rate):

   i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

   ii. Tax Analysis: State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. Under its CFC rules, State T imposes taxation on Parent at less than the normal corporate rate in respect of the income of Opco 2 from the intangible property.

   iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T continues to tax the income from the intangible property, albeit at a reduced rate. Thus, double non-taxation does not arise. This is equivalent to State T introducing an indirect "patent box" regime, which is within the sovereign rights of State T.

d. Joint Ventures:

   i. Facts: A company resident of State T (Parent 1) and a company resident of State R (Parent 2) establish a joint venture. As part of that joint venture, Parent 1 and Parent 2 establish a subsidiary in State R (Opco 2) and each transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. The intangible property held by Opco 2 is licensed to a joint subsidiary of Parent 1 and Parent 2 that is resident in State S (Opco 1).

   ii. Tax Analysis: State R has a "patent box" regime. State T does not have any such regime, and would thus impose taxation on Parent 1 at the normal corporate rate on any royalties directly received by Parent 1, but it has a participation exemption applicable to dividends from Opco 2. State T does not tax Parent 1 in respect of the present value of its intangible property at the time of the transfer to Opco 2, nor do its CFC rules apply to tax Parent 1 on its share of the income of Opco 2. State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence.

   iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State R taxes the income from the intangible property, albeit at a reduced rate, under its "patent box" regime. Thus, double non-taxation does not arise. Introducing a direct "patent box" regime is within the sovereign rights of State R. The parties to the joint venture must for commercial reasons select a jurisdiction in which to establish Opco 2. They can choose State R, State T, or a third jurisdiction. It is inappropriate for State S to effectively preclude the parties from choosing the more favourable regime in State R rather than the less favourable regime in State T, thereby undermining the commercial bargain and the fiscal and industrial policy of State R.

e. CIT/PIT Integration, and Global Capital Markets:

   i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

   ii. Tax Analysis: State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. State T does not impose taxation at the normal corporate rate on Parent in respect of the present value of the intangible property at the time of the transfer to Opco 2, and its CFC rules do not apply to tax Parent on the income of Opco 2. However, Parent is a public company and State T taxes individual shareholders of Parent who are resident in

State T on a "mark-to-market" basis with reference to the closing value of their shares in Parent on December 31 annually. State T also requires public companies based in State T to report to their shareholders the amount of the income of their CFCs that arose from payments that were deductible by other CFCs and that enjoyed preferential treatment or taxation at a substantially lower rate than that normally imposed by State T, thereby enabling the countries in which any non-State T shareholders are resident to implement tax policies to tax their residents' shares of such income in an appropriate manner.

iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T taxes its own residents' share of the income from the intangible property, albeit under its PIT rather than its CIT, under its "mark-to-market" regime, and State T has introduced transparency measures to prevent tax avoidance or inordinate tax deferral or over-integration in favour of non-State T residents. State T has adopted this approach to international taxation in recognition of the fact that some of the shareholders of public companies based in State T are residents of third countries, and thus that it would be inappropriate for State T to effectively tax non-State T residents in respect of non-State T income.

f. Gross vs. Net Taxation:

i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 intangible property for the purpose of taking advantage of the low taxation regime of State R. Opco 2 receives royalties from another subsidiary of Parent that is resident in State S (Opco 1).

ii. Tax Analysis: State S has treaties with States R and T and both treaties provide that royalties may be taxed by the State of source at a rate of 10%. Under the State R tax system, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate (although all development and maintenance costs would be deductible). State T does not impose taxation at the normal corporate rate on Parent in respect of the present value of the intangible property at the time of the transfer to Opco 2, and its CFC rules do not apply to tax Parent on its share of the income of Opco 2.

iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State S taxes the income at a rate of 10% on a gross basis. Such a rate would normally equate to a very high rate of tax on a net basis. It is important to emphasize that the imposition of source country taxation on a gross basis can result in an inordinate and destructive degree of taxation. Indeed, taxation may be imposed in circumstances where the ultimate taxpayers have not earned any net income. This has been recognized at least since the 1960s, and to a significant extent explains the overall compromise reflected in the OECD Model. For example, in 1961, when the maximum rates of source country taxation on dividends, interest and royalties were being discussed among the members of the Organization for European Economic Co-Operation (the "OEEC"), which preceded the OECD, it was being posited that "the maximum rate of 5 per cent proposed for taxation of royalties by the country of source …. was often equivalent to a tax of over 20 per cent on the net amount of the royalties and should be regarded as an absolute maximum for the country of source".[19]

g. Thin-Capitalization Considerations:

i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 capital that Parent has borrowed from arm's length lenders on global capital markets for the purpose of funding intra-group financing activities to be carried on by Opco 2. Opco 2 makes a loan to, and receives interest income from, another subsidiary of Parent that is resident in State S (Opco 1).

ii. Tax Analysis: Under the State R tax system, foreign source interest income is taxed at a preferential rate. State T would impose taxation on Parent at the normal corporate rate on any interest directly received by Parent, but it has a participation exemption applicable to dividends from Opco 2. State T's CFC rules do not apply to tax Parent on the interest income of Opco 2. However, under State T's thin-capitalization rules, Parent is not permitted to deduct interest expense to the extent its borrowings were used to fund the acquisition of shares eligible for the participation exemption on dividends. State S has treaties with States R and T and both treaties provide that interest may only be taxed by the State of residence.

iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T does not permit a deduction for the expense associated with the interest income of Opco 2, which is the equivalent to State T taxing that interest income and then permitting a corresponding deduction for the expense. Thus, double non-taxation does not arise.

h. Efficient Formation and Allocation of Capital:

i. Facts: A company resident of State T (Parent) establishes a subsidiary resident in State R (Opco 2) and transfers to Opco 2 capital that Parent has borrowed from arm's length lenders on global capital markets for the purpose of funding intra-group financing activities to be carried on by Opco 2. Opco 2 makes a loan to,

[19] See, for example, Fiscal Committee, Minutes of the 22nd Session held at the Château de la Muette, Paris, on Tuesday 17th, Wednesday 18th, Thursday 19th and Friday, 20th January, 1961 (FC/M(61)1).

and receives interest income from, another subsidiary of Parent that is resident in State S (Opco 1). From a commercial perspective, it is more efficient for Parent to borrow money on global capital markets and to channel that money to its subsidiaries than for those subsidiaries to borrow directly on global capital markets.

ii. Tax Analysis: Under the State R tax system, foreign source interest income is taxed at a preferential rate. State T would impose taxation on Parent at the normal corporate rate on any interest directly received by Parent, and its CFC rules apply to tax Parent on the interest income of Opco 2. State S has treaties with States R and T. Under the tax treaty with state T, the rate for interest income is 10%. Under the tax treaty with state R, the rate for interest income is 0%. Under the domestic laws of State T, interest paid by Opco 1 to arm's length parties would not be subjected to withholding tax, whereas interest paid to related parties would be subjected to withholding tax at a rate of 25%.

iii. Policy Considerations: In this situation, BEPS concerns should not arise, because State T taxes the interest income. Although State T also allows a deduction for the corresponding interest expense, the combination of these two features serves to match the tax position of Parent to the economic position of Parent. The effect of using Opco 2 as a means of reducing the State S withholding tax rate to 0% is to produce overall tax consequences that are equivalent to Opco 1 having borrowed directly from arm's length parties on global capital markets, since State S would not tax the interest income in such circumstances. In the event that State T were to deny treaty benefits in such a situation, thereby imposing tax on the gross income at a rate of 25%, such taxation would impose a considerable hardship on Parent because it would be taxed while it has not earned any net income. This would lead Parent to seek to cause Opco 1 to raise borrowings directly in global capital markets, thereby causing increased transaction costs and other economic inefficiencies. At a minimum, if State S sought to impose taxation in such a situation, the rate should be limited to the rate that would apply to payments made by Opco 1 to Parent (i.e., 10%), and thus derivative benefits should be granted in principle, and they should be granted on a "to the extent" basis rather than an "all or nothing" basis.