Deloitte.

International Tax

Canada Tax Alert

25 April 2014

FCA limits scope of foreign affiliate anti-avoidance rule in *Lehigh*

Contacts

Sandra Slaats
sslaats@deloitte.ca

For many years, the Canada Revenue Agency (CRA) has maintained that paragraph 95(6)(b) of the Income Tax Act (Act) is a broad anti-avoidance rule that can be applied to many transactions involving the acquisition or disposition of shares of a foreign affiliate of a Canadian taxpayer as part of a tax-advantageous structure. Most tax advisors maintained that the scope of the rule should be limited to the manipulation of foreign affiliate or controlled foreign affiliate status. On 23 April 2014, the Federal Court of Appeal strongly supported the latter interpretation in its decision in *The Queen v. Lehigh Cement Limited* and *The Queen v. CBR Alberta Limited* (*Lehigh*). This should ease concerns raised by the previous Tax Court of Canada decision and constrain the CRA's ability to assess the provision in a broad range of circumstances.

Paragraph 95(6)(b)

Paragraph 95(6)(b) is an anti-avoidance rule that may apply to deem foreign affiliate shares not to have been issued for certain purposes. If the rule applies in respect of shares of a foreign corporation on which dividends have been paid, the shareholder must include the dividends in income but is not allowed to claim a deduction in respect of the dividends received, since the deduction requires the dividends to be paid on shares of a foreign affiliate owned by a taxpayer.

The provision generally applies where a person or partnership acquires or disposes of shares of a corporation "and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax…that would otherwise be payable." Unlike the general anti-avoidance rule (GAAR), there is no exception for transactions that are not abusive, there is no reference to a series of transactions including the acquisition or disposition and there are no rules with respect to recharacterizing the transaction or series of transactions that occurred. The shares simply are deemed not to have been acquired or disposed of if the rule applies.

The example of the rule's application provided in the technical notes issued by the Department of Finance discusses a situation where 11% of the shares of a nonresident corporation are acquired by a foreign affiliate of an unrelated Canadian parent company to obtain foreign affiliate status in respect of the nonresident corporation and avoid the taxation of interest income on a loan to that corporation. The shares will be sold back to the seller when the loan is repaid.

Consistent with that example, most commentators have considered the rule to be a "status rule" that is intended to apply in situations where shares are issued or disposed of either to obtain the 10% threshold for foreign affiliate status with respect to the issuer or to avoid controlled foreign affiliate status (which requires the shareholder to include in income any foreign accrual property income of the issuer).

CRA's assessing policy

The CRA has taken a broader view of the provision. In the 1990s, the CRA applied the rule to reassess many "second-tier finance company" structures, including the structure in *Lehigh*, in which a Canadian subsidiary of a foreign parent company capitalized a foreign affiliate to provide financing to a related foreign company in which it did not hold an equity interest. The introduction of the "indirect loan rule" in subsection 17(2) of the Act in 1998 forced taxpayers to unwind these structures, but litigation is still pending for many taxpayers. The CRA did not accept that the 2005 decision of the Tax Court in *Univar Canada Ltd. v. the Queen*, which held that the provision did not apply to such a structure, was generally applicable but rather continued to pursue these cases.

The CRA also has applied paragraph 95(6)(b) to reassess at least one Canadian subsidiary of a foreign parent company for borrowing to acquire preferred shares of a related nonresident corporation. That litigation is still pending.

Income Tax Technical News Number 36 was released in 2007 to describe the CRA's current assessing policy on paragraph 95(6)(b). In general, the CRA applies an arithmetic approach, comparing the before-tax and after-tax return from the investment. With respect to borrowing to acquire preferred shares of a foreign affiliate, for example, the CRA considers the principal purpose of the acquisition to be the avoidance of tax since the after-tax return from the interest deduction and the dividend exemption far exceeds the economic return from the investment. However, the CRA indicates that it will not mechanically apply the provision to an investment in a financing entity used to finance another foreign affiliate of the taxpayer, since the return from the investment in the other foreign affiliate is unquantifiable and may exceed the tax benefit from the financing structure.

Lehigh

In *Lehigh*, a Canadian subsidiary (CBR Canada) of a Belgian parent company borrowed money in 1995 and, in conjunction with its Canadian subsidiary, CBR Alberta, established a US limited liability company (NAM LLC). NAM LLC made two loans totaling USD 100 million to an indirect US subsidiary of the same Belgian company (CBR US). CBR Canada owned preferred shares in the US parent of CBR US but those preferred shares were redeemed as part of the refinancing. CBR US and its US parent company used the funds to repay existing intercompany financing, including the redemption of the preferred shares. CBR US paid interest on the loans to NAM LLC that was deemed to be exempt surplus under the tax rules in effect at the time. NAM LLC paid dividends to CBR Canada and CBR Alberta in 1996 and 1997, which were included in income under section 90 of the Act and deducted in computing income as exempt surplus dividends received from a foreign affiliate. CBR Canada also claimed over USD12 million of interest expense relating to the investment over the relevant period.

The structure was unwound in late 1997 and CBR Canada invested the USD 100 million in shares of CBR Alberta which, in turn, invested in preferred shares of CBR US (CBR Alberta was used as an intermediary due to a restrictive bank covenant).

The CRA applied paragraph 95(6)(b) to deny a deduction under section 113 of the Act for the dividends received in 1996 and 1997. The GAAR was also originally assessed, but later abandoned.

2013 tax court decision

The tax court rejected the taxpayers' contention that paragraph 95(6)(b), based on its text, context and purpose, is only intended to apply to the acquisition or disposition of shares to manipulate foreign affiliate status, and that the lack of a "series of transactions" test within the rule means that one cannot consider related transactions, such as the borrowing, to determine the purpose of the acquisition or disposition of the shares. The broad wording of the provision and the lack of an exception for transactions that are not abusive led the court to conclude that parliament must have intended the provision to apply to all acquisitions or dispositions of shares of a foreign corporation that are principally tax-motivated.

However, the court concluded that the provision did not apply to the taxpayers. The court stated that, to apply the provision, three tests must be met:

1) One must identify the tax that would "otherwise be payable" that the taxpayers are alleged to have avoided;
2) The acquisition or disposition of the shares must have permitted this reduction, avoidance or deferral of tax; and
3) The purpose of the acquisition or disposition must have been to achieve the reduction, avoidance or deferral of tax.

The provision was held not to apply because the first test could not be met. In determining the "tax otherwise payable" by the taxpayers if the acquisition of the NAM LLC shares had not occurred, the court did not accept the Crown's argument that the deductions claimed by the taxpayers in respect of the dividends received were sufficient to indicate that there was tax otherwise payable if the shares had not been acquired, similar to the concept of "tax benefit" that applies for purposes of the GAAR.

The court accepted the taxpayers' argument that the existence of tax otherwise payable can only be determined by comparing the transaction that occurred to another transaction that might reasonably have been undertaken by the taxpayer. The court held that the most reasonably alternative transaction would have been a borrowing to acquire shares of CBR US directly, as occurred when the structure was unwound in 1997.

While it was not necessary to decide the issue given the finding that no Canadian tax was "otherwise payable", the court found that, since no tax would have been payable in Canada had the alternative transaction been undertaken, the principal purpose of the acquisition of the NAM LLC shares (test 3) was to avoid US tax (by allowing CBR US to deduct interest expense on the loans from NAM LLC).

Federal Court of Appeal (FCA) decision

While the taxpayer also prevailed on appeal, the FCA applied very different reasoning than the tax court judge.

The FCA stated that an examination of each of the text, context and purpose of paragraph 95(6)(b) led to the conclusion that the paragraph "is targeted at those whose principal purpose for acquiring or disposing of shares in a non-resident corporation is to meet or fail the relevant tests for foreign affiliate, controlled foreign affiliate or related-corporation status…with a view to avoiding, reducing or deferring Canadian tax." In short, the rule is one of many specific anti-avoidance rules and should not be used to address a wide variety of transactions in which shares of a nonresident corporation are acquired or disposed of in circumstances that are of concern to the Minister of National Revenue.

It was noted that the rule specifically does not contain wording that refers to "a series of transactions" unlike many other anti-avoidance rules. The FCA noted that there was no basis for it to read in those words, and "good reason not to." In this respect, the FCA noted that the entire series of transactions can be considered for the purpose of discerning the taxpayer's principal purpose for acquiring or disposing of the shares, but not to discern a tax avoidance purpose that is not a specific target of the provision.

The FCA was very concerned with the implications of applying the CRA's broad view of the scope of paragraph 95(6)(b). Noting that, unlike the GAAR, the provision contains no exception for circumstances where a transaction is not abusive, the FCA stated it "would be loathe to interpret paragraph 95(6)(b) in a way that gives the Minister such an unlimited and ill-defined discretion – a standardless sweep – as to whether or not a tax is owing, limited only by her view of unacceptability."

Implications

This decision will be welcomed by taxpayers and their advisors. It confines the scope of paragraph 95(6)(b) to situations where the status of a nonresident corporation is manipulated, similar to the example in the technical notes. Related transactions, such as borrowing to make an investment in a foreign affiliate, should have no relevance. The uncertainty created by the tax court decision has been addressed, both in terms of the potentially broad application of the rule to many common transactions and the difficulty of discerning a reasonable alternative transaction for determining the "tax otherwise payable" if the transaction was not undertaken.

Most situations of concern to the CRA should now be left to the application of the GAAR, which contains the appropriate safeguards to address abusive tax avoidance.

The decision also will be welcomed by many taxpayers, like Lehigh, who were assessed under the provision many years ago for transactions that would no longer be possible under today's tax rules. Hopefully the decision will lead to a resolution of these long-standing tax disputes.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see **www.deloitte.com/about** for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's more than 200,000 professionals are committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte network") is, by means of this communication, rendering professional advice or services. No entity in the Deloitte network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2014. For information, contact Deloitte Touche Tohmatsu Limited.