

Tax Memo

The FCA Decision in *Prévost Car Inc.*— Beneficial Ownership for Tax Treaty Purposes

On February 26, 2009, the Federal Court of Appeal's (FCA's) decision in **The Queen v. Prévost Car Inc.**¹ was released. This case is the first to deal with the meaning of "beneficial owner" in the context of a Canadian tax treaty. In recent years, when the Canada Revenue Agency (CRA) has considered improper "treaty shopping" to have taken place, it has used as one of its strategies to deny treaty benefits the argument that a particular item of income sourced in Canada was not "beneficially owned" by the direct recipient of that income, a treaty-resident entity.

The FCA decision in **Prévost**, upholding the ruling of the Tax Court of Canada (TCC)² in favour of the taxpayer, is significant in that it:

- confirms that arguments based on lack of beneficial ownership are unlikely to become the broad anti-treaty shopping tools that the CRA might have hoped for; and
- adds to the limited Canadian jurisprudence on treaty interpretation and permitted interpretive tools.

The CRA had taken the position that a Netherlands holding company was not the "beneficial owner" of dividends paid to it by a Canadian corporation and that the treaty withholding rate was not available. The dividend article of the Canada-Netherlands tax treaty³ (the "Treaty") contained typical language that provided for a low withholding rate for a dividend paid by a Canadian corporation to a corporation resident in the Netherlands that was the "beneficial owner" of the dividends and that held a requisite percentage of the shares of the Canadian payor.

In brief, the FCA dismissed the Crown's appeal from the decision of the TCC finding that the holding company was the beneficial owner of dividends received from the Canadian taxpayer. In finding that the appeal should be dismissed, the FCA determined that important findings of fact were supported by the evidence and that no "palpable or overriding error" had been shown to have been made in the findings of fact, nor had the trial judge used an incorrect approach in interpreting the treaty provisions.

The Facts

A holding company was established in the Netherlands by two arm's length companies, Henlys Group plc, a British company, and Volvo Bussar Corporation, a Swedish company. Volvo held 51% of the shares of the holding company and Henlys held 49%. The holding company was formed to hold the shares of **Prévost Car Inc.**, the Canadian taxpayer, in what was essentially a joint venture arrangement. The holding company was formed as a vehicle for Henlys and Volvo to

1. 2009 FCA 57.

2. 2008 DTC 3080 (TCC). The case was heard by (then) Associate Chief Justice Rip, who is now the Chief Justice of the Tax Court of Canada.

3. Convention between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Article X.

pursue multiple North American projects although Henlys soon encountered financial difficulties and in fact no other holdings were acquired.

A shareholders' agreement entered into between Henlys and Volvo set out a distribution policy under which 80% of the profits of the companies under joint ownership (i.e., the "Corporate Group" consisting of the holding company, the Canadian taxpayer and any other subsidiaries that might be formed or acquired) would be distributed each year in the form of dividends, returns of capital or repayments of loans. The distribution of the profits was subject to there being sufficient financial resources retained by the Corporate Group to meet normal and foreseeable working capital requirements.

Neither the holding company nor the Canadian taxpayer was a party to the shareholders' agreement. The holding company had no physical office or employees in the Netherlands or elsewhere. All of the members of the Canadian company's board of directors were also members of the board of directors of the holding company.

The acquisition of **Prévost Car Inc.** was completed in 1995. Dividends were paid in each of the 1996 through 2001 years. Tax was withheld on the dividends at the applicable rate under the Treaty (i.e., 6% or 5%, depending on the year). Dividends paid by **Prévost Car Inc.** were matched by corresponding dividends declared and paid by the holding company.

The CRA argued that the Netherlands holding company was not the beneficial owner of the dividends received because the holding company was simply a "conduit" or "funnel" for the dividends. The CRA assessed withholding tax:

- at 15% (under the Canada-Sweden Income Tax Convention 1996) on 51% of the dividends; and
- at 10% on 49% of the dividends (under the Canada-United Kingdom Income Tax Convention 1978).

The CRA later argued that these rates had been in fact a concession and that withholding tax should have been withheld and remitted at 25%.

Tax Court of Canada Decision

The TCC discussed at length expert evidence adduced as to Dutch law and the development of the OECD Model Tax Convention and the Commentaries on the Model Tax Convention, as well as different approaches that might be

taken to determine the meaning of "beneficial ownership" (and "bénéficiaire effectif" in the French version of the Treaty) for the purposes of the Treaty. In the end, although the TCC found for the taxpayer, it was somewhat unclear what weight had been put on each of the authorities cited and experts quoted.

The TCC determined that the relevant provisions of the Treaty required it to look primarily to the domestic meaning of "beneficial ownership" in applying the dividend article of the Treaty. In particular, the TCC mentioned paragraph 2 of Article 3 of the Treaty, which provided (and continues to provide) that any term not defined in the Treaty shall, unless the context otherwise requires, have the meaning that it has under the law of the State applying the Treaty. Reference was also made to the Canadian domestic law, specifically the *Income Tax Conventions Interpretation Act*, which contains a provision similar to that in paragraph 2 of Article 3 of the Treaty.

Implicitly, the TCC rejected the approach followed in at least one British case,⁴ in which the court suggested that, when treaty interpretation is concerned, "beneficial ownership" has an "international fiscal meaning" different from its domestic law meaning. The TCC found that, applying Canadian domestic law, the "beneficial owner" of dividends should be considered to be the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received:

In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income.

The TCC analysis, however, admitted the possibility that an entity might be a conduit and on that basis not considered the beneficial owner of an item of income. The TCC described the testimony of an expert witness who had referred to the 1986 OECD Conduit Companies Report and in particular, one portion of the report. That part of the report states that while the 1977 Commentary had referred to the case of a nominee or agent, it should also be understood that "a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interest parties."

4. *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London*, [2006] EWCA civ 158, [2006] S.T.C. 1195 9Eng. C.A.). This was not a tax case.

However, the TCC found that on the facts, the Netherlands holding company was not a nominee or agent for its shareholders, nor was it in the position of having absolutely no discretion as to the use or application of funds put through it as a conduit. The TCC found it significant that the holding company was not itself a party to the shareholders' agreement and further found that there was no predetermined or automatic flow of funds to Henlys or Volvo. The TCC found that there was "no evidence" that the dividends from **Prévost** were *ab initio* destined for Volvo and Henlys.

Perhaps most significantly, the TCC found that until the management board (board of directors) of the holding company declared an interim dividend and that dividend had been approved by the shareholders, the monies represented by the dividend continued to be an asset of the holding company and available to its creditors, if any.

Appeal to Federal Court of Appeal

The Crown appealed the decision of the TCC. However, the FCA dismissed the appeal, concluding that the TCC did not make any palpable or overriding error in interpreting the term "beneficial owner" or in applying the relevant concepts to the facts. The FCA referred to the TCC judge's statement that "one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit" and endorsed this formulation as "captur[ing] the essence" of the concept of "beneficial owner" (in French, "bénéficiaire effectif") as it emerges from a review of the "general, technical and legal meanings of the term."

To this extent, therefore, the FCA seems clearly to accept the principle that absent a determination that the legal owner of property is an agent or nominee, or has absolutely no discretion as to the use or application of funds arising on the property, the legal owner will also be considered the beneficial owner for purposes of a treaty with terms such as those contained in the Netherlands Treaty. Further, the Crown's assertion that the holding company should be ignored was characterized as "asking the Court to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian government through the process of objection, have adopted."

It is somewhat intriguing that the FCA did not mention or comment on the fact that a key component of the trial judge's approach and reasoning was the provision in the Treaty that directs the meaning of an undefined term to be taken from the domestic laws of the State applying the Treaty, unless the context otherwise requires.

Instead, after endorsing the trial judge's formulation of the test, the FCA states that "most importantly" this formulation accords with what is stated in the OECD Commentaries and in the OECD 1986 Conduit Companies Report and, based on its comments, clearly considers that not only the 1977 Model Tax Convention and the Commentaries thereon, but later OECD Commentaries, including commentaries on the 2003 Model Tax Convention, could and should be taken into account.

Canadian courts have clearly endorsed the use of the OECD Model Tax Convention and the Commentaries thereon as guidance in interpreting a particular treaty.⁵ There has, however, been debate concerning the extent to which later modifications to a Commentary are relevant. The Canada-Netherlands Treaty was based on the 1977 OECD Model Tax Convention. The Commentary on Article X (the dividend article) of the 1977 Model Tax Convention stated that the treaty rate was not available when an intermediary, such as an agent or nominee, was interposed between the beneficial owner and the payer. It went on to say that states that wish to do so are free to make this more explicit during bilateral negotiations. As noted by the trial judge, Canada had not undertaken any negotiations with the Netherlands to make the relevant provisions more explicit.

In 2003, the OECD Commentary to Article X was modified to add a statement that the term "beneficial owner" used in such Article was not used in a narrow technical sense but, rather, it would be understood in its context and in light of the object and purposes of the Convention. As noted above, in 1986, the OECD Conduit Companies Report concluded that a "conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties." However, that Report also stated that the fact that a conduit company's main function was to hold assets or rights was not itself sufficient to categorize it as a mere intermediary. It was

5. **Crown Forest Industries Limited v. Canada**, [1995] 2 S.C.R. 802 (Supreme Court of Canada).

expressly observed that the 1977 Model Tax Convention dealt with the conduit situation in only a rudimentary way, which was why the Commentary mentioned the possibility of defining more specifically during bilateral negotiations the appropriate treatment of such companies.

The FCA in **Prévost Car** states that later Commentaries may be taken into account when:

- they are a fair interpretation of the words of the Model Convention
- they do not conflict with Commentaries in existence at the time a specific treaty was entered into; and
- neither treaty party has registered an objection to the new Commentaries.

Therefore, the OECD Conduit Companies Report and the OECD 2003 Amendments to the 1977 Commentaries were to be considered a helpful complement to the earlier Commentaries, insofar as they were eliciting, rather than contradicting, views previously expressed. To the extent that the TCC might have suggested in its decision in **MIL Investments S.A. v. The Queen**⁶ that it was not permissible to consult a later commentary, this proposition was rejected by the FCA.

It would seem in light of these statements that the FCA must be considered to have found the trial judge's conclusion that, on the facts, the Netherlands holding company was the beneficial owner of the dividends, to be consistent not only with commentary on the 1977 Model Tax Convention but also with the 1986 Conduit Companies Report and the 2003 Model Tax Convention and Commentaries thereon, even though the trial judge did not expressly refer to the 2003 Commentaries. This seems fair, because the trial judge referred to the Report, and the statement from the Report that is referred to in the trial judge's reasons is adopted almost verbatim in the 2003 Commentaries.

Significance of the Federal Court of Appeal Decision

The FCA decision clearly signals the importance attached by that court to OECD Commentaries and further, that in the view of that court the Commentaries as modified from time to time are also relevant interpretive guides, except to the extent that a later Commentary clearly conflicts with OECD Commentary in place at the time the treaty was negotiated or ratified.

With respect to the issues surrounding the use of intermediaries resident in treaty jurisdictions, the outcome suggests that if the Canadian tax authorities are offended by planning that involves holding company structures it may take more than an argument based on lack of beneficial ownership to counter the use of such arrangements. Nevertheless, it remains of utmost importance that all of the facts and circumstances be considered and that care be taken when these structures are put in place and, of course, on an ongoing basis.

No information is available at this time concerning the likelihood that the Crown will apply for leave to appeal to the Supreme Court of Canada.

6. 2006 DTC 3307 (TCC), Appeal dismissed, **The Queen v. MIL (Investments) S.A.**, 2007 DTC 5437 (FCA).

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