Tax Insights
from Tax Services
Issue 2014-23

Federal Court rules on 95(6)(b) in Lehigh

April 24, 2014

In brief

On April 23, 2014, the Federal Court of Appeal (FCA) released an important decision on the scope of paragraph 95(6)(b), an anti-avoidance rule found in the part of the *Income Tax Act* (the Act) that governs the tax treatment of 'foreign affiliates' of Canadian corporations.

There has been a wide gap between the view of the Canada Revenue Agency (CRA) as to the scope of the rule and the interpretation of the rule by the tax advisor community. The case, **The Queen vs. Lehigh Cement Limited and CBR Alberta Limited**, confirms a narrow interpretation of the rule, as contended for by the taxpayer.

In brief, paragraph 95(6)(b) states that, for the purposes of the foreign affiliate rules, when a person 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 or any other amount that would otherwise be payable under the Act, that acquisition or disposition is deemed not to have taken place.

The FCA rejected the CRA's view that paragraph 95(6)(b) functions as a broad anti-avoidance rule that may be invoked by the CRA at its discretion when it believes that the acquisition or disposition of the shares of a foreign affiliate results in what it considers to be abusive tax avoidance.

The FCA further rejected the view that in interpreting the provision, words could be read into the rule that permitted the purpose of a series of transactions of which the share acquisition is a part to be considered.

In detail

In this case, the Canadian corporations involved in the appeal, Lehigh and CBR Alberta, had borrowed to acquire shares of a US corporation that (if paragraph 95(6)(b) did not apply) had foreign affiliate status in relation to them.

This status permitted them to receive dividends on the shares that were not taxable by virtue of the foreign affiliate regime in the Act (as it applied at that time). Lehigh and CBR Alberta obtained a deduction for the interest on the borrowing, which could be used to offset other income.

The CRA's view was that the share acquisition had as its purpose the generation of the tax savings attributable to the permitted interest deduction, and that paragraph 95(6)(b) allowed the acquisition of the shares to be ignored when determining whether the US corporation was a foreign affiliate.

Therefore, the dividends should not be treated as dividends from a foreign affiliate.

The appeal had actually been launched by the Crown, because while the Tax Court of Canada (TCC)[i] had generally favoured the CRA's approach to the rule, it came to a view of the purpose of the transactions that allowed it to conclude in favour of the taxpayer.

The FCA upheld the decision for the taxpayer, but came to this view by applying a very different interpretation of the rule than had been adopted by the TCC.

In summary

The FCA found that based on the context of the rule, its purpose was to address the manipulation of share ownership of a non-resident corporation to meet or fail the relevant tests for foreign affiliate or controlled foreign affiliate status, and it was not intended to act as a broad general anti-avoidance rule.

In coming to this view, the FCA commented on a number of specific targeted measures that had been enacted to counter the type of planning involved in the case, most recently the 'foreign affiliate dumping' rules that were introduced in 2013, and noted that such rules would not have been necessary if paragraph 95(6)(b) were the broad anti-avoidance rule that the CRA suggested it should be.

[i] 2013 TCC 176

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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