

# Preventing treaty shopping: Finance seeks input on possible measures

August 14, 2013

## *In brief*

The Department of Finance (Finance) has released a consultation paper on possible measures to prevent 'treaty shopping.' Comments must be submitted to Finance by December 13, 2013.

## *In detail*

### **Background**

Canada has tax treaties with over 90 countries – one of the largest networks in the world.

The March 21, 2013 federal budget announced that the government would consult on possible measures that would protect the integrity of Canada's tax treaties while preserving a business tax environment that is conducive to foreign investment. To fulfill this mandate, on August 12, 2013, Finance released its consultation paper targeting treaty shopping.

Finance will accept comments on this consultation paper up to December 13, 2013.

### **What is treaty shopping?**

The consultation paper defines 'treaty shopping' generally as a

situation in which a non-resident:

- is not entitled to the benefits of a tax treaty with Canada
- tries to obtain treaty benefits by using an entity resident in a country that has a tax treaty with Canada to earn, through that entity, income arising in Canada

### **Comments sought**

The consultation paper invites comments on seven issues:

1. the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both
2. the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that

should be considered by Canada in evaluating how best to address the problem of treaty shopping

3. whether a general approach is preferred over a relatively more specific and objective approach
4. whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers
5. which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration

6. for those who favour a more specific approach over a main purpose approach – the design of the conditions and the exceptions (e.g. the substantive business operations and derivative benefits exceptions) under a more specific approach as well as any other exceptions that should be considered under this approach to ensure the measure is effective and applies in a reasonably straightforward manner with predictable outcomes
7. whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule

### **PwC observations**

It is evident that, in Finance's view, the government's attempts to address treaty shopping in the Courts have been unsuccessful, and, as a result, Finance believes the CRA requires clearer legislative authority to

successfully challenge treaty shopping arrangements.

Further, although Finance indicates the intention of this consultative process is to examine a range of possible approaches to address the practice of treaty shopping into Canada, Finance seems to favour a domestic treaty override approach.

One possible specific domestic anti-treaty shopping rule introduced in the paper could deny tax treaty benefits to an entity when:

- the entity is owned or controlled by residents of one or more third countries
- the entity pays no or low taxes, in the country in which it is resident, on the income earned in Canada
- the entity is not engaged in substantive business operations in its country of residence (i.e. a substance test)

- the third country residents that own or control the entity are not all resident in a country with which Canada has a tax treaty, and, if resident in a country with which Canada has a tax treaty, that treaty provides at least as much tax relief in respect of the income as the particular tax treaty the entity is relying on (i.e. a derivative benefits test)

Canadian taxpayers and foreign residents earning income from Canada will want to follow developments in this area closely as Canada more fully considers how it should address perceived treaty shopping.

### **Let's talk**

For a deeper discussion of how this issue might affect your business, please contact:

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