Canadian Tax Court comments on cross-border financing structure

Moodys Tax
June 3, 2013

"Taxpayers jockey to get on the right side of the distinctions to take advantage of the rules."
– Professor Vern Krishna as quoted in *Lehigh Cement Limited* v. *R.* –

The Tax Court of Canada recently released their decision in *Lehigh Cement Limited* v. *R.* and *CBR Alberta Limited* v. *R.*, 2013 TCC 176, which deals with whether a cross-border financing structure ran afoul of a specific anti-avoidance provision in the *Income Tax Act* (the "Act"). The Court closely examined the wording of the provision and held in favour of the Taxpayers (collectively, Lehigh Cement Limited and CBR Alberta Limited).

Briefly, the Taxpayers undertook a reorganization and invested in the capital of a United States limited liability corporation (the "LLC") which loaned money to a related corporation undertaking operations in the United States who then accordingly paid interest to the LLC who in turn paid dividends to the Taxpayers. A taxpayer's foreign affiliate status is determined under the Act on the basis of shareholdings in a non-resident corporation. In order for a taxpayer to be able to deduct dividends received under paragraph 113(1)(a) of the Act the dividends must be paid out of exempt surplus of a non-resident corporation and the non-resident corporation must meet the definition of "foreign affiliate" in the Act. However, if the shares in the non-resident corporation are acquired for the purpose of avoiding tax, then paragraph 95(6)(b) of the Act applies to deem the shares not to have been acquired. The Minister of National Revenue (the "Minister") reassessed the Taxpayers under paragraph 95(6)(b) of the Act which resulted in a denial of the deduction of dividends received under paragraph 113(1)(a) of the Act.

The reorganization involved the Taxpayers obtaining an interest bearing bank loan and using these funds to invest in the capital of the non-resident corporation. The reorganization, amongst other benefits, intended to produce a tax savings of US$1.92 million per year in Canada for the Taxpayers as the Taxpayers would receive tax exempt dividends from the non-resident corporation while being able to deduct the interest expense related to the bank loan.

The appellants advocated for a largely textual interpretation of paragraph 95(6)(b) of the Act focusing on the purpose of the share acquisition itself rather than the purpose of the series of reorganization transactions. The appellants' interpretation focused on the plain meaning of the words in the provision as opposed to undertaking a contextual or purposive interpretation. The Minister noted the similarity of the wording between paragraph 95(6)(b) of the Act and the general anti-avoidance rule (the "GAAR") found in section 245 of the Act and stressed that a GAAR like analysis should be used to objectively assess the broader purpose of the transactions. The Court looked to the history of the provision and concluded that paragraph 95(6)(b) of the Act will apply to any acquisition or disposition of shares that is principally tax-motivated, not just those where the shareholdings in the non-resident corporation are manipulated in a manner that masks the true economic ownership.

The Tax Court of Canada stated that there are three stages to an inquiry under paragraph 95(6)(b) of the Act: the first being to identify the tax otherwise payable under the Act that the taxpayer intended to avoid, next to determine whether the acquisition or disposition of the shares permitted this avoidance, and lastly to assess the taxpayer's purpose in acquiring the shares. The Court noted the difference in wording between paragraph 95(6)(b) of the Act which uses the phrase "tax… that would otherwise be payable" and the definition of "tax benefit" under the GAAR. The phrase "tax otherwise payable" necessitates a comparison with an alternative situation and the Tax Court of Canada held that no additional tax would have been payable if an alternative transaction been undertaken, thus there can be no tax avoided as a result of the share acquisition and paragraph 95(6)(b) of the Act is not applicable.

As an aside, at trial the Minister abandoned their argument based on the general anti-avoidance rule (the "GAAR") to support the reassessment of the Taxpayers. Based on Justice Rothstein's comments in *Lipson* v. *R*., 2012 SCC 1, in It is unlikely the Minister would have been successful on the GAAR argument given that a more specific anti-avoidance rule applied to the situation at hand.

As with all tax transactions, the devil is in the detail and taxpayers need to turn their attention to the details if they want to "get on the right side of the distinctions."