It's high time - provisions should be read narrowly: Lehigh

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May 5, 2014

Short summary

On April 23, 2014, the Federal Court of Appeal (the "FCA") released its decision in *The Queen v Lehigh Cement Limited* ("Lehigh"). The Lehigh case involved a double-dip structure which the Canada Revenue Agency (the "CRA") attacked using an anti-avoidance rule in paragraph 95(6)(b) of the Income Tax Act (Canada) (the "Act"). Although the Tax Court of Canada ("TCC") ruled in favour of the taxpayer in 2013, its broad interpretation of that anti-avoidance rule surprised many practitioners and may have had wider implication to the interpretation of other specific anti-avoidance rules in the Act. On the appeal, the FCA revisited the issue and found that a narrow reading of the provision at issue was more appropriate. A textual focus in interpreting anti-avoidance provisions will give certainty to tax planners as they design their plans around these specific rules. However, a narrow interpretation of specific anti-avoidance provisions could increase the CRA's reliance on the GAAR resulting in more GAAR reassessments for taxpayers.

Background

Before diving into the facts of Lehigh, here is a quick refresher on how Canada taxes foreign subsidiaries. Under Canadian rules, a non-resident corporation is a "foreign affiliate" of a Canadian taxpayer if the Canadian taxpayer holds at least one percent of any class of shares in the non-resident and the taxpayer's holdings, when combined with the holdings of any related person, total ten percent or more. A foreign affiliate may also be a "controlled foreign affiliate" if it is controlled by the Canadian taxpayer.

The Act requires that dividends received from a non-resident corporation be included in the recipient taxpayer's income. However, dividends received from a foreign affiliate that are paid out of the affiliate's "exempt surplus" are exempt from Canadian tax by virtue of paragraph 113(1)(a) of the Act. Generally speaking, exempt surplus is active business income earned by the foreign affiliate in a country with which Canada has a tax treaty or a tax information exchange agreement. If the foreign affiliate is also a controlled foreign affiliate, certain passive income is imputed to the Canadian taxpayer even if it has not been received by the Canadian taxpayer – such imputation is known as foreign accrual property income or "FAPI".

Investment income such as interest is normally not active business income. However, in order to assist Canadian multi-nationals with financing their foreign subsidiaries, the Canadian tax rules (at the time of the Lehigh transactions) provided for re-characterization of interest received by a foreign affiliate from a related non-resident corporation as active business income, to the extent the interest related to the non-resident payor's own active business. Such re-characterized income would form part of the foreign affiliate's exempt surplus and would not trigger FAPI imputation.

Facts

Lehigh Cement Limited ("LCL") was a member of a multi-national organization headed by a Belgian company. Its sister companies in the US (CBR ICA and its subsidiary CBR US) were financed partially by a sale of preferred shares to LCL in 1991 and partially by borrowings from other entities within the organization. In 1995, a series of re-financing transactions were undertaken which may be summarized as follows:

- LCL and a Canadian subsidiary set up a Delaware limited liability company (NAM LLC);
- LCL borrowed funds at interest (one tranche at 6.7% and the other at 6.84%) and contributed them to NAM LLC;
- NAM LLC lent the funds to CBR US at an interest rate of 8.25%;
- CBR US used the funds to repay outstanding debts and paid a dividend to CBR ICA so that CBR ICA could redeem its preferred shares previously issued to LCL.

For Canadian tax purposes, NAM LLC met the definition of both "foreign affiliate" and "controlled foreign affiliate" since it was wholly owned by LCL and its Canadian subsidiary. The interest income received by NAM LLC was re-characterized as active business income because the payor, CBR US, was a related party and the interest expense was in respect of the payor's active business. Therefore, the interest income formed exempt surplus allowing NAM LLC to pay dividends to LCL that LCL could treat as tax-free dividends under paragraph 113(1)(a) of the Act. At the same time, LCL was able to deduct the interest on the borrowings.

For US tax purposes, NAM LLC was treated as a pass-through entity and not subject to tax. The interest paid by CBR US to NAM LLC was considered to be the income of LCL and subject to U.S. withholding tax of 10% only (that was the withholding rate during 1995). Meanwhile, CBR US was able to increase its net operating losses carry forward by claiming the interest expense. Additionally, the structure provided for Belgian tax benefits.

The overall result: interest deductions and no corresponding taxable income for both Canadian and US purposes, with Belgian tax benefits on top.

When the Minister stumbled across this structure, it disallowed the tax-free treatment of the exempt surplus dividend LCL received from NAM LLC, and it based its reassessment on paragraph 95(6)(b) of the Act which is a specific anti-avoidance provision. This provision states that, for purpose of subdivision i (which deals with income from a non-resident corporation), where a person acquires or disposes of shares 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 tax payable under the Act, that acquisition or disposition is deemed not to have taken place. The Minister also relied on the General Anti-Avoidance Rule ("GAAR") in section 245 of the Act in its reassessment, but had abandoned that position at trial.

The Tax Court of Canada decision

Counsel for LCL 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. Based on this reading, LCL argued that paragraph 95(6)(b) of the Act applies specifically to situations where shares are acquired or disposed of in order to manipulate foreign affiliate status. The Minister noted the similarity of the wording between paragraph 95(6)(b) of the Act and the GAAR stressing that a GAAR-like analysis should be used to objectively assess the broader purpose of the transactions. Using this approach, the Minister argued that the principal purpose of LCL acquiring shares

in NAM LLC was to earn tax-free dividends while obtaining an interest deduction and hence paragraph 95(6)(b) of the Act applied.

The TCC agreed with the Minister concerning the breadth of paragraph 95(6)(b) of the Act. However, the TCC found that LCL's principal purpose for the acquisition was to avoid U.S. tax rather than Canadian tax, because the same Canadian tax result would arise under an alternative structure – i.e. if LCL borrowed and used the funds to purchase shares of CBR US. Since no Canadian tax was avoided as a result of the share acquisition, paragraph 95(6)(b) of the Act was not applicable.

The FCA decision

The same two issues heard at the TCC were put before the FCA: what was the taxpayers' principal purpose in acquiring the shares and what is the proper interpretation of paragraph 95(6)(b) of the Act? The key issue is whether one can look to the principal purpose of a series of transactions, which include an acquisition or disposition of shares, when considering paragraph 95(6)(b) of the Act. The FCA noted the broad principles of statutory interpretation, text, context and purpose, as per *Canada Trustco*, but noted that this case also invites "a largely textual interpretation" of the Act. Quoting from *Shell Canada Ltd.*, the Court reiterated that where the provision is "clear and unambiguous the words must be simply applied". The FCA held that the wording of paragraph 95(6)(b) of the Act is clear and adopted the taxpayer's position that the principal purpose for the acquisition or disposition, not for the series of transactions, is the focus of the analysis. The Court noted that where more than one transaction is to be considered the phrase "part of a series of transactions or events" is used in the Act.

The Court buttresses their analysis by noting recent amendments to other provisions in the Act, such as the "foreign affiliate dumping" provisions, would have been unnecessary if paragraph 95(6)(b) was to be interpreted as a broad anti-avoidance provision, as suggested by the Minister. The placement of paragraph 95(6)(b) within the Act is also of importance as it is located in subdivision i of Division B of Part I, which focuses on the computation of income and if the provision was intended to be an anti-avoidance provision, it would likely be located in a more general part of the Act, such as Part XVI which focuses on tax avoidance.

Our Take

It is interesting to compare the FCA's analysis in Lehigh with the Court's analysis in *MacDonald*. While the Court in MacDonald notes the textual phrase "in any manner whatever" of the provision, the Court appears to take a broader approach by looking to who initiated the transaction, who received the funds or property from the transaction and the circumstances surrounding the transaction. In MacDonald, the Court criticized the trial judge for not focusing on statutory phrase "in any manner whatever" and this conclusion appears consistent with the Court's textual focus in Lehigh.

Overall, the Lehigh case reinforces the emphasis on a textual interpretation of taxing provisions. A textual focus in interpreting anti-avoidance provisions will give certainty to tax planners as they design their plans around these specific rules. However, a narrow interpretation of specific anti-avoidance provisions could increase the CRA's reliance on the GAAR resulting in more GAAR reassessments for taxpayers. We will continue to watch the FCA's decisions to see if this trend develops.