Bloomberg Tax

Tax Management
International Journal™

October 23, 2024

Reproduced with permission from Tax Management International Journal, 10/21/2024. Copyright @ 2024 by Bloomberg Industry Group, Inc. (800-372-1033) http://www.bloombergindustry.com

Courts Worldwide Diverge in Applying the Principal Purpose Test

Christos Theophilou*
STI Taxand

Although over 100 countries have signed the Multilateral Instrument, courts around the world have diverged in their application of the Principal Purpose Test, says Christos A. Theophilou of STI Taxand.

The OECD's Principal Purpose Test (PPT) has gained extensive adoption, with over 100 countries signing the Multilateral Instrument (MLI) and about 1,950 bilateral tax treaties being covered by the MLI. Despite this broad endorsement, there remains a conspicuous absence of precedents to inform its application. This article examines the intricate landscape of the PPT, tracing its development from the Base Erosion and Profit Shifting (BEPS) initiative to its diverse applications in judicial contexts worldwide.

Part 1 of this series analyzes the landmark decisions in the Canadian *Alta Energy Luxembourg* case, and the Argentinian *Molinos* case. Part 2 will review the 2014 UK *Burlington Loan Management DAC v HMRC* case and discuss the effect of such cases on the interpretation of the PPT. These cases underscore the complexities and nuances inherent in interpreting and applying the PPT. For a comprehensive overview of the MLI and its facets, readers are advised to consult my previous article, *OECD's Principal Purpose Test Versus EU's General Antiabuse Rule* , Bloomberg Tax Insights (July 13, 2022)).

Alta Energy Luxembourg

Facts of the case. In 2011, two US firms created a Delaware partnership (the Group), which in turn incorporated a Canadian tax resident company (Alta Canada) engaged in prospecting and drilling for oil in Canada. In 2012, the Group incorporated a Luxembourg tax resident company (Alta Luxembourg), and Alta Canada's shares were sold to Alta Luxembourg. In 2013, Alta Luxembourg realized a USD 380 million capital gain by selling the shares of Alta Canada. Under article 13 of the 1999 Canada-Luxembourg tax treaty (Canada-Luxembourg Treaty), the Canadian Revenue Authorities were restricted from taxing such a gain at source because the treaty includes the so-called "property rich clause" (similar to article 13(4) of the 2017 OECD Model) and, therefore, does not restrict the Canadian National Revenue from taxing the substantial gain at source. However, such a "property rich clause" includes a carve-out from source-based capital gains tax, the so-called "business property exemption." Therefore, Alta Luxembourg claimed tax treaty protection based on articles 13(4) and (5). That is, the gains from the alienation of any property would be taxed in Luxembourg unless articles 13(1)-(4) apply. Therefore, as the business property carve-out made article 13(4) inapplicable,the gain amounting to USD 380 million from the sale of shares of Alta Canada was not taxable in Canada.

* Christos Theophilou is a tax partner at STI Taxand in Cyprus.

However, the Canadian National Revenue argued that under the domestic general anti-avoidance rule (GAAR),the sale of shares was an avoidance transaction. The Canadian National Revenue appealed unsuccessfully before the Tax Court of Canada and the Canadian Federal Court of Appeal. The Supreme Court of Canada (SCC) held in favor of the taxpayer and dismissed the appeal of the Canadian National Revenue by majority (6:3) (*Canada v. Alta Energy Luxembourg SARL*, 2021 SCC 49). Although this case is based on a domestic GAAR, the Canadian GAAR has similarities with the PPT, and therefore the analysis of the SCC decision is of significant importance.

The SCC Decision. The key question that the SCC had to determine was whether the transaction was abusive and contrary to the object, spirit, and purpose of the Canada-Luxembourg Treaty. In doing so, the SCC began by looking at the fundamental principles of international tax treaties, such as tax treaties do not levy new taxes, bilateral treaties are usually reciprocal, and, importantly, parties to a tax treaty are presumed to know the other country's tax system when negotiating a tax treaty. Further, tax treaties aim to facilitate cross-border trade and investment and eliminate double taxation. Moreover, the SCC looked at the dual nature of tax treaties (i.e., contractual and statutory), which is particularly relevant when applying GAARs. Finally, the SCC referred to the Vienna Convention on the Law of Treaties (VCLT), which states that one must consider the ordinary meaning of the text in the light of its purpose and interpret it with the view of implementing the true intention of the parties. It should be noted that the SCC followed a "nuanced" approach regarding later Commentaries of the OECD Model and concluded that later Commentaries (i.e., amendments in 2003 and 2017) should not be considered for a tax treaty concluded in 2000. Therefore, the SCC followed the so-called "static approach" (the approach followed in the *Prevost* case in 2009 (2008 TCC 231; confirmed in appeal 2009 FCA 57)) rather than the so-called "ambulatory approach" (i.e., adopting later Commentaries such as in the 2020 *Fowler* UK Supreme Court case).

Subsequently, the SCC, in applying the GAAR, followed a three-part process: First, the SCC analyzed whether there is a tax benefit arising from a transaction. Second, whether the transaction is an avoidance transaction (the SCC stated that tax avoidance is not tax evasion). Third, whether the avoidance transaction is abusive (the SCC stated that tax avoidance should not be conflated with abuse). More specifically, the SCC noted that "even if a transaction was designed for a tax avoidance purpose and not for a bone fide non-tax-purpose, such an economic or commercial purpose, it does not mean that it is necessarily abusive within the meaning of a GAAR." To determine the third part, that is, whether a transaction is abusive, the SCC has set out a two-step inquiry:

- Step one: the provisions relied on for the tax benefit are interpreted to determine their object, spirit, and purpose (question of treaty interpretation, i.e., true intentions of the parties); and
- Step two: to undertake a factual analysis to determine whether the avoidance transaction at issue is consistent with or frustrates the object, spirit, and purpose of the provisions.

In the first step, the SCC determined whether Alta Luxembourg was considered a resident under the Canada-Luxembourg Treaty. In doing so, the SCC concluded that corporate residence was to be determined by the domestic law of Luxemburg (i.e., under the laws of the contracting state where residence is claimed) and not the source state (i.e., Canada) that is applying the tax treaty. Notably, the SCC rejected the opposing argument that meeting the definition of resident under the domestic law is not sufficient to qualify as a resident under the tax treaty. Further, unlike the so-called "includes definitions," the term resident is a "means definition." The word "means" should be construed as comprehending what is specifically described or defined. Finally, the SCC confirmed that "liable to tax" does not mean "subject to tax" (i.e., actually pay taxes), but rather, it means that a corporation is

exposed to full tax liability on its worldwide income. Therefore, being liable to tax is "liable to be liable to tax," meaning that taxes are a possibility, regardless of whether the person actually pays any.

In the second step, the SCC considered the object, spirit, and purpose of the carve-out from source-based capital gains tax business property exemption. In doing so, the SCC considered the principle of "economic allegiance" as it is used as a basis for the tax treaties allocation of taxing rights, the "beneficial ownership" provision, and the "subject to tax" limitation. Further, the SCC judges placed significant emphasis on the principles of fairness, certainty, predictability, and the taxpayers' right to minimize taxes, as well as the sanctity of negotiated treaties upheld by the contracting states (pacta sunt servanda article 26 of the VCLT). In the end, the SCC majority concluded that since Canada signed a tax treaty with Luxembourg—a recognized centre for channelling investments by third-country investors—and included the business property exemption, it aligned with the tax treaty's object, spirit, and purpose to provide the tax exemption to Atlas Luxembourg. Effectively, the SCC concluded this for the following three main reasons. First, the business property exemption was not an OECD Model recommendation (i.e., the Canada-Luxembourg Treaty negotiators intended to deviate from the OECD Model), and its inclusion was no accident but to foster international investments (Canada's preference at the time of the tax treaty for taking advantage of economic benefits yielded by foreign investments rather than higher tax revenues). Second, no anti-avoidance provision(s) was included, and therefore, there was a deliberate choice to leave the business property exemption unguarded (e.g., by negotiating and including an anti-conduit rule, a beneficial owner requirement, a purpose test, or a subject-to-tax clause), but rather the Canada-Luxembourg Treaty negotiators included a limitation on Luxembourg holding companies only. Third, regarding double non-taxation, parties to a tax treaty are presumed to know the other country's tax system when they negotiate a tax treaty.

The dissenting judgment of the minority is critically important. Alta Luxembourg was an empty shell company as it lacked substantial economic connection and only existed through a service provider. The three-person minority judges pointed out that this is a blatant tax treaty shopping case because Alta Luxembourg had no genuine economic connections with Luxembourg as it was a mere conduit interposed in Luxembourg for residents of third-party states to avail themselves of a tax exemption under the Canada-Luxembourg Treaty. So, if a GAAR does not apply in this case, when should it be applied?

A similar case in which courts are more inclined to protect interposed companies is Methanex Titan (Trinidad) Unlimited v The Board of Inland Revenue (24 ITLR 408 (2021)).

Molinos Rio

Facts of the case. The opposite side of the *Alta* case was provided in the *Molinos* case (*de la Plata SA v Direccio General Impositiva* (2021)). Molinos Rio de la Plata (Molinos Argentina) was an Argentine company with investments in Peru and Uruguay. During December 2003, Molinos Argentina set up a wholly owned Chilean holding company (Molinos Chile) as an "investment platform compan" and directed its foreign shareholdings (three Uruguayan companies and one company incorporated in Peru) in Molinos Chile. Therefore, the dividends paid by the investments in Peru and Uruguay were taxed in the hands of the Molinos Chile. However, under Chilean domestic law, investment platform companies–effectively holding companies–are subject to tax in Chile only on income sourced in Chile (i.e., only domestic dividends are taxable). Subsequently, when the dividends are paid from Molinos Chile to its parent company (Molinos Argentina), they are not taxable as the 1976 Argentina-Chile tax treaty (Argentina-Chile Treaty) allocates exclusive taxing rights to tax dividends to the state in which the

distributing entity was domiciled (i.e., in this case only in Chile). Therefore, after the restructuring, the dividends were not taxable in Argentina or Chile (i.e., double non-taxation). Notably, before the restructuring, had the dividends been paid directly from the investments in Peru and Uruguay to Molinos Argentina, such dividends would have been taxable in Argentina.

The Argentine tax authorities assessed Molinos Argentina for tax denying the treaty benefit on the dividends received over a number of years under Argentinian domestic GAAR (the domestic GAAR is based on the economic reality principle). Molinos SA appealed unsuccessfully before the lower court and the administrative court of appeal and then appealed to the Supreme Court of Argentina (SCA), arguing that article 11 of the Argentina-Chile Treaty prevented Argentina from taxing the dividends. The SCA upheld the lower court decisions. In effect, the SCA implied a principle of anti-abuse into the interpretation of the Argentina-Chile Treaty, based on the VCLT.

The SCA Decision. The Argentine tax authorities applied the principle of "economic reality" (i.e., substance over form test) under the domestic GAAR, arguing that Molinos Argentina abusively utilized the Argentina-Chile Treaty by employing the Chilean holding company as a "conduit" channelling dividends from its Uruguayan and Peruvian shareholdings through Chilean jurisdiction to avoid paying taxes on income or earnings in either Argentina or Chile. In doing so, the Argentine tax authorities argued that the creation of the Molinos Chile holding company by Molinos Argentina was unjustifiable from a corporate structure perspective, as there were no genuine economic links between Molinos Chile and the Uruguayan or Peruvian companies. They further contended that Molinos Chile lacked economic substance or legitimate business purpose, as Molinos Chile did not retain the dividends from Uruguayan and Peruvian shareholdings but were instead almost immediately transferred to Molinos Argentina. Ultimately, the Argentine tax authorities concluded that the company was established solely to avoid taxation, acting as a conduit to channel earnings from Uruguay and Peru—countries not party to the Argentina-Chile Treaty—through Chile to obtain tax treaty benefits. In sum, Molinos Chile was considereda "conduit company" (lacking economic substance) because:

- Molinos Chile was formed a year after the introduction of the new Chilean laws;
- Molinos Chile immediately repatriated the income from the Uruguayan and Peruvian companies;
- There was no tax treaty between Argentina and the countries where the income originated (Uruguay and Peru); and
- The Uruguayan companies were its main source of income, and there was no substantial income from Chile.

On the other hand, the taxpayer (i.e., Molinos Argentina) argued that there was no abuse of the Argentina-Chile Treaty. This is because Molinos Chile possessed real economic substance and legitimate business purposes and focused on expanding the group's international market share in the aftermath of the 2001 crisis. The company sought to grow by adding new business units across Latin America, Europe, and the United States, as evidenced by its annual reports and financial statements. Further, the provisions of the Argentina-Chile Treaty were wrongly interpreted because the domestic law (i.e., the domestic GAAR) cannot override the Argentina-Chile Treaty as the former is hierarchically subordinated to the latter and since there was no anti-avoidance provisions included in the Argentina-Chile Treaty.

The SCA concluded that the Argentina Constitution establishes that international treaties have a higher hierarchical position than laws; however, such a primacy is not absolute. More specifically, under the constitutional principles of public law, it is evident that no international treaty in force in Argentina can

be used in an abusive manner, regardless of whether the Argentina-Chile Treaty explicitly contains an anti-abuse provision or not. In doing so, the SCA highlighted article 26 of the VCLT (principle of good faith), article 27 (i.e., a contracting party may not invoke the provisions of its internal law as justification for its failure to perform a treaty) and of course the general rule of interpretation under article 31. Therefore, as the aim of the tax treaty was to avoid double taxation, the relevant article should be read in this respect. However, the taxpayer's intention was not to avoid double taxation but rather to achieve double non-taxation, which would not fall within the substantive scope of validity of the Argentina-Chile Treaty, interpreted in good faith. The SCA provided three arguments. First, as noted above, abusive practices cannot restrict the domestic GAAR, and therefore, abusive structures are not protected by tax treaties. Second, the Chilean Internal Revenue Service issued a circular adopting the OECD work in the application of the concept of beneficial ownership and domestic anti-abuse legislation to fight against conduit companies. Third and finally, in 2012, Argentina objected to the Argentina-Chile Treaty, and in 2015, a new tax treaty was signed adopting BEPS Action 6 (e.g., Preamble and PPT). Notably, on the other hand, the dissenting judge (three votes against one) and the advocate general of the SCA provided the following reservations:

- In 2003, a new protocol to the Argentina-Chile Treaty was signed, but the issue was not addressed until 2012;
- No specific anti-avoidance provision to prevent double non-taxation was included in the Argentina-Chile Treaty (e.g., subject to tax clause); and
- Double non-taxation is not considered to be a violation of the Argentina Constitution.

Part 2 of this series will examine the *UK Burlington Loan Management* case and the effect of such cases on the interpretation of the PPT (DAC v HMRC [2024] UKUT 00152 (TCC)). The *Burlington* case is particularly notable because the specific anti-avoidance measure under consideration, Article 12(5) of the Ireland-UK tax treaty, served as a forerunner to the PPT now found in both the 2017 OECD Model and the MLI.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.