**Tax Sparing: Good Intentions, Unintended Results**

Deborah Toaze*

**PRÉCIS**

Comme la plupart des pays membres de l’OCDE, le Canada a négocié des mesures d’allégement fiscal avec ses partenaires dans le cadre des conventions fiscales dont il est signataire. De manière générale, l’OCDE soutenait jusqu’à récemment les régimes d’allégement fiscal en ce qu’ils permettaient de protéger les incitatifs fiscaux offerts par les pays en voie de développement contre une éventuelle érosion entraînée par le traitement fiscal, dans le pays de résidence de l’investisseur, du revenu tiré des activités visées par ces mesures. En 1998, l’OCDE a cependant revu sa position et exprimé des inquiétudes quant aux abus que peuvent engendrer les dispositions d’allégement fiscal. Dans la première partie, l’auteur brosse un tableau du débat soulevé par l’allégement fiscal et trace l’historique de la question aux États-Unis, au Canada et au sein de l’OCDE. Elle y énonce la position actuelle de l’OCDE en matière d’allégement fiscal et explique certaines des raisons pour lesquelles les pays en voie de développement considèrent ces régimes comme d’importants outils de développement économique. Dans la deuxième partie, l’auteur analyse diverses opérations d’évitement pratiquées aux termes de dispositions d’allégement fiscal et explique les motifs qui pourraient amener l’Agence canadienne des douanes et du revenu à contester ces opérations dans le cadre de la Convention Canada-Brésil en matière d’impôts sur le revenu (1984). Cette convention revêt un intérêt particulier, car de toutes les conventions fiscales dont le Canada est signataire, elle est celle qui offre le régime d’allégement fiscal le plus généreux.

**ABSTRACT**

Canada, like most other OECD member nations, has negotiated tax-sparing provisions with tax treaty partners. Over the years, the OECD has generally supported tax-sparing provisions as a means of ensuring that tax incentives offered

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by developing countries are not eroded through the tax treatment of the income from the advantaged activities by the investor’s country of residence. In 1998, the OECD reconsidered its position and expressed concern about abuses associated with tax sparing. The first part of this article looks at the debate over tax sparing and its history in the United States, at the OECD, and in Canada. The article examines the OECD’s current concern with tax sparing and some of the reasons why developing countries might consider it an important economic development tool. The second part of the article focuses on tax-sparing tax-avoidance transactions and considers whether, and on what basis, such transactions might be challenged by the Canada Customs and Revenue Agency in the context of the Canada-Brazil income tax convention (1984). This treaty is of particular interest because, among Canadian tax treaties currently in force, it contains the most generous tax-sparing provisions. **Keywords:** Anti-abuse; Brazil; foreign tax credits; general anti-avoidance rule; international taxation; tax sparing.

**INTRODUCTION**

Over the course of the last 45 years, Canada and other OECD members have included “tax-sparing” provisions in a number of income tax treaties with developing countries. Tax sparing was originally intended to promote economic development among developing nations by ensuring that tax incentives offered to foreign investors by these countries were not eroded through the tax treatment of the income from the advantaged activities in the investor’s country of residence. Historically, not all OECD countries have supported tax sparing. The United States, in particular, will not agree to tax-sparing provisions in its tax treaties as a matter of tax policy.

From the perspective of a developing country, tax sparing may appear to be an ideal form of economic aid—at least for those developing countries that exercise unilateral control over the underlying incentive programs. There is, however, some evidence that tax sparing has produced only marginal economic benefits while providing opportunities for tax avoidance. For this reason, the OECD has called for a reconsideration of tax sparing as an economic development tool and has recommended a review of the inclusion of tax-sparing provisions in income tax treaties.

**TAX SPARING: WHAT IS IT?**

Tax sparing is a mechanism whereby developed countries, such as Canada, recognize and preserve the benefits of tax incentives provided by developing countries to foreign investors. Developing countries often attempt to attract foreign investors with incentives in the form of reduced rates of taxation or, in some cases, the exemption of certain types of income from tax. In order to preserve the resultant investment revenues to the developing country, the country of residence of the investor (that is, the developed country) “spares” the tax that it would normally impose on the low-taxed or untaxed income earned by its resident
abroad by granting foreign tax credits equal to, or possibly greater than, the tax that would otherwise have been exigible in the developing country. The theory is that if this “phantom” tax credit were not granted, the developing country incentive would be largely, if not wholly, nullified. This situation may be particularly problematic in the case of foreign branch operations. Many countries, including Canada, subject the income of foreign branches of their residents to tax on a current basis. Absent tax sparing, the benefit of any foreign tax reduction or incentive accorded the branch operation would be immediately captured by the developed country. Tax treaty provisions granting relief from double taxation are not only ineffective in dealing with the problem, but irrelevant since the tax-advantaged income is not taxed twice; it is taxed once, generally at the rate imposed by the investor’s country of residence (assuming that this rate is higher than that imposed by the developing country) with a foreign tax credit granted for the tax paid or withheld in the developing country.3

It should be noted that many countries provide a tax exemption for certain types of foreign-source income earned by their residents. For example, under its foreign affiliate system, Canada exempts from tax, active business income earned by a Canadian foreign affiliate in a country with which Canada has a tax treaty. This income is considered “exempt surplus” and is never subject to tax in Canada. In other cases, income earned by Canadian subsidiaries may be subject to tax only when repatriated to Canada in the form of dividends. Until the dividends are received by the Canadian resident, the benefit of any foreign tax incentives is preserved to the subsidiary. In each of these instances, tax sparing is either irrelevant or of relatively little benefit.

Other forms of foreign income earned by Canadians—for example, interest, royalties, and portfolio dividends—do not necessarily enjoy the exemption treatment. It is to this non-exempt income that tax sparing, as that term is used in this article, has applicability, operating in conjunction with Canada’s foreign tax credit system.

Tax sparing can be illustrated by a simple example. Assume that the income tax treaty between Canada and country B provides for a withholding tax rate of up to 15 percent on interest. Country B, in an effort to entice lenders to loan it, or its residents, funds at lower than normal interest rates, decides to limit the withholding tax on interest to 5 percent. The tax treaty between Canada and country B provides that where a Canadian resident receives interest from a resident of country B, Canada shall grant a foreign tax credit equal to the amount of tax paid by the Canadian resident to country B in respect of withholding tax on the interest. Further, the treaty provides that the withholding tax paid by the Canadian recipient of the interest shall always be deemed to be equal to 15 percent of the gross amount of the interest (the tax-sparing provision). A Co, a Canadian-resident corporation, purchases bonds issued by a corporation in country B and receives an interest payment of $200,000. A Co’s Canadian tax rate is 40 percent. The following table sets out the results to A Co under three scenarios: first, where country B imposes withholding tax at the maximum treaty rate of 15 percent;
second, where tax is imposed at 5 percent without a tax-sparing provision; and third, where the 5 percent rate applies and Canada provides tax sparing.\(^4\)

<table>
<thead>
<tr>
<th></th>
<th>Base case 15% withholding</th>
<th>5% withholding without tax sparing</th>
<th>5% withholding with tax sparing</th>
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<tbody>
<tr>
<td>Income</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
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<tr>
<td>Canadian tax rate</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Canadian tax</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>($30,000)</td>
<td>($10,000)(^a)</td>
<td>($30,000)(^b)</td>
</tr>
<tr>
<td>Canadian tax payable</td>
<td>50,000</td>
<td>70,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Total tax paid:</td>
<td></td>
<td></td>
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<tr>
<td>To country B</td>
<td>30,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>To Canada</td>
<td>50,000</td>
<td>70,000</td>
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<tr>
<td>Total</td>
<td>80,000</td>
<td>80,000</td>
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\(^a\) The foreign tax credit granted by Canada is equal to five percent of $200,000. Five percent is the rate at which tax was actually withheld by country B. \(^b\) The foreign tax credit granted by Canada is equal to 15 percent of $200,000. Fifteen percent is the rate provided for in the tax treaty at which tax would otherwise have been withheld absent the rate reduction by country B.

With a 5 percent withholding tax rate and no tax sparing, A Co pays, in total, the same amount of tax as it would have paid in the base case. The key difference between the base case and a reduced withholding tax rate without tax sparing is that the ratio of tax paid to country B and to Canada, respectively, is substantially altered; where the rate of withholding is reduced, the tax forgone by country B is paid to Canada. For A Co, when the 5 percent withholding rate is combined with a tax-sparing provision, less tax is paid in total and there is no increase in the amount of Canadian tax over that paid in the base case. In other words, the intended benefit of the tax incentive to A Co is preserved. Absent the tax-sparing provision, the reduced withholding tax rate provided by country B would result in (1) A Co’s paying less tax in country B and more tax in Canada; (2) a consequential transfer of tax revenues from country B to the Canadian government; and (3) the complete erosion of any benefit to A Co associated with the reduced withholding rate offered by country B.\(^5\)

The rather simple concept of tax sparing has given rise to significant debates, ranging from tax policy issues to the practical effectiveness of tax sparing as an economic development tool. In some cases, opposing positions have become so entrenched that tax treaties have not been concluded and are not likely to be concluded any time soon. Beyond the policy debates, tax-sparing provisions also present opportunities for controversial tax-planning strategies.
TAX SPARING: GOOD INTENTIONS, UNINTENDED RESULTS

THE TAX-SPARING DEBATE: HISTORY, POLICY, AND ECONOMICS

Tax sparing is not a new concept. Its genesis can be traced back to the early 1950s, when a British royal commission recommended that the United Kingdom adopt tax sparing. The British Parliament initially rejected this recommendation, and it was not until 1961 that legislation was enacted that enabled the government to offer tax sparing to developing countries on a bilateral basis. Today, most OECD countries have tax-sparing provisions in at least some of their tax treaties with developing countries, developed countries, or both. The one OECD country that has consistently refused to ratify tax treaties that include tax-sparing provisions is the United States.

Tax Sparing: The US Position

The United States has provided the most active forum for the debate over tax sparing. Over the years, its position has changed. In the early 1950s, the US Department of the Treasury supported the concept of tax sparing.

Developing countries had argued that they were unable to attract US investment through the use of tax incentives without a US tax-sparing concession. They also pointed out that the US failure to recognize tax sparing was at odds with its stated policy of encouraging development in those countries. In response to these arguments, Treasury Secretary George M. Humphrey stated in 1954 that he would favour “giving credit for general foreign income taxes which are waived for an initial limited period as we now grant credit for taxes which are imposed.” The US Treasury argued that tax sparing promoted free trade as well as economic development and could be used by the United States to encourage developing countries to give up source-based taxation and high withholding tax rates.

In 1955, President Eisenhower endorsed tax sparing in his foreign economic message to Congress when he stated:

[Under proper safeguard, credit could be given for foreign income taxes which are waived for an initial limited period, as we now grant a credit for foreign taxes which are imposed. This would give maximum effectiveness to foreign tax laws that are designed to encourage new enterprises.]

In 1957, the US Treasury department submitted the following tax-sparing provision to the US Senate as part of a proposed tax treaty with Pakistan:

For the purposes of this credit there shall be deemed to have been paid by a United States domestic corporation the amount by which such Pakistan taxes (other than the business profits tax) have been reduced under the provisions of section 15B of the Income Tax Act (XI of 1922) as in effect on the date of the signature of the present Convention: Provided, that any extension made by law of the period within which an industrial undertaking may be set up or commenced in order to obtain the reduction provided in section 15B shall be deemed to be in effect on the date of the signature of the present Convention.
The provision was narrowly drafted to apply only to specified business enterprises that were established in Pakistan by US residents during 1958 and earned no greater than a 5 percent return. During the course of the Senate committee hearings, however, the Pakistan government’s tax provision that provided the tax incentive and was the subject of sparing expired, and the treaty was ultimately ratified without the tax-sparing provision. Although the Senate Committee on Foreign Relations did not foreclose the use of tax sparing as an economic development tool in future treaties, the US position subsequently shifted. By the mid-1960s, the Treasury department would no longer entertain the inclusion of tax-sparing provisions in any US tax treaties.

The evolution of the US Treasury department’s position was significantly influenced by Stanley S. Surrey of Harvard University Law School. Testifying before the Senate foreign relations committee in 1957, Surrey argued that tax sparing irrationally granted credit for phantom taxes and that the attendant explanations for non-payment of US taxes were illogical. He further argued that tax sparing distorted capital export neutrality, disproportionately benefited multinational corporations by providing a “windfall,” and changed the tax treaty process by permitting rates of tax applicable to US citizens to be fixed by treaty rather than by domestic legislative process.

In the introduction to a collection of papers dealing with “Major Problems of National Policy,” Surrey summed up his views of the Treasury department’s attitude toward tax sparing in the mid-1950s as follows:

A tax preference or incentive granted by the Congress is in effect a subsidy and can be viewed as a direct payment of dollars to the groups receiving the preference. One basic question, therefore, is whether a tax preference or incentive should be granted only in those situations where the Congress would be willing to pay out dollars directly outside the tax mechanism on a no-questions-asked basis. . . .

Consider Uncle Sam, when he is over at his desk in the Development Loan Fund. Here he is a skeptical and distrustful banker. An American foreign investor applying for a loan for a foreign project can tell him that the foreign country grants tax concessions for this type of project, and that the foreign finance minister approves it. But that would not move the banker. He must satisfy himself as to the value of the project. . . .

But then consider Uncle Sam over in the Treasury Department in charge of administering tax sparing agreements. Here he is the genial scoutmaster or Rotarian. If a foreign investor comes in and says he has had his foreign tax reduced by a tax concession, Uncle Sam’s reply now is “How jolly good. That foreign finance minister must be a splendid chap. You must certainly have a fine project. Of course we will reduce your United States tax. No more questions or forms telling us about the wonderful project, old man. That’s how we do business in the Treasury Department.” . . .

I submit that the one issue here is whether we should do business in that automatic no-questions-asked way at the Treasury Department under tax incentive measures unless Congress would be willing to do it in the same way on a direct subsidy payout.
Notwithstanding Surrey’s views, in 1960 the Treasury department submitted to the US Senate for its consideration three more draft tax treaties that included tax-sparing provisions.17 Surrey subsequently became assistant secretary for tax policy, Department of the Treasury, in the Kennedy administration and, ultimately, it was his view of tax sparing that prevailed. The three treaties containing tax-sparing provisions were never ratified and were withdrawn in 1964.18 Since that time, the United States has consistently refused to include tax-sparing provisions in its tax treaties, and it is the developed world’s most vocal opponent of the concept.

Interestingly, however, there has been a recent resurgence in the debate over tax sparing in the United States. It is difficult to determine the reason for the renewal of the discussion, but it may be related to the difficulty that the United States has had in concluding tax treaties with developing nations, coupled with pressures from various business groups.19 For example, Brazil’s insistence on the inclusion of a tax-sparing provision in any tax treaty with the United States is one of two reasons why these countries have yet to conclude a tax treaty.20 The most that the United States has offered treaty partners and potential treaty partners is a commitment to amend an existing treaty if it should agree to tax sparing in any other treaty. This “undertaking” was made with India,21 for example, after three decades of treaty negotiations obstructed primarily by lack of agreement on precisely this issue.22 Given the US opposition to tax sparing, the value to India of having secured this commitment is questionable, to say the least.

The arguments currently being advanced by those who support tax-sparing provisions in US tax treaties are as follows:23

1) US businesses are at a competitive disadvantage abroad because of the lack of tax-sparing provisions in US tax treaties. The lack of tax-sparing provisions, it is argued, results in the imposition of a heavier tax burden on US companies vis-à-vis companies whose countries of residence provide tax sparing in their treaties. This tax burden effectively raises a company’s costs and may lead to pricing disadvantages.

2) The US tax treaty network with developing countries is not as well developed as it should be because of the United States’ unwavering position on the issue. Because tax treaties are considered to contribute to the improvement of conditions for international trade, to provide certainty with respect to taxing jurisdiction, and to facilitate dispute resolution, a lack of tax treaties in turn hurts US businesses operating in non-treaty countries.

3) The United States could negotiate for enhanced treaty benefits if it were willing to agree to tax sparing.

4) Developing countries themselves often consider tax sparing an important component of their overall development program. From a developing country’s perspective, tax incentives permit it to direct investment as it sees fit without having to justify projects to, or otherwise consider the views of, the governments of other countries. Tax sparing is also seen as compensation for the reduction of withholding tax rates (on interest, dividends, and royalties, in
particular) by the developing country. In addition, developing countries often resent what is considered a paternalistic attitude toward the spending of aid dollars by developed countries and consequently reject the notion that the United States, or any other nation, should control how aid dollars are spent.24

There may be some merit to the assertion that the US tax treaty network is not as well developed as the networks of nations that grant tax-sparing provisions.25 The United States currently has tax treaties with 63 countries. By way of comparison with countries that have agreed to tax sparing, the United Kingdom and France each currently have more than 100 treaties in force, Canada has more than 75, and Germany has more than 80. However, it seems to be an oversimplification to attribute the difference in the number of treaties entirely to tax sparing. For example, the United Kingdom, Germany, and France were all colonial powers in the 19th and 20th centuries, and many of their tax treaties have been concluded with former colonies. It would not be unreasonable to posit a link between the number of treaties and the historical relationships between these countries. On the other hand, such relationships would not account for the high number of Canadian tax treaties.

In addition, the OECD has noted that the lack of a tax treaty may be an impediment to doing business in another country. At the same time, many US companies indicated to the OECD that they do not consider a tax-sparing provision essential to their ability to do business abroad.26 In some respects, it may be a “chicken and egg” situation. The United States would like to have an expanded treaty network, but it may not be able to get it without agreeing to tax sparing.

With respect to the argument that the United States could negotiate for enhanced treaty benefits if it were willing to agree to tax sparing, it is not evident that this would necessarily be the case. Given that developing countries must compete to attract foreign investment, high withholding tax rates may be seen as an impediment to the achievement of that goal; consequently, it does not automatically follow that tax-sparing provisions are the only reason for the willingness of developing countries to agree to lower withholding tax rates. On the other hand, non-OECD member countries have expressed concerns regarding the tendency of OECD members to press for lower withholding tax rates in return for the granting of tax-sparing provisions in treaties.27

On the other side of the debate, the main reasons advanced for continued US opposition to tax sparing are as follows:28

1) Agreeing to tax sparing would be contrary to the key US tax policy objective of capital export neutrality. The United States seeks to create an environment where investment decisions are made by US residents without regard to taxation. Because tax sparing in effect provides credits for taxes not paid, and reduces the rate of home country tax on foreign income below the rate imposed on domestic income, from a tax perspective investment abroad

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becomes more attractive than domestic investment. Thus, tax sparing compromises export neutrality.

2) Providing US tax benefits to US residents through the treaty mechanism of tax sparing is contrary to the US policy of using a tax treaty to provide US benefits to non-residents and foreign tax benefits to US residents.

3) Related to item 2 is the position that tax sparing reduces US control over the taxation of US persons because the incentives are provided at the discretion of a foreign government. The quantum and terms of any tax-sparing provisions would effectively permit foreign governments to set the US tax rate on income earned abroad by US residents. From the US perspective, permitting a foreign government to set the US rate of tax on certain income, whether directly or indirectly, not only may be unacceptable on policy grounds, but also may be unconstitutional.

4) The benefits of tax sparing to the investor are overrated, largely because, even without tax sparing, the United States does not tax active business profits of US foreign subsidiaries until such time as the profits are repatriated to the United States.

5) Tax sparing is detrimental to developing countries because the mechanism favours tax systems that are irrational and unstable, and promotes the repatriation of funds by investors rather than the reinvestment of income in business expansion.

6) As a foreign aid tool, tax sparing is objectionable because the grantor of the “aid” relinquishes all ability to channel investment to particular types of activities.

7) An about-face by the United States in respect of the sparing issue would be at odds with the emerging consensus among OECD countries that tax sparing should be curtailed.

Most of the foregoing points relate to either explicit or implicit policy decisions that the United States has made on the issue. There are also some concrete data available that may be seen to support the proposition that the benefits of tax sparing are overrated in the US context. Out of 30 leading locations for foreign investment by US firms, Brazil ranked ninth in terms of assets of subsidiaries of US corporations abroad. All of the countries that ranked ahead of Brazil were developed countries, and all but one was an OECD member. From this list one might conclude that the lack of tax sparing has not materially dampened US investor enthusiasm for investing in Brazil vis-à-vis other developing countries—even though the United States does not have a tax treaty with Brazil.

Notwithstanding the recent interest in tax sparing in the United States and the ongoing debate, it is unlikely that the US Treasury will reverse its position on the issue. Apart from the policy issues inherent in any decision to permit tax sparing in treaties, the United States has given commitment letters, similar to the one exchanged with India, to a number of countries. In the circumstances, the cost
to the United States of reversing its position could be significant. Of equal interest, however, is the direction in which the OECD position on tax sparing is moving—a position that, as suggested above, is closer to the US position.

**Tax Sparing and the OECD Position: An Evolutionary Process**

Neither the current OECD model tax treaty nor any of its previous versions contains a specific tax-sparing provision. This should not, however, be taken to suggest that the OECD does not recognize or has not supported tax sparing. Indeed, since the late 1960s and early 1970s, most of its members have included tax-sparing provisions in at least some of their tax treaties, on the basis that it is a component of an overall foreign aid policy aimed at promoting industrial, commercial, and scientific activities in developing countries. In addition, the OECD has stated that tax sparing has been used by its members to secure more favourable withholding tax rates, to advance the competitive position of their own residents, and to expand treaty networks with developing countries.

In the commentary on article 23 of the 1963 model treaty, it was recognized that tax incentives or concessions granted by developing states, and particularly “underdeveloped” states, were nullified where the state of residence of the investor permitted a foreign tax credit only for tax actually paid in the country where the investments were located. The 1963 commentary suggested that countries might alleviate the problem either through exempting such income from taxation in the investor’s home country or through tax sparing.

The commentary on the 1977 model treaty considerably expanded the discussion of the issue. In addition to recognizing that tax incentives offered by a developing nation would be nullified to the extent that only a credit for tax actually paid was allowed, the OECD went on to suggest that if the two treaty partners agreed, article 23 could be modified to address the problem. Three modification formulas were recommended:

1) The state of residence of the investor could allow a credit for the amount of tax that the source state could have imposed in accordance with domestic legislation or the tax treaty, even if the source state waived all or part of the tax.
2) The state of residence of the investor could allow a credit for tax at an amount fixed at a higher rate than that otherwise imposed by the source country.
3) The state of residence could exempt from tax, income that benefited from tax incentives.

The 1977 commentary also suggested that the relief could be made subject to time limitations.

The world economic map has changed since 1977, and the OECD has reported that its members have become increasingly skeptical and concerned about the value of tax sparing. In 1998, the OECD published a paper on tax sparing in which it concluded that this mechanism is not an effective means of promoting
economic development in developing countries.\textsuperscript{35} This conclusion was based on the reported experiences of OECD members and on a 1995 OECD study on the taxation of foreign direct investment.\textsuperscript{36} Other studies support the OECD’s conclusion with respect to economic development.

For example, one recent article\textsuperscript{37} questioned the effectiveness of tax incentives in attracting incremental foreign investment and suggested that the associated revenue cost to the developing country may be quite high. In the authors’ view, the best strategy for sustained investment “[c]onsists invariably of providing stable and transparent legal and regulatory frameworks as well as adequate support institutions and facilities, and of putting in place a tax system that is in line with international norms.”\textsuperscript{38}

On the other hand, there is some evidence that tax sparing contributes to positive economic results. A recent study by James R. Hines Jr.\textsuperscript{39} concluded that tax sparing promotes foreign direct investment, significantly influences the location of such investment, and encourages developing countries that are parties to tax-sparing agreements to provide special tax incentives or concessions to foreign investors. The study does not, however, deal with the qualitative issues related to tax sparing. For example, while Hines concludes that tax sparing positively influences foreign direct investment, he does not consider the quality of the investment or the development activity spurred by tax sparing, the cost to the treasury of the developing country of granting various tax incentives, or the cost to the developed country of granting tax sparing.

The fact is that the actual cost to a country offering tax sparing to a treaty partner and the related benefits to a developing country are difficult to measure. It is not clear how either the developed or the developing country can determine whether a particular investment would or would not have been made in the absence of tax sparing, or if the quantum of the investment would have otherwise been made in a lower amount.

In April 2000, acting upon the conclusions of the tax-sparing paper, the OECD replaced those parts of the 1992 commentary on the model treaty that related to tax sparing. While the OECD has not gone so far as to state that its members should refrain from negotiating or implementing tax-sparing provisions, it does recommend that tax sparing should be considered only in circumstances where the economic level of the country to which sparing is granted is considerably below that of the OECD country. In addition, the OECD recommends that objective criteria be used to identify countries that should be eligible for tax sparing.\textsuperscript{40}

Whatever the merits of the pure economic argument, the OECD has categorized its members’ concerns about tax sparing in the commentary and in the tax-sparing paper as follows:\textsuperscript{41}

\begin{itemize}
  \item The lack of control mechanisms normally associated with foreign aid programs and an attendant inability to measure the effectiveness of the aid provided through tax sparing, as well as the cost to the treasury of the granting country.
\end{itemize}
• The promotion of excessive repatriation of profits by investors in order to immediately access the benefits of tax sparing, which defeats the goal of most developing countries of encouraging reinvestment in key industries.
• The validity of the assumption that without tax sparing, revenues are necessarily and automatically transferred to the treasury of the investor’s country of residence. For example, if the investor’s country of residence exempts certain foreign income from tax, there will be no transfer of tax revenue from the developing country.
• Administrative difficulties.
• The use of tax sparing as a tax-planning and tax-avoidance tool.

Not surprisingly, many of the concerns expressed by the OECD and its members are the same as those raised by the US Treasury department over the years. The OECD has also published, in the tax-sparing paper, a number of “best practices” aimed at “better targeting of the provisions and reducing the potential for abuse.” These best practices include

• specifically identifying the tax incentive programs that are the object of any tax-sparing provision in a tax treaty;
• limiting the applicability of tax-sparing provisions to specified activities and excluding financial intermediary activities such as banking and insurance;
• refusing to grant tax sparing in circumstances where the investor’s country of residence provides for an exemption of the foreign income from tax;
• making tax-sparing provisions subject to domestic anti-abuse rules where such laws have been enacted by the investor’s country of residence; and
• placing a time limit on the availability of tax-sparing relief so as to ensure that it does not become a permanent concession.

OECD members—including Canada—are clearly no longer willing to grant tax sparing on the same unquestioning basis as in the early years.

Tax Sparing: The Canadian Position

The debate over tax sparing in Canada seems to have been much less intense than that which has taken place, and is continuing, in the United States. Indeed, in the literature of the 1950s and 1960s, there is a distinct scarcity of Canadian material on the subject.

There are several possible reasons for this modest level of interest:

• First, Canada’s exemption system in respect of the taxation of dividends received by residents from foreign affiliates has resulted in the recognition of certain foreign investment incentives even absent tax-sparing treaty provisions. Before 1972, Canada exempted from tax all dividends paid by a foreign corporation to a Canadian-resident corporation in circumstances where the Canadian corporation held more than 25 percent of the voting
shares of the foreign corporation. Thus, the exemption system for dividends arguably made tax sparing a less important issue for Canada.

- Second, Canada, like many developing nations, has, from time to time, been an importer of capital. As a result, there may have been more sympathy in Canada than in the United States for the position of developing countries.  
- Third, and perhaps most important, given that other OECD countries were including tax-sparing provisions in treaties with developing nations, Canada may have considered that it had little choice if it wanted to ensure that Canadian businesses would be competitive in developing countries.

In 1966, R. Alan Short wrote:

Tax-sparing and tax-exemption, in particular cases . . . may represent an appropriate means by which the tax system in a capital-exporting country can be made to accommodate the incentives of the developing countries. If an investment incentive is necessary to induce the developing countries to enter into a treaty, and since both sparing and exemption provisions are being offered by other developed countries, Canada may also have to consider a similar approach.\textsuperscript{43}

Short further observed:

\textit{[T]}he Canadian foreign tax credit, foreign dividend exemption and non-resident withholding tax provisions must be regarded as generous. However, primary reliance on a unilateral approach does have its drawbacks in a world where bilateral treaties are becoming the rule. As a result, it may be that Canada’s “open-door” approach, however laudable and defensible in principle, is now inadequate to protect the competitive position of Canada’s foreign traders and investors.\textsuperscript{44}

In 1966, Canada signed a tax treaty with Ireland that contained a tax-sparing provision. This provision was limited in that it applied to dividend income only and was relevant only in specific situations.\textsuperscript{45} The next treaty that included a tax-sparing provision, the treaty with Israel, was not signed until 1975\textsuperscript{46} and was broader in scope. It applied to both dividends and interest, as well as in respect of profits attributable to a trade or business carried on by a Canadian resident in Israel under specified tax incentive programs.

By the mid-1970s, the issue of tax sparing had arguably become more significant in Canada, spurred, at least in part, by Canadian tax reform. The new legislation provided a full exemption from Canadian tax only for dividends paid out of exempt surplus of a foreign affiliate of a Canadian corporation\textsuperscript{47} that was resident in a country with which Canada had a tax treaty. Accordingly, there was concern that Canadian taxation would negate foreign tax incentives in cases where dividends were paid out of income that was

- active business income of a foreign affiliate not resident in a treaty country; or
- non-active business income of any foreign affiliate; or
income paid to any Canadian corporation which was classified as rents, royalties, interest, or management fees.\textsuperscript{48}

In 1976, Gérard Coulombe, then assistant director, Personal & International Tax Division at the Canadian Department of Finance, wrote:

In every case where a developed country utilizes the method of foreign tax credit to relieve double taxation, the failure to adopt a tax sparing or a matching credit provision will result in a transfer of revenues from the Treasury of the developing country to the Treasury of the developed country whenever the developing country reduces or eliminates its tax as an incentive to foreign investment. For example, if developing country A reduces its withholding tax rate from 25% to 5% in the case of royalties paid in respect of advanced technology, and if Canada applies its ordinary foreign tax credit provisions, the net result of the sacrifice of country A will likely be to increase the amount of Canadian tax payable.\textsuperscript{49}

Coulombe stated,\textsuperscript{50} however, that tax sparing played a minor role in the conclusion of tax treaties with developing countries, at least as far as Canada was concerned, because

\begin{itemize}
  \item all dividends paid by a foreign affiliate out of active business income would be exempt from Canadian taxation; and
  \item most developing countries want to attract investment in the types of activities that give rise to active business income as opposed to investment in passive-income-generating activities.
\end{itemize}

Nevertheless, by 1985, Canada had agreed to tax-sparing provisions in its tax treaties with 23 countries.\textsuperscript{51} Generally, Canada can be seen as following the commentary on the OECD model treaty as well as the United Nations model treaty\textsuperscript{52} in granting relief in respect of tax spared by specific incentive legislation in developing countries.\textsuperscript{53}

The tax-sparing provisions that Canada has agreed to over the years range from the narrow to the expansive. The most generous and expansive provision of all is article 22 of the Canada-Brazil income tax convention (1984).\textsuperscript{54} One writer suggests that this treaty

seems to provide an unlimited credit for both business income tax and non-business income tax, with the limitation on the credit being the Canadian tax on the same income computed before the tax credit and on the assumption that the Brazilian tax on dividends does not exceed 25 percent of the gross and, on interest and royalties, 20 percent of the gross.\textsuperscript{55}

The current trend, however, is to the narrow type of provision. For example, in the Canada-Argentina tax treaty, signed in 1993,\textsuperscript{56} article 23 limits tax sparing to the first five years of the treaty (subject to extension) and provides that sparing
does not apply to interest otherwise exempt from Argentine withholding tax under the treaty.

Since the mid-1980s, the number of Canadian tax treaties with operative tax-sparing provisions has dwindled. Currently, Canada has operative tax-sparing provisions in treaties with nine developing countries and three OECD member countries.57

**Tax Sparing from the Perspective of the Developing Countries**

Many developing countries are as adamant about the inclusion of a tax-sparing provision in tax treaties as the United States is about its exclusion. As noted above, the United States and Brazil still do not have a tax treaty largely because both parties are intransigent in their positions on this issue.

One of the principal arguments that developing countries have used for tax sparing is that without incentives, it would be much more difficult to attract and retain foreign investment. In addition, tax sparing permits developing countries to target tax incentives to particular sectors of the economy58 and may increase their ability to compete with other countries that offer various forms of tax incentives. Developing countries may also resent the obsessive desire of developed countries to exercise control over development programs, along with other symptoms of “paternalism.”59 Once the hurdle of negotiating the tax-sparing provision is overcome, tax sparing permits the developing—not the developed—country to exercise control over the underlying incentive programs.

The OECD has noted that non-member countries are becoming concerned about the concessions that developed nations are requiring if tax-sparing provisions are to be included in tax treaties.60 These concessions include lower withholding rates and stricter rules regarding permanent establishments. It is unlikely, however, that pressure to agree to such terms will deter developing countries from pursuing tax sparing. Rather, developing countries may simply be registering their objections to the increasingly high price extracted for these provisions.

The fact is that no South American, African, or Middle Eastern nations and only a few Asian nations hold membership in the OECD. Moreover, it has been suggested, in the context of the debate over harmful tax practices, that the OECD does not necessarily have the best interests of non-members at heart. As one writer has commented,

> [t]he OECD is essentially a cartel of the world’s richest countries, most of which are high tax jurisdictions. . . . The OECD’s policies are clearly designed to assist its member countries, rather than the world at large. No one other than its own members has ever given it a mandate to tell other countries how to behave.61

**Concluding Comments**

Whatever the preference of developing countries for tax sparing, OECD members (to the extent that their individual views are reflected in pronouncements of the
organization as a whole) are becoming increasingly wary of including such provisions in bilateral tax treaties, given that there is little hard evidence that the benefits of the provisions outweigh the costs and drawbacks. The days of generous and unbounded provisions appear to be over. In light of the evolving OECD position, the United States is less likely than ever to alter its stance on the matter.

Tax sparing might be considered nothing more than a tax-based tool for economic aid—once popular; today less favoured, more circumscribed, and the subject of some conflicting economic data. There is, however, a growing realization that tax-sparing provisions in treaties lend themselves to inappropriate tax planning and tax-avoidance opportunities. The next part of this article focuses on tax sparing, tax planning, tax abuse, and, in particular, tax planning/abuse in the context of the Canada-Brazil treaty. The Canada-Brazil treaty is of particular interest because, as discussed below, among Canadian tax treaties it has an especially generous tax-sparing provision and thus may present enhanced opportunities for abusive transactions.

**TAX SPARING AND ABUSIVE TRANSACTIONS**

According to the OECD,

> [n]ot only may residents inappropriately exploit tax sparing provisions, but the residence country may also be used as a conduit by third country residents (treaty shopping). The cost of such tax avoidance schemes to the residence country may be huge—particularly where the country is being used as a conduit. The source country may also find that its revenue base is eroded in unintended ways.

The OECD considers that the most common abuses of tax-sparing provisions take one of four forms:

1) **Transfer-pricing abuse.** This strategy involves inflating the profits of an affiliate in the host country through the use of non-arm’s-length pricing practices for intercompany sales of products and services. The inflated profits provide the potential for the payment by the affiliate of inflated dividend amounts that would be subject to tax-sparing benefits.

2) **Conduit situations.** In this scenario, a third-country investor establishes a company in a country that has a tax-sparing provision in its tax treaty with a developing country and uses that company as a conduit for an investment in a developing country.

3) **Routing.** Routing is an arrangement under which a financial institution makes a loan to a foreign investor through another financial institution in a developing country.

4) **Government abuse.** In this scenario, governments of developing countries maintain artificially high rates of tax in order to provide greater tax-sparing benefits to foreign investors.
With respect to transfer-pricing planning and abuse, a number of OECD countries have enacted transfer-pricing legislation to deal with the issue. The legislation normally requires that related-party transactions take place at arm’s-length prices and that the parties maintain contemporaneous documentation to support the proposition that the pricing is arm’s length. While not specifically directed at tax-sparing planning, these requirements may go some way toward dealing with the first concern cited above, although, as a practical matter, such requirements are often difficult for tax authorities to enforce. It is important to note that most bilateral tax treaties provide for arm’s-length pricing between related parties; consequently, domestic statutes do not generally cause treaty override problems. Even Brazil recently conceded that treaty provisions on this issue override its domestic law.

With respect to the fourth concern noted above—abuse originating with the government of a developing country through the setting of artificially high tax rates—it is virtually impossible for the other treaty partner to deal adequately with this item on a unilateral basis. The treaty partner can, however, minimize the potential for abuse by restricting the operation of tax-sparing provisions to specific incentive programs over specified periods of time.

Arguably, it is the second and third abusive strategies that may pose the most significant challenges to revenue authorities. Consider, for example, a scheme described by the OECD that would have utilized New Zealand intermediaries or conduits to invest funds in a company in country X, a developing country and a treaty partner of New Zealand. The opportunity for abuse hinged on two key factors: first, New Zealand and country X have a tax-sparing provision in their treaty that provides for a 10 percent credit in respect of tax on interest income; and second, country X does not impose withholding tax on interest paid to non-residents. The proposed scheme worked as follows:

1) Foreign Financier, resident in a third country (neither New Zealand nor country X), had $200 million available to loan to a company in country X.
2) To maximize the tax-sparing benefits in the New Zealand-country X treaty, Foreign Financier would first loan $60.6 million to New Zealand company no. 1 at 7.5 percent interest.
3) Foreign Financier would make a second loan of $139.4 million to New Zealand company no. 2 at 7.5 percent interest.
4) New Zealand company no. 1 would use the $60.6 million to make an equity investment in New Zealand company no. 2.
5) New Zealand company no. 2 would lend $200 million to country X company at 7.5 percent interest.
6) New Zealand company no. 2 would receive interest income from country X company of $15 million ($200 million times 7.5 percent), less interest expense of $10.454 million in respect of its loan from Foreign Financier, for net interest income of $4.546 million.
7) The tax on New Zealand company no. 2’s income of $4.546 million would be $1.5 million (assuming a tax rate of 33 percent), and this would be offset by a tax-sparing credit of $1.5 million ($15 million interest income times the 10 percent tax credit rate provided for in the treaty).

8) New Zealand company no. 1 would deduct interest expense of $4.546 million ($60.6 million times 7.5 percent) on its loan from Foreign Financier in computing its income.

9) The interest paid by New Zealand company no. 1 and New Zealand company no. 2 to Foreign Financier might or might not have been subject to New Zealand withholding tax, and Foreign Financier might or might not have been taxable on the interest income received from the New Zealand companies.

10) The interest rates on the various loans would have been set to ensure that each party to the transaction—Foreign Financier, New Zealand company no. 1, and New Zealand company no. 2—would share in the benefit of the tax-sparing credit.

These transactions, if implemented, would have resulted in a tax benefit or cash subsidy equal to the value of the tax spared by New Zealand. The OECD’s view of the transactions was that they were contrary to the purpose of tax sparing, which is intended to prevent the home country clawing back the tax incentive of the developing country. It is not there to give a cash subsidy equal to the value of the tax spared by the developing country.67

In the scenario described, the country of residence of Foreign Financier would not likely have had a tax-sparing provision in its tax treaty with country X or, alternatively, would not have had a tax treaty with country X. The use of New Zealand company no. 1 and New Zealand company no. 2 by Foreign Financier was intended to permit the indirect transfer of the tax-sparing benefits to Foreign Financier, through the strategic setting of the rate of interest charged on its loans to the two New Zealand companies.

Rather than amend New Zealand’s domestic law to deal with the type of scheme described above, New Zealand and the relevant treaty partner agreed to add an anti-avoidance rule to the tax treaty that provided the New Zealand competent authority with the right to deny tax-sparing claims by New Zealand residents in circumstances considered abusive.68 In addition, the New Zealand government now requires taxpayers that claim tax-sparing credits under a tax treaty to complete a tax-sparing disclosure form each year, reporting, among other details, the type of income derived, the country of derivation, and the amount of the credit.

While New Zealand authorities believed that the treaty change deterred “international financiers” from using the treaty concerned, they also noted that some of the “financiers” indicated that they would simply “run the scheme through other countries with tax sparing provisions.”69
Other tax-planning or avoidance schemes are often variations of the scheme outlined above. Some involve circular flows of funds and intermediaries, while others involve “interest strips” and still others utilize a combination of derivatives to achieve the desired result. All, however, involve an intermediary or conduit in a situation designed to distribute the benefits of tax-sparing provisions in what the OECD would likely consider to be an unintended manner. It may even be possible to achieve a result, through the use of a combination of derivatives, whereby an intermediary takes no credit risk with respect to the issuer of the debt and no interest rate or market risk on the debt securities, but is able to claim the benefits of tax sparing. At a minimum, the intermediary profits through retaining a portion of the tax benefit for its own account. In certain situations, the transactions may cause the intermediary to earn a profit in respect of the transactions before the tax credit arises. While the OECD often refers to conduits that are established by non-residents for the sole purpose of transferring the benefits of tax sparing to those non-residents, in many cases, all that is required is a party willing (for a fee) to fulfill the role of conduit or intermediary.

It is reasonable to assume that the Canadian government, like the OECD, would frown on transactions undertaken for the sole purpose of enabling a non-resident to obtain the benefits of tax sparing that were intended to accrue to Canadian residents, on the ground that they constitute an abuse or unacceptable tax avoidance. Given that the New Zealand government concluded that it could not find a suitable remedy to the abuses described above in the application or amendment of its domestic law, the interesting question is whether the provisions of Canada’s Income Tax Act and/or the principles set out in the relevant case law would apply to cause the tax benefits accruing to a Canadian-resident intermediary in respect of tax-sparing transactions involving debt securities, specifically, to be substantially reduced or totally negated in the context of the Canada-Brazil treaty.

The treaty was negotiated almost 20 years ago, and article 22, entitled “Methods for the Elimination of Double Taxation,” contains a tax-sparing provision that is unique among Canada’s tax treaties in terms of its form and scope. Paragraphs 2 and 3 of article 22 read as follows:

2. Unless the provisions of paragraph 4 or 5 apply, where a resident of Canada derives income which, in accordance with the provisions of this Convention, may be taxed in Brazil, Canada shall allow as a deduction from the tax on the income of that person, an amount equal to the income tax paid in Brazil, including business-income tax and non-business income tax. The deduction shall not, however, exceed that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil.

3. For the deduction indicated in paragraph 2, Brazilian tax shall always be considered as having been paid at the rate of 25 per cent of the gross amount of the profits to which paragraph 5(b) of Article 10 applies and at the rate of 20 per cent of the gross amount of the income paid in Brazil in the case of interest to which paragraph 2 of Article 11 applies and royalties to which paragraph 2(b) of Article 12 applies.
These provisions stand in contrast to the following wording (“the standard wording”) governing the granting of foreign tax credits, which is normally employed in Canada’s tax treaties:

Subject to the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions (which, however, shall not affect the general principle hereof) and unless greater credit is provided under the law of Canada, tax paid in [country] in accordance with this Convention on profits, income or gains arising in [country] shall be deducted from any Canadian tax payable in respect of such profits, income or gains.

Canada is not alone in granting generous tax-sparing provisions to Brazil. In fact, in terms of negotiating generous tax-sparing provisions with its treaty partners, Brazil may be the powerhouse of developing nations.74 Whether its success in this area is the result of its potential as a market for goods and services or the result of a desire on the part of developed nations to obtain access to the country’s rich natural resources can only be a matter of conjecture.

While the treaty sets an upper limit of 15 percent on the rate of withholding tax on interest paid by Brazil or by a resident of Brazil to a resident of Canada,75 the Brazilian government may impose withholding tax at a lesser rate or simply forgo withholding tax altogether. For example, there is no Brazilian withholding tax on certain Brazilian government bonds,76 and Brazil generally does not impose withholding tax on interest on certain corporate debt with a term of eight years or longer.77 When a zero or reduced withholding tax rate is coupled with a tax-sparing provision that deems Brazilian tax to have been paid at a rate of 20 percent of the gross amount of the interest paid, there is arguably fertile ground for abusive tax planning.

The treaty was signed at a time when financial engineering was in its infancy. In 1984, Canadian taxpayers were uncertain as to the tax treatment of interest rate swaps.78 Credit derivatives were unknown. In the circumstances, the treaty negotiators could not have foreseen some of the derivative-based tax-sparing transactions that have been developed. The same cannot be said for arrangements similar to the one encountered by New Zealand tax authorities (described above) or for arrangements involving interest strips. Whether any particular arrangement could or should have been foreseen, however, is of little consolation in dealing with the reality of abusive tax-sparing transactions.

There are at least three possible bases on which the Canada Customs and Revenue Agency (“the CCRA”) might challenge tax-sparing tax-avoidance schemes that utilize Canadian intermediaries. First, the CCRA could seek to apply the provisions of section 126 of the Act, including the anti-avoidance provisions, in determining the quantum of foreign tax credits that might be available to a Canadian resident involved in tax sparing. Second, the CCRA could attempt to apply the general anti-avoidance rule (GAAR) in section 245 of the Act. Third,
the CCRA could seek to attack abusive schemes on some other basis, such as a liberal interpretation of the treaty provisions.

**Section 126 of the Act and Article 22 of the Treaty: Mutually Exclusive?**

It is important to address the application of section 126 of the Act in the context of the Canada-Brazil treaty because, if section 126 were found not to apply, a Canadian resident’s tax credit entitlement and the tax credit computation would be governed by the treaty alone, and not by the treaty and the Act. In this event, the specific anti-avoidance provisions contained in section 126 also would not apply. In other words, Canada’s domestic law, as it pertains to this particular entitlement, would be irrelevant and the CCRA would have no basis on which to apply its provisions to counter offensive schemes.

Section 126 of the Act sets out the various rules for the determination of the amount of foreign tax credit that a Canadian taxpayer may claim in respect of foreign tax paid on income from sources outside Canada. In addition to the detailed calculation provisions, the section also contains specific anti-avoidance provisions designed to restrict foreign tax credit claims to circumstances where the taxpayer has an “economic profit” from the transactions at issue and to limit the tax credit where the taxpayer has entered into certain short-term securities transactions.79 Tax-sparing proposals that utilize conduits may rely on the fact that the foreign tax credit in respect of which the tax is spared is not significantly limited or subject to anti-avoidance provisions as either a treaty matter or a domestic tax matter in the country of the recipient of the tax-spared income.

In *The Queen v. Crown Forest Industries Limited et al.*, the Supreme Court of Canada set out the method to be followed in interpreting a tax treaty:

> In interpreting a treaty, the paramount goal is to find the meaning of the words in question. This process involves looking to the language used and the intentions of the parties.80

The court added that

> in ascertaining these goals and intentions, a court may refer to extrinsic materials which form part of the legal context (these include accepted model conventions and official commentaries thereon) without the need first to find an ambiguity before turning to such materials.81

Given this method of interpretation, the available evidence tends to support the theory that article 22 of the Canada-Brazil treaty is not, and was not intended to be, subject to any domestic foreign tax credit provision.

The first step in the process of interpreting a provision of a treaty is a “plain language reading.”82 Such an approach would not be inconsistent with the method of statutory interpretation employed by the Supreme Court in a domestic context,
although it is clearly not an approach to be used blindly or exclusively when international treaties are involved.

The language used in article 22 of the treaty is quite straightforward and seemingly unambiguous. It simply states that, unless paragraph 4 or 5 applies, where a resident of Canada derives income that may be taxed in Brazil, Canada shall allow, as a deduction from the tax on the income of the Canadian resident, an amount equal to the income tax paid in Brazil, including business-income tax and non-business-income tax. The only limitation imposed on the deduction from tax is that the deduction cannot exceed the part of the income tax as computed before the deduction that is “appropriate to the income which may be taxed in Brazil.” Paragraph 3 of article 22 provides that Brazilian tax shall always be considered to have been paid at the rate of 20 percent of the gross amount of interest paid in Brazil to which paragraph 2 of article 11 applies.

Article 11 deals with amounts of interest arising in one contracting state and paid to a resident of the other contracting state. Paragraph 2 sets out the conditions that must be met in order for the recipient to avail itself of reduced rates of withholding tax under the treaty. First, in the case of interest received by a Canadian resident, the interest must arise in Brazil. Interest paid by the federal government of Brazil, or by a political subdivision or a local authority thereof, is deemed to arise in Brazil. Second, the Canadian recipient must be a corporation. Third, the corporation must be the beneficial owner of the interest.

The treaty attaches no other criteria or limitations to the application of paragraphs 2 and 3 of article 22. No anti-avoidance tests or treaty benefit limitation provisions are set out in the treaty. There is no reference to Canadian domestic law in either article 22 or article 11. Therefore, if the tests in paragraph 2 of article 11 are met in respect of the interest, Canada is arguably obligated, on the words of the treaty, to provide the Canadian resident with a credit for tax paid in Brazil in respect of the interest without regard to any limiting provisions in its domestic legislation.

A review of the treaty reveals no other provision that would apply to cause the tax credit provided for in article 22, as it relates to either business or non-business income, to specifically become subject to section 126 of the Act or any other specific or general anti-avoidance provisions of the Act. Article 22 of the treaty provides a complete framework for the granting and the calculation of foreign tax credits by Canada.

Article 22 also imports certain concepts of section 126 of the Act directly into paragraph 2—in particular, the concepts of “business income” and “non-business income.” No other Canadian tax treaty incorporates these concepts, and yet they are essential to the Canadian foreign tax credit regime. If section 126 of the Act were intended to apply in the context of the treaty, there would be no need for the use of these terms. Rather, the drafters would presumably have referenced the Canadian domestic law in the preamble to paragraph 2, as is the case in Canada’s other tax treaties.
Article 22 outlines the limitations that are to be imposed on the deduction from tax by a Canadian resident. Under paragraph 2, the deduction is not to “exceed that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil.” Again, this language imports the section 126 concept of limiting the amount of a foreign tax credit claim to the amount of Canadian tax that would be payable on the income. In fact, paragraph 2 of article 22 may not provide quite as unlimited a benefit as has sometimes been suggested.84

Given this framework, the drafters of the treaty arguably had no need to incorporate a reference to any provision of the Act in article 22. On the basis of the words used and the framework outlined in article 22, it would be reasonable to conclude that section 126 of the Act is not relevant to the determination of a Canadian resident’s foreign tax credit claim in respect of Brazilian income. It is, however, equally intriguing to attempt to gain an understanding of the intentions of the parties to the treaty with respect to the possible application by Canada of section 126 of the Act.

On the question of implementing the true intentions of the parties to a tax treaty, the words of Addy J in the Federal Court—Trial Division decision in *Gladden Estate v. The Queen* are often cited as providing the proper framework:

Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.85

Notwithstanding that the goal of tax sparing is to preserve the benefits of tax incentives to the treasury of a developing country, Canada’s income tax treaties specifically bring the determination of foreign tax credits, including tax credits resulting from tax-sparing provisions, within the ambit of section 126 of the Act through the use of the standard wording regarding the granting of tax credits by Canada.86

All except three of Canada’s current tax treaties—of which the Canada-Brazil treaty is one87—contain the standard wording. This wording clearly has the effect of making the computation of allowable foreign tax credits subject to section 126 of the Act, inasmuch as the provisions contained in that section existed at the time that the particular treaty came into force, and it makes the deduction subject to the provisions of section 126 as they may be amended from time to time thereafter.

The standard wording, or a variation thereof, has been included in Canada’s tax treaties since the first treaty with the United States was signed in 1942. The 1942 Canada-US treaty provided that Canada would allow a deduction for US taxes on income received by a Canadian resident derived from US sources as long as the general principle is maintained “[i]n accordance with the provisions of Section 8 of the Income War Tax Act.”88 The tax treaty between Canada and the
United Kingdom signed in 1946 and the tax treaty between Canada and New Zealand signed in 1948 each contained the following wording: “Subject to the provisions of the laws of Canada regarding the deduction from tax payable in Canada of tax in a territory outside Canada.” From the beginning, it appears that Canada’s position has been that the claiming of foreign tax credits by a Canadian resident should be governed by domestic legislation and that tax treaties should reflect this intent.

Given that virtually all of Canada’s treaties contain the standard wording, given that many of those treaties were negotiated in the same time frame as the Canada-Brazil treaty, given the tax credit calculation framework contained in article 22 of that treaty, and given the importing of section 126 concepts directly into article 22, it is difficult to believe that the omission of the standard wording and the substitution of different wording were inadvertent departures from usual practice.

While the standard wording differs from that in the OECD model treaty (whether one refers to the 1963, the 1977, or the current version), the commentary on the 1977 model treaty explicitly recognized that many nations have detailed rules relating to foreign tax credits in their domestic laws and that a number of tax treaties contain a reference to domestic law provisions. Canada’s standard wording is consistent with this practice. A departure from the standard wording in the Canada-Brazil treaty, and the use of wording more closely in accordance with the language in the OECD model treaty, would presumably have required some thought. This should lend further support to the notion that the omission of the standard wording was intended, in that it appears that, in normal circumstances, the treaty language dealing with the granting of foreign tax credits is language to which Canada has paid particular attention over the years.

Turning to the commentary on article 11 (interest) of the 1977 OECD model treaty, it is explicitly contemplated that treaty partners may negotiate certain aspects of the taxation of interest income. Paragraph 9 of the commentary states:

The paragraph [paragraph 2 of article 11] lays down nothing about the mode of taxation in the State of source [of the interest]. It therefore leaves that State free to apply its own laws.

And paragraph 10 states:

It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

It may be ventured that, as a subscriber to the OECD view of tax treaties, Canada settled the treatment of interest by way of bilateral negotiations. In the case of interest on certain Brazilian debt obligations, Brazil, as the source country, has chosen not to deduct tax at source. While this decision is not conditional on the Canadian tax treatment of such interest received by a Canadian corporation, Canada and Brazil specifically negotiated the tax credit provided for in article 22
of the treaty. That tax credit is to be granted without limitations, other than those limitations imposed by the treaty. The treaty partners agreed to this treatment in the course of bilateral negotiations, as suggested in, and in accordance with, the 1977 commentary.

Of course, one of the most important elements in determining the intention of the treaty partners—the comments of the respective governments and the participants in the negotiations—is absent from the discussion because the Canada-Brazil treaty has not been the subject of extensive comment by government officials. The CCRA has issued some technical interpretations relating to the treaty, but these have generally dealt with such questions as whether only corporations are permitted the benefits of tax sparing under the treaty and whether bonds issued in lieu of interest would be subject to the tax-sparing provisions. The question of intention with respect to the application of section 126 may ultimately be resolved with certainty only if, in the course of a CCRA assessment of a Canadian taxpayer, the Canadian and Brazilian governments make representations to a Canadian court on the matter. On the basis of the foregoing analysis, however, there are strong grounds to conclude that section 126 has no application in the determination of foreign tax credits associated with Brazilian tax sparing, whether or not the related arrangements are considered to be of an abusive nature.

**GAAR and the Treaty: Does It Matter?**

Having regard to the wording of article 22 of the Canada-Brazil treaty, two questions arise in determining whether GAAR could be used to thwart what could be considered tax-avoidance or abusive tax-sparing transactions under the treaty:

1) Can a domestic anti-avoidance provision, such as GAAR, be applied to such transactions if the treaty partners have not explicitly so agreed in the domestic law override?

2) If GAAR can be applied in the context of the treaty, would tax-sparing schemes be avoidance transactions that result in a misuse or an abuse of the Act?

In other words, given the wording of section 245 of the Act, can there be a misuse or an abuse of the Act if the particular section of the Act that would normally apply is not relevant in determining the tax result of a transaction because of the terms of an international treaty?

With respect to the first question, the CCRA’s position is that GAAR overrides tax treaties. The CCRA has also stated that it prefers to rely on GAAR to counter arrangements involving treaty shopping. In particular, the CCRA’s position is expressed in the technical explanation (third protocol) of paragraph 7 of article XXIX A of the Canada-US treaty, which states:

> Canada remains free to apply such [anti-avoidance] rules to counter abusive arrangements involving treaty shopping through the United States. . . . The agreement to state this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions [emphasis added].

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To date, only one case has dealt with GAAR in the context of a tax treaty. In that case, *RMM Canadian Enterprises Inc. et al. v. The Queen*, Bowman TCCJ lent fairly strong support to the CCRA’s view when he wrote in obiter:

> It would be a surprising conclusion that Canada, or indeed, any of the countries with which it has tax treaties... had intentionally or inadvertently bargained away its right to deal with tax avoidance or tax evasion by residents of treaty countries in its own domestic tax law. It would be equally surprising if tax avoidance schemes that are susceptible of attack under either general anti-avoidance provisions or specific anti-avoidance rules, if carried out by Canadian residents, could be perpetrated with impunity by non-residents under the protection of a treaty. That is not what treaties are for.101

Bowman TCCJ further stated:

> Even if I did not consider that the definition of dividends in the U.S. Convention was broad enough to cover deemed dividends arising from the combined operation of sections 245 and 84 (or section 84 alone), I would still have concluded that the U.S. Convention could not prevent Canada from applying GAAR to recharacterize the transaction as one to which sections 84 and 212 applied.102

The CCRA also considers that its position on the application of domestic anti-avoidance provisions in the context of treaty-shopping abuse is supported by the OECD.103 This view appears to be largely based on the commentary on the current model treaty—in particular, the commentary on article 1, paragraphs 23 and 24, which states that national tax laws dealing with “substance over form” rules and “sub-part F type”104 provisions are not affected by tax treaties.105 The commentary indicates that it is the view of the majority of OECD member states that the underlying principles relating to tax avoidance do not have to be confirmed in the text of a treaty in order to be applicable.

Therefore, in a situation involving a tax-sparing transaction that the CCRA considers abusive, it would not be illogical to conclude that the CCRA would attempt to apply GAAR to deny a Canadian intermediary or conduit the benefits of the foreign tax credits arising under the Canada-Brazil treaty to the extent that those credits represent tax that has not actually been paid by the Canadian resident and to the extent that the benefits are passed on to a non-resident. Given that the treaty includes no anti-avoidance provision, however, the CCRA would have to rely on the commentary on the current OECD model treaty and jurisprudence such as *RMM Canadian Enterprises* to support its GAAR position.

Not everyone agrees with the CCRA’s interpretation of the OECD commentary and not everyone agrees that GAAR overrides Canada’s tax treaties. For example, one view is that the OECD comments relate only to “base companies” and are not relevant to conduit or treaty-shopping situations.106 The more reasonable interpretation of the current commentary would be that treaty partners must explicitly agree to the override of a tax treaty by domestic anti-avoidance provisions. This interpretation is supported by the fact that, notwithstanding significant additions
to the current commentary in respect of article 1, paragraphs 7 through 10 of that commentary are unchanged from the version in the 1977 model treaty. Further, it has been suggested that paragraph 7 of article XXIX A was required in the Canada-US treaty precisely because Canadian officials recognized the need to explicitly permit a GAAR override in the context of a tax treaty. 107

In any event, the commentary on the 1977 OECD model treaty (the one in place at the time that the Canada-Brazil treaty was signed) is clear in its position that the intention to invoke domestic anti-avoidance provisions in the context of a treaty should be explicitly stated and agreed to in a treaty, and some would argue that it is the 1977 commentary that would be the proper interpretive aid. Although the question of which commentary should be considered relevant in the context of a treaty signed almost 20 years ago is open to debate, the Supreme Court in Crown Forest Industries reviewed only the commentaries that were in existence at the time that the relevant tax treaty was signed by the parties.

With respect to the CCRA’s position that GAAR overrides Canada’s tax treaties, Welch and Wilson concluded:

In circumstances where a claim for treaty entitlement is consistent with the words of the treaty but not its purpose, Canadian courts in applying the treaty will have to determine which is to prevail if the courts are unable to stretch or restrict the words to accord with the purpose. Where purpose prevails and the treaty entitlement is denied as a matter of treaty interpretation, the potential for GAAR is moot. Where the treaty entitlement is granted on the basis that the words prevail, the resulting avoidance or deferral of tax under the Tax Act should constitute an abuse of the Tax Act for the purposes of the GAAR. In this case, the question of whether the GAAR overrides Canada’s tax treaties is germane and we conclude it doesn’t primarily because the GAAR does not contain any express intention to override and, given its heritage, no intention to override should be imputed. 109

The conclusion that GAAR does not override Canada’s tax treaties was also reached by Tremblay and Goyette. In addition, Tremblay concluded that, where tax treaties have been entered into before 1992—as is the case with the Canada-Brazil treaty—it is unlikely that the 1992 revisions to the commentary on article 1 of the OECD model treaty would be relevant in an argument that GAAR can be utilized to deny treaty benefits.

Finally, as noted previously, Brazil is not a member of the OECD. If one party to a treaty does not specifically or necessarily subscribe to OECD positions at the time that a treaty is entered into, it may be appropriate to ask whether OECD positions should be considered relevant in the interpretation of that treaty, particularly when the issue is whether to import domestic anti-avoidance laws into the context of the treaty. The answer may be that the OECD commentaries are less relevant in such a case, but this is not at all clear.

On the basis of the foregoing, it is not at all clear that the CCRA’s position that GAAR can be used to attack tax treaties is well founded—particularly in the context of the Canada-Brazil treaty—and the better view may be that it is not. Assuming
for the moment, however, that the CCRA is correct in maintaining that GAAR can be used to attack treaty abuse, would abusive tax-sparing schemes be avoidance transactions that are the result of a misuse or an abuse of the provisions of the Act?

In order for GAAR to apply, the following conditions must be met:

- there must be a tax benefit arising from the transaction (or series of transactions),
- in circumstances where it may not reasonably be considered that the transaction was arranged primarily for bona fide purposes other than to obtain the tax benefit, unless
- it may reasonably be considered that the transaction would not result, directly or indirectly, in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole.

**Tax Benefit**

The first step in any GAAR analysis is the determination of whether there is a tax benefit. In the GAAR cases that have been decided to date, the emerging reasoning appears to be that the definition of tax benefit “assumes the existence of a standard amount of tax against which a reduction may be measured”\textsuperscript{114} and the standard should not be the tax result associated with having done nothing.\textsuperscript{115}

The choice that a Canadian intermediary is arguably faced with is (1) participating in the tax-sparing scheme by purchasing Brazilian debt securities (or interest in the case of an interest strip), receiving interest, claiming a foreign tax credit provided for in the treaty, and passing some or all of the benefit on to a non-resident third party; or (2) investing the funds in other income-producing investments or ventures that do not have the tax-sparing entitlements. On this basis, the tax benefit would be the benefit associated with the enhanced foreign tax credit.

It should be noted that in all of the GAAR cases to date, the measurement of the tax benefit has not been particularly problematic. For example, in *McNichol*,\textsuperscript{116} the tax benefit was measured as between the tax on a distribution by way of a liquidating dividend and the tax resulting from the sale of the shares—the decision to dispose of the underlying shares had already been made. In *Canadian Pacific Limited*,\textsuperscript{117} the benefit was the difference in tax resulting from borrowing in Canadian dollars and borrowing in Australian dollars. In *Jabs Construction Limited v. The Queen*,\textsuperscript{118} the benefit was defined as the tax on capital gains, along with a charitable deduction relating to the disposition of an interest in real property. There is no reason to believe that the tax benefit in a tax-sparing transaction would be difficult to identify or measure.

Interestingly, the fact that the tax credit may arise solely out of the Canada-Brazil treaty rather than as a function of both the treaty and the Act should not have an impact on the issue of whether a tax benefit is found to exist. This is due to the fact that a tax benefit is considered to arise when there has been a reduction of tax payable or a refund under the Act. The definition says nothing about the source of the amount that gives rise to the tax reduction or refund.
Avoidance Transaction

If a tax benefit is held to exist, the next issue is whether any particular tax-sparing scheme constitutes an avoidance transaction. Put another way, could the transaction reasonably be considered to have been undertaken by a Canadian intermediary primarily for bona fide business purposes other than to obtain the tax benefit?

The case law relating to GAAR to date has emphasized that GAAR should not be applied in the circumstances of transactions that have a primary commercial purpose. For example, in Canadian Pacific Limited, Bonner TCCJ held that there was no avoidance transaction as defined in subsection 245(3) of the Act given that the arrangements were primarily intended to produce the borrowed capital that the company required for business purposes. Further, he stated that “[n]o transaction forming part of the series can be viewed as having been arranged for a purpose that differs from the overall purpose of the series.”

In Geransky v. The Queen, Bowman ACJTC held that there was no avoidance transaction because the primary commercial objective was to dispose of assets, and that the taxpayer had simply accomplished that objective in a tax-effective manner. In other words, the tax benefit was not the primary objective, and the transaction could—and probably would—have been completed in its absence. In Husky Oil Limited v. The Queen also, the taxpayer was found to have undertaken the transactions at issue in order to achieve a commercial purpose. In Jabs Construction Limited, the taxpayer’s purpose was charitable in nature.

There are other cases, however, that provide insight into circumstances where a taxpayer may not be considered to have a primary purpose other than the obtaining of a tax benefit. In OSFC Holdings Ltd. v. The Queen, Bowie TCCJ found that there was an avoidance transaction within the meaning of subsection 245(3) in that the primary purpose of the transactions was to obtain the tax benefit. The proffered explanation of the parties to the transactions that they had undertaken the plan in order to maximize the marketability of the mortgage portfolios was considered not “objectively reasonable” in the circumstances. In Duncan et al. v. The Queen, the taxpayer was considered not to have had a bona fide purpose in mind other than to reap the tax benefit associated with a partnership arrangement. Similarly, in McNichol and RMM Canadian Enterprises, the taxpayers failed to meet the test set out in subsection 245(3).

In each of these cases where the primary purpose of the transactions at issue has been considered to be the obtaining of the tax benefit, either the taxpayers offered up vague or generalized explanations of some non-tax purpose and failed to objectively demonstrate, through solid documentary evidence, that the tax benefit was not the primary purpose of the transactions, or the taxpayers engaged in behaviour that was inconsistent with the primary commercial purpose.

With respect to tax-sparing transactions, some schemes may enable an intermediary to earn a profit on the entire tax-sparing arrangement, absent the foreign tax credit. On this basis, it might be argued that the transactions have the primary commercial purpose of earning a profit. This line of reasoning might be particularly appealing in the context of an entity whose business involves trading in
financial instruments and related products and earning fee income. On the basis of the findings in Canadian Pacific Limited, Husky Oil Limited, and Geransky, this reasoning could lead to the conclusion that there is no avoidance transaction.

On the other hand, tax-sparing arrangements that utilize intermediaries, taken as a whole, would not likely exist absent the tax benefit. The role of the intermediary is to enable a non-resident of Canada to obtain indirect access to tax-sparing benefits through a structured arrangement. Depending on the design of any particular arrangement, the return to the intermediary may be too small, absent the foreign tax credit, to warrant the time and effort required to implement the strategy when compared with the return on other investment proposals. Further, any related documents might not have a positive impact on a Canadian court in considering the issue of purpose. On this basis, a court could find that the primary purpose of the transactions was to obtain the tax benefit and that the transactions are avoidance transactions within the meaning of subsection 245(3).

At the end of the day, it would be a finding of fact, based on all of the relevant circumstances, as to whether any particular tax-sparing transaction was undertaken for a purpose other than the obtaining of the tax benefit. Perhaps the answer is that where a taxpayer has a reasonably specific business purpose that has nothing to do with obtaining a tax benefit, and where the transactions would otherwise be undertaken absent the tax benefit, an avoidance transaction as defined in subsection 245(3) should not exist. On the other hand, where the taxpayer has only a vague business purpose—such as “to earn a profit” or “to expand the business”—or where the transaction makes little or no sense absent the tax benefit, and the documentary evidence is substantially focused on tax-sparing benefits, an avoidance transaction would more likely be considered to exist.

In any event, it may be imprudent for a taxpayer who is contemplating acting as an intermediary in a tax-sparing transaction to leap to the conclusion that the arrangement does not constitute an avoidance transaction on the basis that it is being undertaken “to earn a profit.” It is unclear that such a general motivation would be sufficient to enable a court to conclude that the primary motive was other than to obtain the tax benefit, since the profit could not be earned without the taxpayer’s first agreeing to secure the tax credit for the indirect benefit of the non-resident.

Misuse or Abuse

If a tax-sparing arrangement gives rise to a tax benefit and it is an avoidance transaction, the only remaining issue is whether it can reasonably be considered that the transaction (or series of transactions) results, directly or indirectly, in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole. Absent a misuse or an abuse of a provision of the Act or of the Act taken as whole, GAAR cannot apply. To date, in each of the cases where GAAR has been held to apply, the court has been able to identify a particular section (or sections) of the Act that has been misused or an abuse that has struck at a particular scheme of the Act.
If any section of the Act would be subject to misuse or abuse in a tax-sparing arrangement, it would presumably be section 126, since that is the domestic law that governs the foreign tax credit claim of a Canadian resident and it is the foreign tax credit claim that may be implicated under such an arrangement. Generally, foreign tax credits are granted in order to ensure that a Canadian resident is not subject to double taxation of income. Foreign tax credits are not provided in order to enable Canadian residents to export the tax benefits to non-residents.

It has been suggested above that section 126 does not apply in the context of tax-sparing transactions to which article 22 of the Canada-Brazil treaty applies. If this is so, it is difficult to understand how such a transaction could be considered a misuse or an abuse of that provision. Nor is it reasonable to conclude, in the circumstances, that there has been a misuse or an abuse of the provisions of the Act read as a whole once it has been established that the relevant foreign tax credit entitlement and determination is not governed by the Act but is mandated by the treaty. This is particularly à propos in respect of the treaty, since Canada could have followed its normal practice of making the Act applicable to the foreign tax credit determination but apparently chose to deviate from that practice. There may be a misuse or an abuse of a provision of the treaty and an abuse of the Canadian government’s foreign aid largesse, but there can be no misuse or abuse of a provision of the Act.

It has been argued that an abuse of Canada’s tax treaties is an abuse of the Act. This view is based on the fact that the enabling legislation in respect of tax treaties amends the Act and that the Act incorporates provisions that reduce taxes to levels provided for in Canada’s tax treaties. On the basis that this theory permits the CCRA to mount a GAAR challenge, it may be possible (although difficult) for the CCRA to demonstrate that there has been a misuse or an abuse of the Act. At some point, however, this approach begins to look like a challenge based on treaty interpretation and application—a challenge that may be better made in its own right. In addition, the theory that an abuse of the Canada-Brazil treaty is an abuse of the Act may not be relevant to abusive tax-sparing transactions involving that treaty, simply because the treaty was signed and ratified before GAAR was enacted. Absent compelling evidence that both treaty partners intended that domestic law, including anti-avoidance provisions, apply to treaty-based transactions, a Canadian court may be hard pressed, in the circumstances, to find a basis on which to extend the scope of GAAR to Brazilian tax-sparing transactions.

While any answer to this problematic question is not free from doubt, it appears that it may be exceedingly difficult, if not futile, to attempt to use GAAR to attack tax-sparing arrangements where a Canadian intermediary claims foreign tax credits under the Canada-Brazil treaty.

Have We Been Looking in All the Wrong Places?

If section 126 of the Act does not apply to Brazilian tax-sparing transactions, and if GAAR would not be applicable or if a GAAR challenge would be difficult to sustain for any one of a number of reasons, should a Canadian corporation that is
contemplating what may be considered an abusive Brazilian-based tax-sparing scheme, assume that it can undertake the transactions without fear of a successful CCRA attack? Or have we been looking in all the wrong places?

The Crown Forest Approach

The decision in Crown Forest Industries stands for the proposition that only residents of the countries that are parties to a particular tax treaty are entitled to benefit from that treaty; residents of third countries are to be denied treaty benefits\(^{129}\)—whether or not the transactions giving rise to the benefits are considered abusive. It is this finding, along with the liberal approach to treaty interpretation that the Supreme Court endorsed, that arguably results in the greatest tax risk for Canadian intermediaries in potentially abusive tax-sparing arrangements.

Crown Forest Industries Ltd. was a Canadian-resident corporation that paid barge rental payments to a related company, Norsk. Norsk was incorporated in the Bahamas but had its only office and place of business in the United States; thus, the rental payments were made to that office. Although Norsk filed a US tax return, it did not pay any US tax on its income because of an IRC exemption provided to Bahamian corporations. Crown Forest withheld Canadian part XIII tax on its rental payments to Norsk at the rate of 10 percent, as provided for in the Canada-US treaty, on the basis that Norsk was a resident of the United States. The Supreme Court held unanimously that Norsk was not a resident of the United States and, therefore, was not entitled to benefit from the reduced rate of withholding on rental payments provided for in the treaty. The reasoning and comments of the Supreme Court in arriving at its conclusion are insightful and relevant in a consideration of the result of any tax-sparing arrangement.

First, the court focused on the goals of the tax treaty. It concluded that the goal was not to permit companies incorporated in third party countries (the Bahamas) to benefit from a reduced tax liability on source income merely by virtue of dealing with a Canadian company through an office situated in the United States. As far as I can see, if there were any tax convention that Norsk would be able to benefit from it is that concluded between the US and the Bahamas.\(^{130}\)

In other words, tax treaty benefits should accrue only to residents of the countries that are a party to the particular treaty.

Second, the court held that to permit Norsk to benefit from the Canada-US treaty would be to encourage corporations to route their income through particular countries in order to obtain benefits that were designed to be given to residents of the treaty contracting states (treaty shopping). The Supreme Court arguably created a presumption against treaty shopping\(^{131}\) without distinguishing between those cases where a non-resident attempts to access the benefit directly and situations where access is sought through a non-related or related Canadian intermediary:
It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements.132

Third, the court endorsed a liberal approach to treaty interpretation, embracing

- an understanding of the words or a plain meaning test; and
- an understanding of the intentions of the drafters of the relevant treaty as evidenced by the treaty itself, by extraneous materials, and, in particular, by OECD materials.

The liberal approach to treaty interpretation may be founded, in part, on the notion that treaties are international agreements and are more difficult to alter or amend than the Act.

In the case of the Canada-Brazil treaty, article 1 provides that the treaty applies to residents of one or both contracting states. Paragraph 1 of article 4 of the treaty defines a resident of a contracting state to be “any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” In the case of a tax-sparing arrangement involving a Canadian intermediary or conduit, the intermediary would be a resident of Canada and would, at least ostensibly, meet the treaty test. The residency of the ultimate beneficiary of the arrangement is also not in question; if the ultimate beneficiary of the arrangement were a resident of Canada, the transactions would be moot since the beneficiary could directly access the treaty benefit.

On a rudimentary review of the arrangement, it could be argued that since the intermediary to the tax-sparing arrangement is a Canadian resident, it is entitled to the enhanced foreign tax credit benefit provided for in the treaty. In this respect, at least, the situation is distinguishable from that of Norsk. Norsk, which was actually a resident of the Bahamas, attempted to access the benefit of the Canada-US treaty by claiming to be a US resident.

A different result is arrived at, however, if one follows the approach in Crown Forest Industries and identifies the parties whom the treaty is intended to benefit—in particular, the group intended to benefit from article 22. The group intended to benefit may be considered to be Canadian-resident corporations that purchase Brazilian debt obligations and take the risks, whether they are in the nature of credit, liquidity, or interest rate risks, associated with those obligations. There is no evidence in either the treaty or other related materials that would support the contention that non-residents of Canada are the intended beneficiaries of the tax-sparing benefits provided for in the treaty. Therefore, in line with Crown Forest Industries, a Canadian court could well find that, looking at the tax-sparing arrangement as a whole, the treaty benefits should be denied to the Canadian intermediary.
to the extent that they are ultimately being accessed by an unintended party that is neither a resident of Canada nor a resident of Brazil.

To permit the tax-sparing arrangements, taken as a whole, to prevail would be to permit non-residents to take part in treaty-shopping expeditions, using Canada as a credit card to access treaty-sourced tax benefits that would otherwise be unavailable. This would be inconsistent with the Supreme Court’s view of treaty shopping, and a Canadian court could well look to ensure that judicial interpretation would not support the practice in tax-sparing cases.

Although, under a strict interpretive approach to the treaty and the Act, abusive tax-sparing arrangements might be held to be technically feasible, the liberal interpretive approach espoused in Canadian jurisprudence in respect of tax treaties may result in the defeat of such arrangements. Notwithstanding that the liberal approach may have hurdles to overcome in looking through specific agreements to the arrangement as a whole, it would require a court to take into account the views of the Canadian government and the OECD regarding the purpose of tax sparing and the intended beneficiaries. The OECD clearly does not support abusive tax-sparing transactions, and it would be hard to imagine that the Canadian government would take an alternative view.

The liberal approach could also give recognition to the notion that the treaty negotiators might have included anti-avoidance provisions in the treaty if they could have anticipated the abusive transactions of more recent times. In view of the foregoing, a Canadian court could deny the benefits of article 22 of the treaty in the context of abusive tax-sparing schemes on the basis that the lack of a specific anti-avoidance provision in the treaty should not be fatal. Using this approach, a court would be able to avoid addressing the issue of whether GAAR overrides Canada’s tax treaties while coming to a conclusion that would not be inconsistent with the application of GAAR.

Such a position would not be inconsistent with positions taken by US courts in treaty cases. For example, in Great West Life Assur. Co. v. United States, the court recognized that the treaty negotiators had erred in failing to foresee how the treaty language might apply. The court searched for the result that it believed that the negotiators would have reached had they been confronted with the facts that were presented to the court.

On the other hand, in the only Canadian case involving tax sparing, Canada-Israel Development Ltd. v. MNR, the Tax Court refused to search for the reason why the drafters of the protocol to the Canada-Israel tax treaty may have overlooked or omitted particular wording. The case did not, however, involve treaty shopping or any other type of abusive tax arrangement. Consequently, the court may not have been motivated to take a Great West Life type of approach.

In circumstances where the purpose of a tax-sparing transaction is to transfer treaty benefits intended for Canadian residents into the hands of non-residents, a Canadian court might well use the Crown Forest Industries approach to strike at abuses. Interestingly, the approach of restricting treaty benefits to residents of the
treaty countries is precisely the solution that New Zealand arrived at in dealing with tax-sparing abuses, albeit through the process of negotiating treaty amendments.

Other Approaches
As an alternative to the Crown Forest Industries approach, there may be other bases on which tax benefits of Brazilian tax sparing might be either reduced or denied in cases where the Canadian corporation is acting as an intermediary in an abusive transaction.

Depending on the facts of the particular tax-sparing transaction, it may be arguable that the Canadian intermediary is not the beneficial owner of the Brazilian debt obligations and/or is not the beneficial owner of the interest. The details of such an argument are beyond the scope of this article, but the effect would be to cause the Canadian corporation to be denied any entitlement to a foreign tax credit under article 22 of the treaty. This result would follow from the fact that the Canadian resident would not meet one of the tests in article 11 that must be complied with in order for the tax credit in article 22 to be triggered. This test would have the effective result of equating the Canadian intermediary’s role to that of agent of the non-resident.

Alternatively, the amount of the foreign tax credit may be significantly reduced, although probably not totally negated, by simply applying the words of the treaty. Paragraph 2 of article 22 provides that the deduction from Canadian tax shall not exceed “that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil.” The question then becomes, what is the amount of “income which may be taxed in Brazil”?

In order to determine the Canadian tax on an amount of interest income, the expenses incurred to earn the income must be deducted from the gross amount of the interest. This would include the cost of any funds used to purchase the debt obligations as well as, arguably, the cost of any transaction that is integral to the tax-sparing arrangement as a whole. This calculation may seriously disturb the purported economics of a tax-sparing proposal to the Canadian intermediary and make the transaction less attractive.

The income calculation, however, may not be the entire answer in schemes such as the proposed scheme involving New Zealand intermediaries that was described earlier. In that type of arrangement, a revenue authority may have to consider whether there is a basis for denying the company playing the role of New Zealand company no. 1 an interest deduction in respect of the funds borrowed from the offshore entity. In the context of Canadian tax law, the CCRA could attempt to deny the deduction on the basis that the amount was not paid or incurred to earn income. The importance of basic tax principles should not be overlooked in any tax-sparing analysis.

Finally, the CCRA could attempt to apply GAAR to the deduction of any amount payable under the tax-sparing arrangement by a Canadian intermediary.
to a non-resident in circumstances where the arrangement is considered to be offensive. Such a challenge would presumably be mounted on the basis that the scheme constitutes a misuse or an abuse of the section (or sections) of the Act giving rise to a deduction in respect of the payment to the non-resident. This would be similar to the line of reasoning taken in *OSFC Holdings Ltd.*

**CONCLUSION**

Tax sparing started out as a well-intentioned foreign aid tool. Good intentions, however, are rarely sufficient to achieve concrete goals. There is little evidence to support the assertion that tax-sparing aid has resulted in better quality or more economic development than that which has been achieved through traditional foreign aid programs. At the same time, the opportunities for unintended tax results have expanded over the years as international financiers have devoted efforts to the engineering of new structures to take advantage of arbitrage opportunities. There seems to be a significant discrepancy between the original good intentions and some of the real life consequences of tax sparing.

Dealing with tax-sparing abuses under domestic law has proven difficult. New Zealand ultimately opted for incorporating anti-avoidance provisions in its tax treaties and requiring the reporting of tax-sparing benefits accessed by New Zealand taxpayers. In the Canadian context, sustaining an attack on an offensive Brazilian tax-sparing scheme based on GAAR would be difficult. In challenging an arrangement, the CCRA would likely have to rely on an approach to treaty benefit entitlement along the lines of *Crown Forest Industries*, or an argument that the Canadian intermediary did not meet the criteria in the particular treaty in order to access the enhanced tax credit. Australia has become so disenchanted with tax sparing that it has announced that it will neither renegotiate tax-sparing provisions in existing tax treaties nor agree to such provisions in new treaties.136

Given the concerns of the OECD and its member nations regarding tax-sparing abuses and the difficulties that can be encountered in dealing with such abuses under domestic laws, it seems prudent for OECD member countries to follow the New Zealand approach and incorporate specific anti-avoidance provisions in any tax treaty that contains a tax-sparing provision. New Zealand was fortunate in that its treaty partners agreed to amend the relevant treaties. In the case of the Canada-Brazil treaty, given the unsettled state of Canada-Brazil relations (owing to trade disputes in the 2000-2001 period), it is uncertain whether Brazil would be amenable to a treaty amendment.

The United States remains steadfast in its refusal to grant tax sparing in any of its tax treaties. At the end of the day, for both policy and practical reasons, the US position may represent the future of tax sparing at the OECD. Perhaps Stanley Surrey posed the right question in 1960 when he asked:

> One basic question, therefore, is whether a tax preference or incentive should be granted only in those situations where the Congress would be willing to pay out dollars directly outside the tax mechanism on a no-questions-asked basis.137
Notes

1 Organisation for Economic Co-operation and Development. The OECD is an organization of, currently, 30 member countries. Its goals are to promote policies designed to achieve high levels of sustainable economic growth and employment, contribute to economic expansion among member and non-member countries, and contribute to the expansion of world trade on a multi-lateral, non-discriminatory basis. The current member countries are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.


3 There may be circumstances where the developing country, rather than the investor’s country of residence, imposes the higher rate of tax. In such a case, the investor’s country of residence would normally grant a maximum foreign tax credit equal to the tax it imposes on the income. In this situation, the income is still taxed once but at the higher rate imposed by the developing country.

4 The example ignores various limitations that may be imposed by section 126 of the Income Tax Act in respect of the amount of foreign tax credit that may be claimed: RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).

5 From time to time, a distinction has been made between a tax-sparing and a “matching-credit” system. Although the two systems are similar in nature, tax sparing has been defined as a system whereby the foreign tax credit granted by the developed country corresponds exactly to the rate of tax that would have been payable in the source country absent the tax incentive. Matching credit has been defined as a system whereby the foreign tax credit granted by the developed country is at a rate higher than the rate that would have otherwise been applicable in the source country. See Gérard Coulombe, “Certain Policy Aspects of Canadian Tax Treaties,” in Report of Proceedings of the Twenty-Eighth Tax Conference, 1976 Conference Report (Toronto: Canadian Tax Foundation, 1977), 290-303, at 298. To illustrate the difference between the two systems, assume that a Canadian resident receives $100 of interest in respect of debt obligations of the government of country B and that the maximum withholding tax rate on interest under the tax treaty between Canada and country B is 15 percent. Country B, however, imposes no withholding tax on interest payments made by the government of country B to non-residents. In a tax-sparing system, Canada would grant the Canadian recipient of the interest a tax credit for $15 ($100 interest times the 15 percent withholding tax rate). In a matching-credit system, Canada and country B would negotiate for Canada to grant a tax credit on the interest at a rate that exceeds the maximum 15 percent treaty withholding tax rate. For example, the countries might negotiate a tax credit rate of 20 percent in respect of interest on country B debt obligations. In the example, Canada would grant a tax credit of $20 ($100 times 20 percent), even though the maximum treaty withholding rate on interest is 15 percent. Canada has adopted both systems in its tax treaties. For example, the treaty with Spain applies the tax-sparing approach while the treaty with Brazil provides for the matching-credit system. For the purposes of this article, the term “tax sparing” will be used to include both methods.

6 See supra note 2, at 15.

7 See ibid., at 64-69, for chart summaries of nations with which OECD countries have concluded tax treaties that contain tax-sparing provisions.

8 Joseph P. Crockett, “‘Tax Sparing’: A Legend Finally Reaches Print” (1958), vol. 11, no. 2 National Tax Journal 146-55, at 148-49.

9 Ibid.

11 Supra note 2, at 15.
12 Ibid., at 16.
13 Ibid.
14 Capital export neutrality exists when decisions between domestic and foreign investment opportunities are guided by market factors and not by tax policy considerations—in particular, by tax incentive programs.
17 The treaties were with India, Israel, and the United Arab Republic.
19 Supra note 10, at 455.
The history of US-Brazil treaty negotiations covers a lengthy period. The first negotiations began in 1949. In 1967, the first completed treaty was submitted for ratification to the legislative bodies of the respective countries. This treaty provided for a form of tax sparing: the United States would agree to provide its residents with a tax credit equal to 7 percent of the amount of any investment in buildings and equipment in Brazil. The provision was seen as similar to a US domestic tax credit offered during the period in respect of investments in tangible capital assets. The US Senate did not ratify the treaty, however, and it entered a reservation on the provision on the basis that, in view of the US economic situation, it was not appropriate to encourage investment in other countries. See David R. Tillinghast, “Tax Treaty Issues” (April 1996), 50 University of Miami Law Review 455-82, at note 99.
21 In the exchange of letters accompanying the US-India tax treaty, concluded in September 1989, the United States made the following commitment: “Both sides agree that a tax sparing credit shall not be provided in Article 25 (Relief from double taxation) of the convention at this time. However, the Convention shall be promptly amended to incorporate a tax sparing credit if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.” See Tax Treaties, vol. 2 (Chicago: CCH) (looseleaf), paragraph 4215.
22 Supra note 10, at 458.
23 Ibid., at 454-55.
24 Tillinghast, supra note 20, at 476.
26 Supra note 2, at 25.
27 Ibid., at 13.
28 Supra note 10, at 455-58.

31 Including China, Korea, Thailand, Morocco, Tunisia, and Israel.


33 Supra note 2, at 19.


35 Supra note 2, at 12.


38 Ibid., at 319.

39 James R. Hines Jr., Tax Sparing and Direct Investment in Developing Countries, Working Paper 6728 (Cambridge, MA: National Bureau of Economic Research, September 1998). The paper compared the patterns of Japanese and US foreign direct investment over the same time period and found that Japanese firms locate a much higher portion of their investment in countries with which Japan has negotiated tax-sparing provisions. US firms locate a lower portion of their investment in these countries. Hines found that “[a]ll other things being equal, ‘tax sparing’ agreements are associated with 140%-240% higher FDI (foreign direct investment) levels and 23% lower tax rates on FDI.” Ibid., at 3.


41 Supra note 2, at 35.

42 Ibid.


44 Ibid., at 177.

45 The provision benefiting corporations owning more than 25 percent of the voting shares of an Irish company was made redundant, in part, when Canada enacted subsection 113(1) of the Act as part of its tax reform package of the 1970s. Subsection 113(1) provides for a full or partial deduction of dividends received by a Canadian corporation from a foreign affiliate (that is, a corporation in which the taxpayer and related parties own at least 10 percent of the shares).

46 The Convention Between Canada and the State of Israel for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Ottawa on July 21, 1975 (entered into force July 27, 1976). The tax-sparing provision of this treaty is the only one, to date, that has been the subject of tax litigation in Canada (Canada-Israel Development Ltd., 85 DTC 719 (TCC)).

47 Before the tax reform of 1973, dividends received by a Canadian company from a wholly owned foreign subsidiary were generally tax deductible to the Canadian parent. There was no active business test in the pre-1972 Income Tax Act.

49 Coulombe, supra note 5, at 298.

50 Ibid., at 299.

51 The countries with which treaties had been concluded were Bangladesh, Barbados, Cameroon, Cyprus, the Dominican Republic, Egypt, Indonesia, Ireland, Israel, the Ivory Coast, Jamaica, Kenya, Korea, Malaysia, Morocco, Pakistan, Romania, Singapore, Spain, Thailand, Tunisia, and Zambia. A treaty with Brazil was awaiting ratification. See Nathan Boidman, “Some Current Issues with Treaty Tax-Sparing Provisions” (1985), vol. 39, no. 8/9 Bulletin for International Fiscal Documentation 387-91, at 388-89.

52 United Nations Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/102.


54 The Convention and Protocol Between the Government of Canada and the Government of the Federative Republic of Brazil for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Brasilia, June 14, 1984 (herein referred to as “the Canada-Brazil treaty” or “the treaty”).

55 Ward, supra note 53, at 1748.


57 See supra note 2, at 64-69. Tax-sparing provisions are included in treaties with the following developing countries: Argentina, Brazil, China, India, Indonesia, Malaysia, the Philippines, Singapore, and Thailand. In addition, treaties with Ireland, Korea, and Spain, all OECD members, contain tax-sparing provisions. While Canada still has tax-sparing provisions in treaties with the countries listed in note 51, supra, these provisions are no longer relevant since they were drafted to apply to tax incentives under specific programs that have since been terminated by the treaty partner.

58 Supra note 15, at 170.

59 Tillinghast, supra note 20, at 476.

60 Supra note 2, at 13.


62 Supra note 2, at 28.

63 Ibid.

64 For example, Canada has enacted section 247 of the Act, which mandates arm’s-length pricing in related-party transactions and requires the Canadian resident to create and maintain supporting contemporaneous documentation. The United States has enacted a similar provision by way of section 482 of the Internal Revenue Code of 1986, as amended (herein referred to as “IRC”), and regulations thereto. The United Kingdom, Australia, France, and Japan have also enacted transfer-pricing legislation.


66 Supra note 2, at 72-75.

67 Ibid., at 74-75.
Although the OECD tax-sparing paper does not name the treaty partner with which New Zealand negotiated anti-avoidance provisions, New Zealand’s treaties with both Singapore and the People’s Republic of China have been amended to incorporate this change. In the case of the New Zealand-Singapore tax treaty, the following provision was added as part of the second protocol to the treaty, signed on July 1, 1993:

Notwithstanding paragraph 3 of Article 19 of the Agreement, a New Zealand resident deriving income from Singapore, being income referred to in that paragraph, shall not be deemed to have paid Singapore tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of Singapore, that it is inappropriate to do so having regard to:

a) whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 of Article 19 for the benefit of that person or any other person;

b) whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor a Singapore resident;

c) the prevention of fraud or the avoidance of the taxes to which the Agreement applies;

d) any other matter which the competent authorities consider relevant in the particular circumstances of the case including any submissions from the New Zealand residents concerned.

See the Agreement Between the Government of New Zealand and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Singapore on August 21, 1973, as amended by the protocol signed on July 1, 1993. In the case of the New Zealand-People’s Republic of China tax treaty, the following provision was added as part of the second protocol to the treaty, signed on October 7, 1997:

Notwithstanding Article 23 of the Agreement, a New Zealand resident deriving income from the People’s Republic of China, being income referred to in paragraph 3 of Article 23 of the Agreement, shall not be entitled to the benefit of that paragraph where:

a) arrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 of Article 23 for the benefit of that person or any other person that are contrary to the spirit and intent of that paragraph; or

b) any benefit accrues or may accrue to any person who is neither a resident of New Zealand nor a resident of the People’s Republic of China.

See the Agreement Between the Government of New Zealand and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Wellington on September 16, 1986, as amended by the protocol signed on October 7, 1997.

Supra note 2, at 75.

Ibid., at 77.

In a typical interest strip, a company (“Subco”) resident in a country that has a tax-sparing provision in a tax treaty acquires the right to receive certain interest payments from its parent (“Parentco”) or an unrelated party that is resident in a country that does not have a tax-sparing provision in the relevant tax treaty. Parentco owns the underlying debt securities and sells, by an equitable assignment, all of its rights, title, and interest in the interest payments.

The pricing of the assignment reflects the expected foreign tax credits in respect of the interest payments.

For example, a corporation (“A Co”) may purchase debt securities and enter into a credit default derivative and an interest rate swap with a third party (“B Co”) in respect of the debt securities. The credit default derivative allows A Co to exchange the credit risk associated with the issuer
of the debt for the credit risk associated with B Co, the writer of the default protection. By entering into an interest rate swap with B Co, A Co is able to manage the interest rate or market risk. B Co assumes the credit risk associated with the debt securities and receives amounts equal to the interest payments on the debt security through the interest rate swap.

73 Article 22 of the treaty, supra note 54, deals with the granting of Canadian tax credits in respect of Brazilian taxes paid by a Canadian resident on Brazilian-source income. Article 22 corresponds to article 23 of the OECD model treaty.

74 For example, paragraph 3 of article 23 of the Brazil-Denmark tax treaty (Convention and Protocol Between the Government of the Kingdom of Denmark and the Government of the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Copenhagen on August 27, 1974) provides that Denmark shall grant to a resident receiving Brazilian-source interest or royalties a tax credit equal to the tax paid in Brazil. Paragraph 4 of the same article provides that the Brazilian tax shall always be considered to have been paid at a rate of 25 percent. Brazil’s tax treaties with the Czech Republic, the Netherlands, Korea, Finland, and the Philippines, among others, also contain generous tax-sparing provisions.

75 Article 11 of the treaty. The rate is 10 percent if the interest is in respect of a loan guaranteed by the Export Development Corporation of Canada for a minimum period of seven years.

76 Article 777 of the Brazilian income tax legislation provides that interest arising from Brazilian foreign debt bonds and from the national treasury bonds issued by the National Treasury that were exchanged for the government foreign debt and are registered with the Brazilian Central Bank is not subject to Brazilian withholding tax. This exemption is also supported by article 4 of Law no. 10.179/2001.


79 Subsections 126(4.1) and (4.2) of the Act were added by the 1998 budget and are effective for 1998 and later years. Subsection 126(4.1) is designed to limit a taxpayer’s foreign tax credit in cases where it is not reasonable to expect that the taxpayer will recognize an “economic profit” from the underlying property. “Economic profit” is defined in subsection 126(7). Subsection 126(4.2) limits the foreign tax credit in circumstances where the taxpayer holds the underlying shares or debt obligations for one year or less.

80 95 DTC 5389, at 5393 (SCC).

81 Ibid., at 5396.

82 Supra note 80, at 5393.

83 Paragraphs 4 and 5 deal with tax on income in the form of dividends and thus are not relevant to the analysis of the treatment of tax arising on interest income.

84 See, for example, Ward, supra note 53, at 1748.

85 85 DTC 5188, at 5191 (FCTD).

86 See the text following note 73, supra, for the relevant paragraphs of article 22 and the standard wording used in other treaties.

87 The other two exceptions are the treaties with Norway and Ireland. The Norwegian treaty provides that Canada shall allow as a deduction from any Canadian tax on income derived from sources in Norway, an amount equal to the Norwegian tax payable in respect of the income. The Irish treaty makes a claim of a tax credit subject to the laws of Canada but omits the reference to subsequent modifications thereof. Both of these treaties were concluded in 1966. The 1967 income tax treaty between Canada and Denmark also contained wording similar to that found in the Norwegian tax treaty. Canada and Denmark, however, entered into a new tax treaty in 1997.

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The new treaty provides that any tax credit claim shall be subject to the existing provisions of the law of Canada and to any subsequent modifications of those provisions.


89 Article XIII(3) of the Agreement Between Canada and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at London on June 5, 1946.


91 In the earlier treaties, the claiming of tax credits was made subject to the provisions of the Income Tax Act at the time a particular treaty was entered into by the parties. This practice has sometimes been referred to as “freeze-framing.” Subsequently, the wording was added that made the tax credit not only subject to the provisions of the Act at the time a treaty was entered into but also subject to the provisions as they might subsequently be modified.

92 Twenty-two tax treaties were signed by Canada in the period 1980-1989, and all except the Canada-Brazil treaty include the standard wording. The latter treaty was signed in 1984.


94 The relevant portion of article 23B of the 1977 OECD model treaty (supra note 32), the model in place at the time that the Canada-Brazil treaty was negotiated, reads as follows:

Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in the other State;

b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in the other State.


96 For a detailed consideration of this question, see Nathalie Goyette, Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue (Toronto: Canadian Tax Foundation, 1999); and Jill Welch and Jim Wilson, “The GAAR and Canada’s Tax Treaties: Which Is Trump?” in Special Seminar on Canadian Tax Treaties: Policy and Practice, supra note 40, tab 12.

97 Subsection 245(2) provides:

Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions.
Subsection 245(4), however, provides:

For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or in an abuse having regard to the provisions of this Act, other than this section, read as a whole.

An avoidance transaction is defined in subsection 245(3) as any transaction (or series of transactions) that . . . would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide business purposes other than to obtain the tax benefit.

Subsection 245(1) defines a tax benefit as a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act.


100 Technical Explanation, supra note 98, at article 18.

101 97 DTC 302, at 313-14 (TCC).

102 Ibid., at 316.


104 “Subpart F” refers to IRC sections 951 through 964, which deal with the amount of income of a foreign corporation that must be included in the income of a US shareholder on a current basis. The rules apply in circumstances where a US person owns, or constructively owns, 10 percent or more of a foreign corporation’s shares that have voting rights. Subpart F income is similar to Canadian foreign accrual property income.

105 Supra note 32.

106 Supra note 103, at 38:3-5. Also see Goyette, supra note 96.

107 Ibid.


109 Welch and Wilson, supra note 96, at 7.

110 Supra note 103, at 38:41.

111 See Goyette, supra note 96, at 75-76.

112 Supra note 103, at 38:42. The CCRA may be in a stronger position to challenge offensive tax-sparing arrangements using GAAR where the relevant treaty has been concluded after 1992— for example, the Canada-Argentina treaty (signed at Buenos Aires on April 29, 1993). These later treaties, however, are much more circumscribed and presumably less subject to abuse.

Interestingly, the transaction in RMM Canadian Enterprises took place in 1989 and 1990— before the publication of the 1992 OECD model treaty (supra note 32) and before the 1995...
addition of article XXIX to the Canada-US treaty (supra note 99). Notwithstanding the foregoing, Bowman TCCJ considered that GAAR overrode the tax treaty, although the issue of timing was not explicitly considered.

113 See François Vincent, “Crown Forest Industries: The OECD Model Tax Convention as an Interpretive Tool for Canada’s Tax Conventions” (1996), vol. 44, no. 1 Canadian Tax Journal 38-58, at 54. It is also interesting to consider how a Canadian court’s view of the potential applicability of GAAR might be influenced by the fact that Brazil formerly took the position that domestic law overrides tax treaties—at least in the transfer-pricing context. Brazil subsequently reversed its position owing to international pressure.

114 Canadian Pacific Limited v. The Queen, 2000 DTC 2428, at 2431 (TCC).

115 See also McNichol et al. v. The Queen, 97 DTC 111 (TCC).

116 Ibid.

117 Supra note 114.

118 99 DTC 729 (TCC).

119 Supra note 114, at paragraph 15.

120 2001 DTC 243 (TCC).

121 99 DTC 308 (TCC).

122 99 DTC 1044 (TCC).

123 2001 DTC 96 (TCC).

124 In some respects, it is difficult to reconcile the different outcomes in McNichol and Geransky. In both cases, the taxpayers had decided on a course of action as a business matter and then consulted professional advisers on the most tax-effective manner of achieving their goals.

125 OSFC Holdings, supra note 122, is a good example of a situation where documents, including drafts, created by a party associated with a transaction or a series of transactions can be particularly detrimental to a taxpayer’s case. The liquidator (Ernst & Young) created or had created draft documents that contained substantial discussion and illustration of the tax advantages of the transactions but made no mention of any other motivation for the use of the proposed structure. When the final version of the liquidator’s report was filed, there was no mention of tax motivation for this structure. On the basis of the lack of tax discussion in the final report and the sudden appearance of a discussion of various business objectives of the transactions, coupled with the unconvincing testimony of the liquidator’s representative, the Tax Court found that the primary purpose of the transactions was to obtain the tax benefit.

126 In the technical notes to subsection 245(4), the Department of Finance stated that “a transaction structured to take advantage of technical provisions of the Act but which would be inconsistent with the overall purpose of these provisions would be seen as a misuse of these provisions. On the other hand, a transaction may be abusive having regard to the Act read as a whole even where it might be argued, on a narrow interpretation, that it does not constitute a misuse of a specific provision.” Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (Ottawa: Department of Finance, June 1988). The department does not indicate in the technical notes any intention to apply GAAR in circumstances where misuse or abuse occurs outside the Act, as would be the case in the misuse or abuse of a treaty provision.

127 In McNichol, supra note 115, and RMM Canadian Enterprises, supra note 101, the court determined that the scheme of the Act was that the distributions at issue were to be treated as dividends and not capital gains. The taxpayers’ attempts to convert what should have been dividends to capital gains were considered inappropriate. In OSFC Holdings, supra note 122, it was subsection 18(13) of the Act that was considered to have been misused; in Duncan, supra note 123, it was sections 13 and 20 of the Act; in Nadeau v. The Queen, 99 DTC 324 (TCC), subsection 84(3) was considered to have been misused.
128 For a discussion of this theory, see Jean-Marc Déry and David A. Ward, “Canada,” in International Fiscal Association, Cahiers de droit fiscal international, vol. 78a, Interpretation of Double Taxation Conventions (Deventer, the Netherlands: Kluwer Law and Taxation, 1993), 259-93, at 88; Goyette, supra note 96, at 24-30; and Welch and Wilson, supra note 96, at 69.


130 Supra note 80, at 5397.

131 Supra note 113, at 48.

132 Supra note 80, at 5397.

133 678 F.2d 180, at 189 (Ct.Cl. 1982).

134 Robert Thornton Smith, “Tax Treaty Interpretation by the Judiciary” (1996), vol. 49, no. 4 The Tax Lawyer 845-91, at 857. This case involved the interpretation of article XII of the Canada-US tax treaty. Great West Life had interpreted article XII as exempting income from US tax in circumstances where the income-generating assets were part of its US business. Both Great West Life and the Internal Revenue Service agreed that the technical requirements of article XII had been met by the taxpayer. The court held that such a broad interpretation of the provision was not in keeping with the purpose of the provision.

135 85 DTC 718 (TCC).


137 Supra note 16, at 218.