# 2ND NORTH AMERICAN REGION MEETING

## Panel V – Practical Issues and Learning from Recent Tax Treaty Law Cases

## Adams Challenge (UK) Ltd. v. Commissioner - Overview

- The United States Tax Court upheld the IRS assertion to deny deductions and credits to a foreign corporation that failed to timely file Form 1120-F.
- The court considered the application of section 882(c)(2) and the US/UK Treaty (the “Treaty”).
- Section 882(c)(2) generally denies deductions to a foreign corporation engaged in a US trade or business if it fails to file a tax return.
- The court further held that the business profits provisions of Article 7 of the Treaty and the nondiscrimination provisions of Article 25 do not apply.
- The court held this result despite the fact that section 882(c)(2) does not apply to US corporations.

# Adams Challenge (UK) Ltd. v. Commissioner - Facts

- In 2009 and 2010, Adams Challenge (UK) Limited, a UK corporation, ("Adams") organized a "multipurpose support vessel" to help with decommissioning oil and gas wells and with removing debris from the U.S. outer continental shelf.
- Adams failed to file U.S. returns reporting its income related to this operation.
- The IRS identified Adams as a potential non-filer using a Lloyds ship registry and tracked its days on the OCS using a satellite-enabled tracking service.
- In 2014, the IRS prepared and subscribed returns for Adams and issued a notice of deficiency, in which it disallowed deductions and credits for 2009 and 2010 under Code section 882(c)(2).
- The taxpayer filed a petition with the Court challenging the IRS's disallowance in 2015, but did not file protective Forms 1120F for those years until 2017.

# Adams Challenge (UK) Ltd. v. Commissioner – Adams Arguments

- The IRS was not entitled to tax the income:
  - Adams was not engaged in a U.S. trade; and
  - Adams did not have a U.S. permanent establishment.
- The IRS could not disallow deductions and credits:
  - The 23.5 month filing deadline lacked a statutory basis; and
  - Under Article 7, foreign corporation shall be entitled to deduction of expenses, and because disallowance was inconsistent with Article 25 nondiscrimination provisions.

# Adams Challenge (UK) Ltd. v. Commissioner – Adams Section 882(c)(2) Arguments

- Regulations in 1990 added a grace period – generally eighteen months after the unextended due date for Form 1120-F – within which corporate taxpayers could file delinquent tax returns without fear of losing their deductions.
- Under the current version of the 1990 Regulations, after expiration of this grace period, a taxpayer can only preserve its right to deductions by establishing to the satisfaction of the Commissioner that it had acted "reasonably and in good faith," considering several factors, the first and foremost of which is "whether the corporation voluntarily identifies itself to the Internal Revenue Service . . . before the Internal Revenue Service discovers the failure to file." Regs. § 1.882-4(a)(3)(i).
- The court in *Adams Challenge* concluded that it did not have to reach the issue of validity of the 1990 Regulations because Adams had lost its right to claim deductions even under pre-1990 law.
- Applying the principles laid out in the quoted passage above, the court concluded that the "terminal date" had passed before Adams filed its protective forms 1120-F.
- The IRS prepared and subscribed returns in 2014, while the taxpayer did not file protective returns for those years until 2017.
- The court also rejected Adams' claim that a common law "good faith" exception should apply: "the relevant question is not whether the taxpayer displayed good faith in some abstract sense, but whether it attempted in good faith to file a U.S. income tax return before the IRS prepared a return for it."

# Adams Challenge (UK) Ltd. v. Commissioner – Adams Treaty Arguments

- The court first found no conflict with the statement in article 7(3) that deductions "shall be allowed" to a foreign corporation engaged in a U.S. trade or business, because "this phrase typically means 'shall be allowed so long as certain conditions are met.'"
- The court helf that section 882(c)(2) did not discriminate against U.K. corporations in a manner prohibited by paragraph 25(1). The court cited several factors as indicating that there was no impermissible discrimination such as: foreign corporations are not at risk of losing deductions until long after the due dates applicable to U.S. corporations; foreign corporations that want to dispute whether they are taxable can preserve deductions by filing timely protective returns; the OECD model treaty commentary's admonition that foreign corporations should not be subject to more onerous returns, payments or prescribed times were not violated – protective returns are simple and foreign corporations have more time to file than U.S. corporations; foreign corporations are not in the same circumstances as U.S. corporations when it comes to filing returns because foreign corporations are better able to avoid identification by the IRS; and other provisions treat foreign and domestic corporations differently, without violating the Treaty.

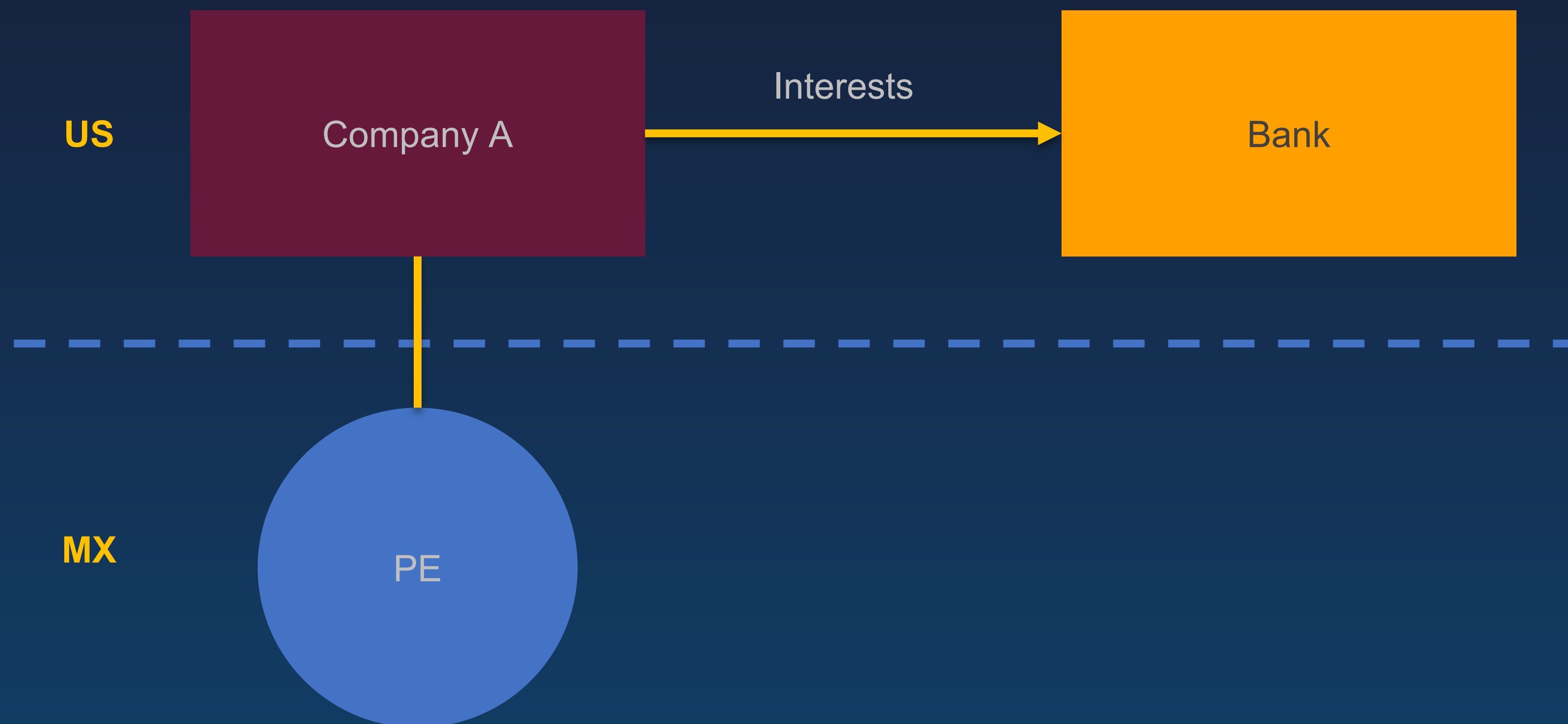
# Adams Challenge (UK) Ltd. v. Commissioner – Adams Treaty Arguments (cont'd)

- The court rejected Adams' argument that section 882(c)(2) violates Article 25(2)
- Article 25(2) provides that U.S. taxes should not be "less favourably levied" on U.K. corporations than on U.S. corporations.
- Adams was effectively being taxed on its gross income in 2009 and 2010, but "[i]t was entirely within petitioner's control whether it would be taxed on a gross or a net basis for 2009 and 2010, as it was for 2011. Petitioner simply had to follow the administrative requirements of U.S. law with respect to how its deductions needed to be claimed."
- The court found this to be consistent with the negotiating, drafting and/or administrative history of the U.S.-U.K. Treaty, the U.S. Model Treaty and U.S. treaties in general.

# FICTITIOUS PERMANENT ESTABLISHMENT

AMPARO DIRECTO EN REVISIÓN 4157/2017

# Tax computing option



# Tax computing option

DTT MX-USA. Article 6 – Immovable property

A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State **may elect for any taxable year to compute the tax on such income on a net basis as if such income were attributable to a permanent establishment in such other State**. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the immovable property is situated agrees to terminate the election.

# Fictitious PE

- Scope of the wording “as if”.
- Does PE have to comply only with expense documentation (as stated in the US-MX treaty technical explanation)?
- Does PE have to comply with every other obligation of a Mexican company, such as withholding taxes?

# Toulouse v. Commissioner - Overview

The U.S. Tax Court held that a U.S. citizen resident abroad was not entitled to claim a foreign tax credit to offset U.S. tax paid relating to net investment income (NII).

# Toulouse v. Commissioner - Facts

- The taxpayer in this case was a U.S. citizen resident in a foreign country who paid creditable income taxes to France and Italy. She applied foreign tax credit (FTC) carryovers to zero out her liability for U.S. tax on NII imposed by §1411.
- The IRS reassessed the NII tax without benefit of the FTC, and the taxpayer ultimately sought relief in the Tax Court. The taxpayer conceded that the Code does not provide an FTC against the NII tax, as the relevant provisions apply the credit only against taxes imposed by Chapter 1 of the Code, whereas the NII tax, enacted in 2010, appears in a new Chapter 2A.
- The taxpayer argued that the "Relief from Double Taxation" articles of the U.S. tax treaties with France and Italy provided "a foreign tax credit independent of the Code."

# Toulouse v. Commissioner - Holding

The Tax Court held that these articles “do not provide an independent basis for a foreign tax credit against the net investment income tax” and thus that the taxpayer was not entitled to claim the FTC against her NII tax.

# TECHNICAL ASSISTANCE / PERSONAL SERVICES

ISSUE

Mexico has narrowed down the scope of “business profits”.

“Business profits” is a term not defined by the Model Convention…

Commentaries on Article 7, Paragraph 7

32. Although it has not been found necessary in the Convention to define the term “profits”, it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise . Such a broad meaning corresponds to the use of the term in the tax laws of most OECD Member countries.

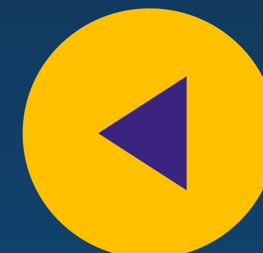
# Timeline

| 2004 | 2005 | 2008 | 2009 | 2021 |
|---|---|---|---|---|
| Income tax law reform to exclude specific types of income as "business activity" | Issuing of a rule defining "business profits" as "income from business activities". | Court rules technical assistance not deemed "business profits" | Court continues ruling with same criteria | Court rules independent personal services (IPS) do not fall under the scope of DTT Article 7 |

- **Business activities**: Mercantile activities
- **Personal services**: Excluded
- Specific types of income (Royalties, rental, construction, advertising): Excluded

- Tesis: VIII-P-1aS-838 R.T.F.J.A. Octava Época. Año VI. No. 56. Julio 2021

Disregarded historic evolution of DTT articles 7 and 14.



# US Treaty technical explanation

## Article 3. General definitions

Subparagraph (d) defines the term "enterprise" as any activity or set of activities that constitutes the carrying on of a business. The term "business" is not defined, but subparagraph (e) provides that it includes the performance of professional services and other activities of an independent character.

## Article 7. Business profits

In addition, as a result of the definitions of "enterprise" and "business" in Article 3 (General Definitions), the term includes income derived from the furnishing of personal services.

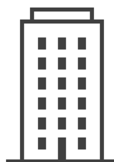
# Individuals vs. Corporations

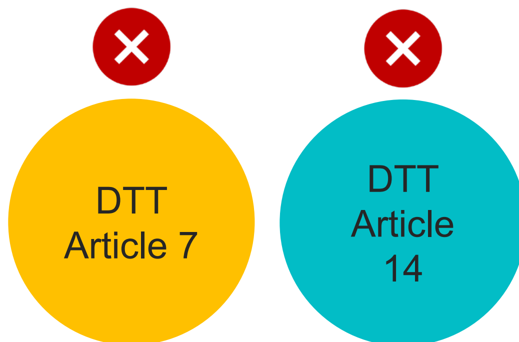
Services under
MX Income Tax Law
Article 175

Services under
DTT
Article 14

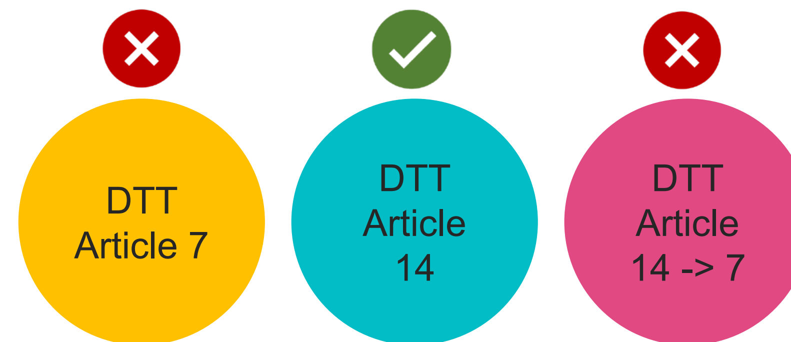
# Individuals vs. Corporations

Services by corporations






Services by individuals



# Treaty override?

OECD/LEGAL/0253 adopted on Jan/10/1989, recommends:

- To undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties;
- To avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations.

OECD Model Convention. Tax Treaty Override adopted on Oct/10/1989: (Type of override)

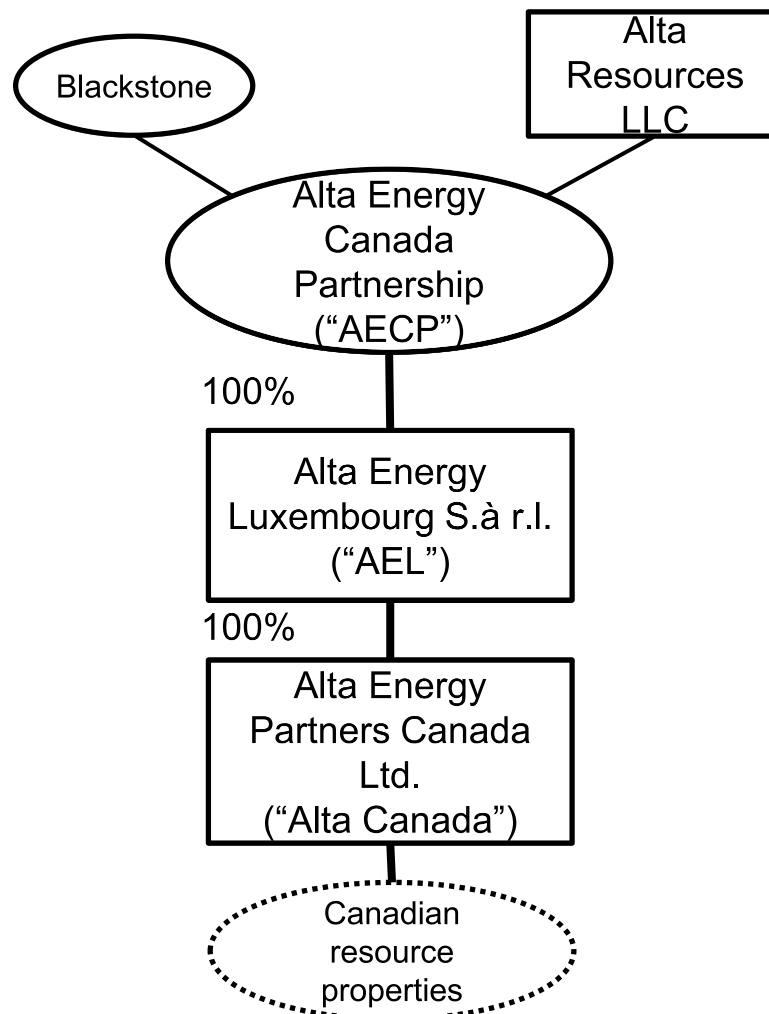
- A state may change de definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purpose of the treaty. In this case **there is no override** where the treaty contains a provision (…) which provides that (…) **any term not defined** in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of the State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law **provided such changes were compatible with the context of the treaty**.

# Canada v Alta Energy Luxembourg S.A.R.L., 2021 SCC 49

# Canada v Alta Energy Luxembourg S.A.R.L., 2021 SCC 49

## Facts

**Pre-restructuring**: Alta Canada owned by a Delaware LLC (Alta Energy Partners LLC), which was owned by Blackstone and Alta Resources LLC




**Restructuring (2012)**: Delaware LLC sold Alta Canada to Luxco (AEL).

- No capital gain realized; FMV = tax cost

**2013**: Luxco sold Alta Canada shares to Chevron Canada

- ~$380 million capital gain; AEL relied on exemption in Can/Lux Treaty

**CRA**: argued the general anti-avoidance rule (GAAR) allows Canada to tax capital gain despite Article 13(4)(a) of the Treaty

Canada v Alta Energy Luxembourg S.A.R.L., 2021 SCC 49

# Article 13(4) of the Canada-Lux Treaty

4. Gains derived by a resident of a Contracting State from the alienation of:

(a) shares (other than shares listed on an approved stock exchange in the other Contracting State) forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State; or

…

For the purposes of this paragraph, the term "immovable property" does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company.

# TCC Decision (2018 TCC 152)

- The shares of Alta Canada were “treaty-protected property” (as a result of Art. 13(4) and (5) of the Canada-Luxembourg Treaty)
- There was no misuse or abuse of the ITA or the Canada-Luxembourg Tax Treaty; the GAAR did not apply
- Business property exemption demonstrates an intention to depart from Model Treaty, in order to attract foreign investment in business property situated in Canada
- Minister seeking to use GAAR as backdoor treaty shopping rule which it never enacted (Canada and Luxembourg did not include a limitation on benefits article in the treaty)

## FCA Decision (2020 FCA 43)

- TCC decision upheld
- Object, spirit and purpose of relevant provisions of the Treaty (Arts. 1, 4, 13) are reflected in the words as chosen by Canada and Luxembourg
- Minister’s argument is an attempt to add qualifications to or modify the terms of the Treaty
- Would change identity of who is a “resident” (i.e. needs to be an “investor”)
- No underlying requirement that the exemption benefits only persons with sufficient commercial or economic ties to Luxembourg
- Residence of ultimate partners not relevant

Canada v Alta Energy Luxembourg S.A.R.L., 2021 SCC 49

## SCC Majority Decision

- “The principles of predictability, certainty, and fairness and respect for the right of taxpayers to legitimate tax minimization are the bedrock of tax law”
- GAAR does not apply (no misuse/abuse); capital gain not taxable in Canada
- Depth of AEL’s economic ties to Luxembourg are not relevant
- Policy of specific treaty provision at issue is clear from text (supported by context and purpose): to encourage foreign investment in Canada
- Dual nature of treaties as both statutory and contractual
- Deliberate choice not to limit treaty benefits to certain corporations using measures suggested by OECD that would have applied to AEL
    - “The GAAR was enacted to catch unforeseen tax strategies”

## Canada v Alta Energy Luxembourg S.A.R.L., 2021 SCC 49

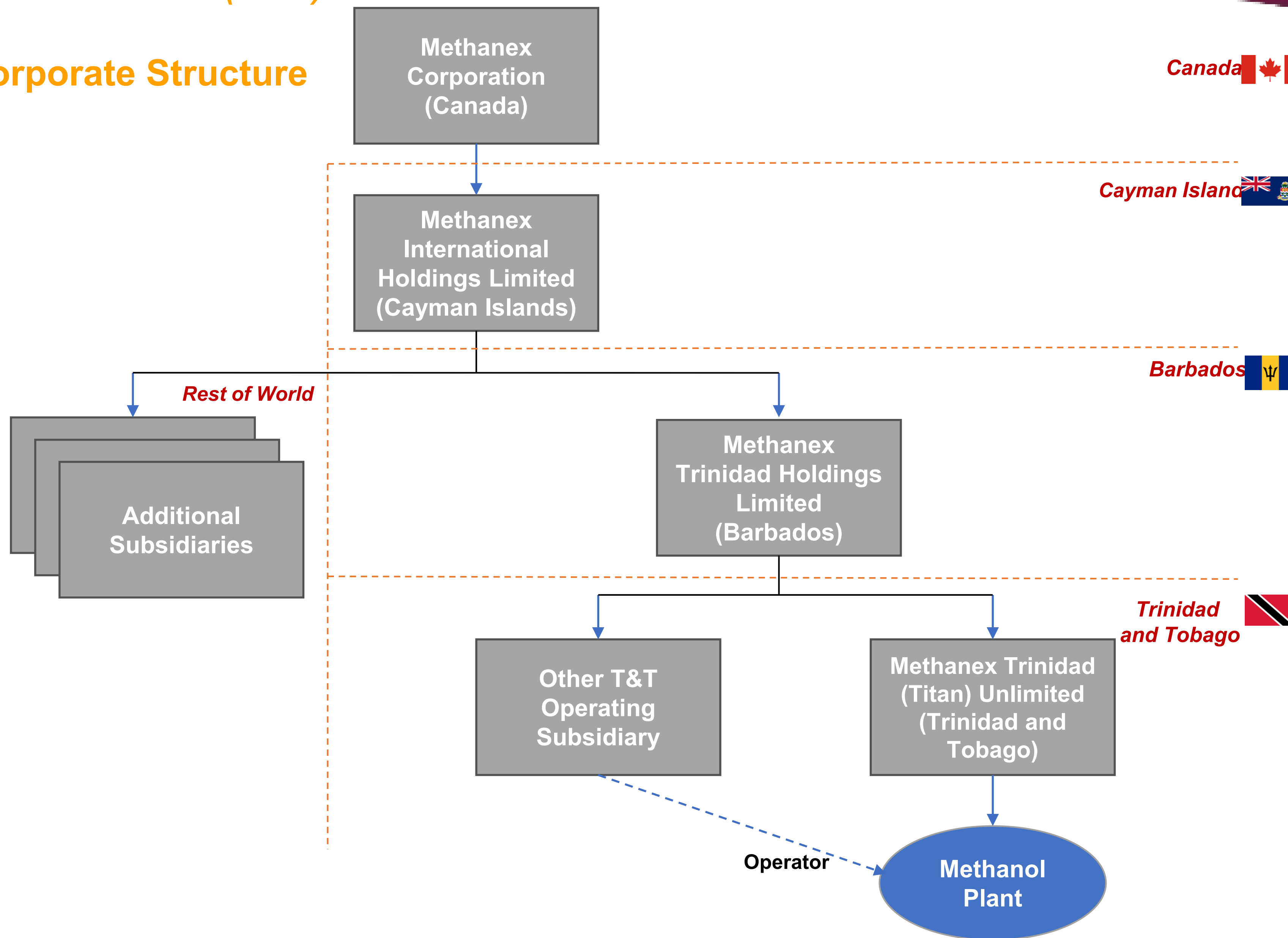
### SCC Dissenting Decision

- “Multinational companies exploiting gaps and mismatches in international tax rules erode domestic tax bases and cost countries an estimated US$100 to US$240 billion in lost revenue annually”
- Treaty shopping is abusive where there is an absence of a “genuine economic connection with the state of residence”
- Purpose of all relevant articles read together “is to assign taxing rights to the state with the closest economic connection to the taxpayer’s income”
    - Majority: that is a purpose in the Treaty, but the business property exemption specifically at issue here has a different purpose

# Methanex Trinidad (Titan) Unlimited v. Board of Inland Revenue

# Methanex Trinidad (Titan) Unlimited v. Board of Inland Revenue

## Corporate Structure



## Methanex Trinidad

- In 2007, Appellant declared four dividends to Methanex Barbados
- Methanex Barbados declared four dividends to Methanex Cayman
- In 2007, Methanex Cayman earned income from various sources, and used its income to pay expenses, repay loans, invest in subsidiaries and pay a dividend to Methanex Canada

## Methanex Trinidad

- Original CARICOM Tax Treaty entered in 1973
  - Included beneficial ownership requirement in dividends article
  - Included LOB and "purpose test"
  - Somewhat "conventional" treaty (i.e. mainly residence state taxation, restricting source state taxation)
- Current CARICOM Tax Treaty entered in 1994
  - Multilateral treaty - T&T and Barbados both Member States
  - All beneficial ownership requirements deleted (with one minor exception)
  - No LOB; no purpose test, no anti-abuse rule
  - Opposite to OECD Model – exclusive taxing right for source states

## Methanex Trinidad

Article 11 - Dividends:

*1. Dividends paid by a company which is a resident of a Member State to a resident of another Member State shall be taxed only in the first-mentioned State.*

*2. The rate of tax on the gross dividends shall be zero percent.*

Article 4 - Residence

*1. For the purposes of this Agreement, the term "resident of a Member State" means any person who under the law of that State is liable to tax therein by reason of that person's domicile, residence, place of management or any other criterion of a similar nature.*

## *Methanex Trinidad (Titan) Unlimited v. Board of Inland Revenue*

### Methanex Trinidad

- Appellant did not withhold any T&T tax on the basis of Article 11 of the CARICOM Tax Treaty
- T&T assessed 5% withholding tax on the dividends
  - Argued that Methanex Barbados (an IBC) was not resident in Barbados because not "liable to tax"
  - Argued that Methanex Barbados was not the beneficial owner of the dividends paid to it by the Appellant
  - Deemed the dividends to be paid to Methanex Canada
  - Argued it is entitled to "disregard" the payment of the dividends to Methanex Barbados and attribute such payment to Methanex Canada on the basis of a provision of the domestic law of T&T – section 67 ITA
    - *Where the Board is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious, … the Board may disregard any such transaction …and the persons concerned shall be assessable accordingly.*

## Methanex Trinidad

- T&T Tax Appeal Board (trial level):
  - Methanex Barbados was liable to tax and resident in Barbados for purposes of CARICOM Treaty
  - Beneficial ownership not an express requirement of Article 11 to obtain reduced withholding tax rate
  - Tax authority entitled to disregard dividends paid to Methanex Barbados and attribute said dividends to Methanex Canada
- T&T Court of Appeal:
  - Upheld conclusion of TAB that Methanex Barbados was liable to tax and resident in Barbados
  - Upheld conclusion of TAB that based on its findings of fact, tax authority was entitled to disregard dividends paid to Methanex Barbados and attribute same to Methanex Canada
- Appeal to the Judicial Committee of the Privy Council pending

# GE Financial Investments v. HMRC - Overview

- GE Financial Investments ("GEFI"), a UK resident, was a member of a Delaware limited partnership that was engaged in credit finance activities.
- As a result of GEFI's shares being stapled with the shares of a US-based general partner, GEFI was subject to US tax on its worldwide income in addition to being subject to UK tax on the share of its profits from such general partner.
- GEFI claimed UK double tax relief for approximately £125 million in respect of the US tax it paid over six years.
- HMRC denied the relief following an audit into GEFI's tax returns.

# GE Financial Investments v. HMRC - Holding

- The First-Tier Tax Tribunal ("FTT") held that GEFI was not entitled to the double tax relief because:
  - GEFI was not treated as a US tax resident as required for Article 4 of the UK-US double tax treaty (and as a result, double tax relief under Article 24 was not available to GEFI); and
  - GEFI was not carrying on a business in the US through a permanent establishment (and, as a result, GEFI could not argue that the UK should not tax the share of its US profits under Article 7 of the UK-US tax treaty).

# GE Financial Investments v. HMRC - Analysis

- The FTT explored various tax authorities (including the OECD commentaries) on whether GEFI could be treated as a US tax resident because its shares were stapled with the shares of another US company. However, it concluded that the share stapling mechanism did not impose a sufficient US territorial connection or link to treat GEFI as a US tax resident. Also, it was not enough that GEFI was treated as a US worldwide income taxpayer for these purposes.
- The FTT was referred to several cases on what amounts to a “business” when determined the business of GEFI in the US.
- GEFI made and managed a series of loans in excess of $2.82 billion, received substantial sums by way of interest and made distributions to the partners, it was carrying on an effective business.
- However, in FTT’s view, these were not the only factors that had to be considered. It was also necessary to consider whether the activities were actively pursued with a reasonable degree of continuity and regularity, had sound and recognizable business principles and whether the activities were of a kind which were commonly carried out by those who sought to profit by them.

# GE Financial Investments v. HMRC - Holding

- The FTT's view was that, although the activities of the Delaware limited partnership could be considered as significant, making five affiliate loans over six years was more of a sporadic, passive or isolated activity than a regular and continuous series of activities.
- The FTT also pointed out that there was an apparent lack of participation in the strategic direction of Delaware limited partnership by the directors of its general partner.
- The judge agreed that the holding did not turn on questions of US law but rather UK law. The FTT found that the treaty language does not require consideration of the basis on which the US tax is imposed.
- The FTT concluded that if GEFI had been carrying on a permanent establishment in the US, it would have concluded that that tax was payable in the US on such income.