

Americans Challenge Canadian Investment Trust Tax by Lisa M. Nadal

The Canadian government's decision to tax income trusts is being challenged by American investors under chapter 11 of the North American Free Trade Agreement.

Marvin and Elaine Gottlieb on October 30, 2007, filed a notice of intent to submit a claim for arbitration against Canada under chapter 11 of NAFTA. The Gottliebs asserted that the changes to the taxation on income trusts in Canada caused them US \$6.5 million in losses and that NAFTA protects them from financial loss caused by one of the treaty partners.

The Gottliebs' claim relates to a change in the Canadian tax laws contained in the Tax Fairness Plan for Canadians, introduced by Finance Minister Jim Flaherty. Before the "Halloween surprise," as some have called Flaherty's announcement of the tax change effective October 31, 2006, publicly traded flow-through entities and income trusts were not subject to an entity-level tax.

Under the new law, a 31.5 percent entity-level tax would be introduced on business and other income, effectively eliminating the pass through status of those entities. The tax is akin to the tax payable by most Canadian public companies and was intended to level the playing field between income trusts and corporations.

Claim

The Gottliebs claimed that the new tax gives rise to a claim under chapter 11 of NAFTA. That chapter gives individuals and corporations the right to sue Mexico, Canada, or the United States when actions taken by those governments have adversely affected the investments of an investor from one of the other countries. The right to sue under chapter 11 has most often been invoked when the governments have passed laws that favor their residents.

Under chapter 11, the remedy is compensation for the investor because a NAFTA tribunal cannot infringe on the sovereignty of a government and force it to repeal its laws. If a NAFTA tribunal finds a claim is valid, the claimant will generally be entitled to damages in the amount that is found to put the claimant in the same position the claimant would have been in had the law or rule not been imposed.

According to a letter submitted by Mr. Gottlieb to U.S. Treasury Secretary Henry Paulson, the Canadian government's new tax broke its promise not to tax Canadian income trusts. Another investor supporting the claim reiterated the broken-promise rhetoric. In a letter to Paulson, Donald Rouanzion, managing partner of Ardon Investments, said that he supported the NAFTA claim headed by the Gottliebs, adding, "On October 31, 2006, the Canadian government broke its promises and eliminated their income trust model, causing massive financial losses to thousands of American investors."

Todd Grierson-Weiler, professor and consultant in many NAFTA cases, and one of the three attorneys representing the Gottliebs, explained that both the previous Liberal government and the current Conservative government had promised that they would not tax income trusts,

following a public review process that took place in fall 2005. He added that the new measure violates a commitment made in the Canada-U.S. income tax treaty that states that U.S. citizens holding investments in Canada by trust would be subject to an effective rate of no more than 15 percent on the proceeds. Since the new measures tax the holdings of a trust as if they were shares in a corporation, the effective tax rate will be much higher than the 15 percent withholding tax imposed upon returns to the individual investor. The Canadian government "not only breached the promises they made to energy trust investors generally, but also breached the promises in the tax treaty," said Grierson-Weiler.

Rick Schechter, executive vice president of M. Gottlieb and Associates, reiterated that sentiment in an interview with Tax Analysts, saying that Gottlieb was indignant that the government promised not to impose a tax on income trusts and then imposed one with no open debate.

Legal Arguments

One can see how U.S. investors would be resentful of a tax that has caused U.S. investors huge losses. But the broken-promise rhetoric seems more sentimental than grounded on legal theory. And it raises several questions. For one, doesn't a claim against a tax measure simply on grounds that the new tax caused financial losses for taxpayers infringe on Canada's fiscal sovereignty? Don't all new taxes cause affected taxpayers financial loss, so that every new tax could be challenged under chapter 11?

Not so, said Grierson-Weiler, explaining that only if a tax is discriminatory, confiscatory, or employed in clear breach of legitimate expectations should it be challenged. Normal tax policy, he added, is enacted after hearings and announcements, and affects everyone fairly and equally.

Grierson-Weiler discussed the three legal arguments on which the NAFTA claim rests. The first legal basis for the claim is expropriation, he said, explaining that the test is whether the Canadian government substantially interfered with the investments at issue. He said that under the new measures, in two more years the investment trusts will no longer exist, so the Canadian government has essentially killed the tax vehicle the investors chose and has "taken" their ability to invest in a trust vehicle.

The second legal basis is fair and equitable treatment, which is similar to the expropriation argument, said Grierson-Weiler. This theory is akin to the detrimental reliance theory, that is, that representations will be binding on the basis that it is not fair or equitable to induce someone to rely on a representation and then breach it.

The last argument is that the measure was discriminatory, said Grierson-Weiler, explaining that under NAFTA and many similar bilateral investment treaties, countries must offer treatment no less favorable to investors from other countries than what it offers its own investors, or investors of another party. He explained that under the tax change, real estate trusts are exempt but energy trusts are not, even though they are similar vehicles with similar underlying assets.

In both cases the trusts are managing a useful asset's depreciable life, he pointed out. Therefore, both trusts should face the same tax treatment, especially since there is high U.S. ownership of energy trusts as well as high Canadian ownership of real estate trusts, said Grierson-Weiler.

He added that the discrimination argument is more persuasive because Flaherty has said that part of the reason for not giving the same exemption to energy trusts that is given to real estate trusts is because most energy trusts are owned by Americans. "The test [for discrimination] doesn't even require discriminatory intent, but in this case we have it," Grierson-Weiler said.

What Next?

To date, no claim has actually been submitted; only a notice of intent to submit a claim to arbitration has been submitted by the Gottliebs, alerting the Canadian government of the possibility of a claim. The notice of intent is the first procedural step required for a NAFTA claim, said Grierson-Weiler, explaining that it gives the parties a chance to amicably settle the dispute. The notice of intent must be filed at least six months before a claim is filed if the claim is challenging a tax measure. The notice was filed on October 30, 2007, and the six-month period has not yet expired.

In the meantime, the Gottliebs have set up a Web site (www.naftatrustclaims.com) that urges aggrieved investors to join in the claim. Grierson-Weiler said that the idea is to put together a de facto class action. He clarified that the class action would only be de facto because there is no mechanism for class actions in NAFTA arbitrations. Whereas in class action suits only one representative claim can be filed to represent multiple claimants, in a NAFTA arbitration all claimants first must file a claim and then the claims can be consolidated. To facilitate the process, the Gottliebs are setting up an organization (yet to be named) that will pool resources and help manage the claims more efficiently.

As to when the claims will be filed, Grierson-Weiler said that claimants have a limitations period of three years from the date the claimant knew or should have known of the breach that gave rise to the claim. "There's plenty of time," Grierson-Weiler said, adding that the date for filing the claim will depend on how long it takes to organize the group of claimants.