Income Tax Treaties, Canadian Style

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My topic is the application of tax treaties in and by Canada and the interaction of these treaties with our domestic law. Although it may not be apparent, I have abbreviated the notes regarding some topics that have received dedicated treatment elsewhere.[1] My aim is to reduce consideration of the OECD Model or comparative approaches in order to focus on Canadian practice. As well, the consideration of special provisions of particular treaties (such as the US fifth protocol) will be limited. In the oral presentation, I will necessarily be selective in addressing the range of matters touched upon in this outline.

Please note that references in the text to specific treaties as containing or expressing a particular text or principle are only examples or illustrations, and not exhaustive lists.

Overall, my rather ambitious aim is to provide both a general overview of tax treaties and an examination of certain issues they raise in Canada. I hope to reveal the outlines of the forest while also examining some selected trees.

Note: Notwithstanding its length, this outline is meant only as a stimulus to discussion. It is incomplete and, particularly in attempts to summarize so many Canadian treaty provisions, may contain inaccuracies.

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* I would like to thank Daniel Sandler for struggling through a draft of these notes, and for his helpful comments.

[1] Restricting myself to IFA Canada materials, I refer to prior Travelling Lectureships on treaty interpretation and specific treaty issues and also the *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2000). No attempt is made in the footnotes to establish a bibliography of the substantial material on Canadian tax treaties.

This lecture is dedicated to the memory of Jean-Marc Déry and Al Short: friends, dedicated Canadian public servants and the architects of our tax treaty network.

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I. **Introduction**

A. What is a tax treaty?

1. The Vienna Convention on the Law of Treaties ("Vienna Convention").[2] A treaty is defined as: "an international agreement concluded between States in written form and governed by international law." Treaties are legally binding obligations. They are not the only such obligations but, unlike ordinary commercial agreements between states, treaties are governed by international law.[3]

2. The *Income Tax Conventions Interpretation Act* ("ITCIA").[4] A convention is defined as: "any convention or agreement between Canada and another state relating to tax on income, and includes any protocol or supplementary convention or agreement relating thereto."

3. The *Income Tax Act* (the "Act"). A "tax treaty" with a country is defined in s. 248(1) as: "a comprehensive agreement or convention for the elimination of double taxation on income, between the Government of Canada and the government of the country, which has the force of law in Canada at that time."

4. Nomenclature. The terms "treaty," "convention" and "agreement" will be used interchangeably here. Unless otherwise specified, the reference is to a bilateral convention between Canada and another country governing taxes on income and, in most cases, capital.

B. Canadian constitutional law

1. The allocation of taxing powers. The federal government has jurisdiction over "The raising of Money by any Mode or System of Taxation" (s. 91(3), *Constitution Act, 1867* [5]) and the provinces over "Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes" (s. 92(2)) and the raising of money by any mode or system of taxation in respect of non-renewable natural resources, forestry and the generation of electricity (s. 92A(4)). The resulting "double

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[2] Canada Treaty Series 1980/37. Signed May 23, 1969; entered into force on January 27, 1980. Canada acceded on October 14, 1970.

[3] See, generally, Malgosia Fitzmaurice and Olufemi Elias, *Contemporary Issues in the Law of Treaties* (Utrecht: Eleven International Publishing, 2005), 1 – 25; Malgosia Fitzmaurice, "The Practical Working of the Law of Treaties," in Malcolm D. Evans, ed., *International Law*, 2nd ed. (Oxford: Oxford University Press, 2006), 187 – 216.

[4] R.S.C. (1985), c. I-4.

[5] 30 & 31 Victoria, c. 3. (U.K.) reprinted in R.S.C. 1985, App. II, No. 5, formerly The British North America Act, 1867.

taxation" is a fact of Canadian fiscal life.[6]

2. Power to make treaties. The *Constitution Act, 1867* is silent regarding the power to make treaties.[7]

a) Section 9 provides that the executive government and authority of and over Canada is vested in the Queen. At common law, the royal prerogative includes the power to conclude international treaties. The King issued letters patent in 1947 to "authorize and empower Our Governor General, with the advice of Our Privy Council for Canada or of any members thereof or individually, as the case requires, to exercise all powers and authorities lawfully belonging to Us in respect of Canada."[8]

b) This is generally, although not universally, considered to have transferred treaty-making powers to the federal government. Some argue that there is a constitutional basis for provincial treaty-making within areas of provincial jurisdiction,[9] including taxation. This would permit a binding international agreement being entered into by a province dealing solely with local and private matters within its legislative competence (although such a document would not be a "treaty" within the meaning of the Vienna Convention). Québec has, indeed, entered into a "tax treaty" with France (see II.A.2.d) below).[10] While the constitutional issue of its validity as a binding international agreement is interesting, the practical consequence does not seem to depend on the outcome of that debate. The matter could arise only if the Québec authorities

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[6] And is not unconstitutional: *In Re Bowater's Newfoundland Pulp and Paper Mills, Limited: Tax Exemptions Claimed Under Pre-Confederation Statutes of Newfoundland*, [1950] SCR 608.

[7] The only reference to treaties is s. 132, which concerns the federal power to enact legislation giving effect to treaties. This does not expand the federal legislative jurisdiction; i.e., federal laws cannot impinge on exclusive provincial jurisdiction merely because they are meant to implement a treaty validly entered into by Canada. The proposition is traced back to *Attorney-General for Canada v. Attorney-General for Ontario (Labour Conventions Reference)*, [1937] AC 326, at 351.

[8] *Letters Patent constituting the office of Governor General of Canada* (1947), in *Canada Gazette*, Part I, vol. 81, p. 3014 (reproduced in R.S.C. 1985, App. II, No. 31, Article II. Available at http://www.efc.ca/pages/law/cons/Constitutions/Canada/English/LettersPatent.html

[9] See Mathieu Roy, "Treaty-making powers of Canadian provinces: Revisiting the 1960s debate in light of subsidiarity and federal loyalty," LL.M. Thesis, Faculty of Law, University of Toronto, August 2005.

[10] Entente fiscale entre le gouvernement du Québec et le gouvernement de la République Française en vue d'éviter les doubles impositions et de prévenir l'évasion fiscale en matière d'impôts sur le revenue et de la fortune, signed September 1, 1987 and substantially modified by a protocol signed September 3, 2002.

challenged the validity of the agreement, which seems unlikely. Furthermore, it has been enacted into Québec law[11] and that enactment should be valid even if the "entente" to which it purports to give effect were not.

3. Role of Parliament. Not all treaties require legislative action but if they are to affect individual rights and become the law of the land, such action is required. The domestic legal effects of a treaty depend upon its being implemented by a statute passed by Parliament or a provincial legislature having the legislative competence over the subject matter of the treaty.[12] In other countries, the process may be different. E.g., in the US, the President has the power, by and with the advice and consent of the senate (a 2/3 vote), to make treaties that are, without further action, the law of the land.

4. Process.[13] The Minister of Foreign Affairs has principal responsibility for treaty-making, exercised through the treaty Section of that Department.[14] However, tax treaties are negotiated between officials of the Department of Finance and representatives of the other contracting state. After a text has been agreed to in principle by the officials engaged in negotiation, it is initialed. At this stage, the treaty is not a document of public record. When approved, the text is signed on behalf of Canada by a person so authorized by order-in-council (usually by the local ambassador or consular official) and the other party. At this point, it is published. The convention becomes binding on the states when it is ratified (again, an executive not a legislative act, essentially a certificate issued by the Minister of Foreign Affairs) and instruments of ratification are exchanged (Vienna Convention, Article 14), even though it is not yet in force (Vienna Convention, Article 1(1)(f)). In practice, treaties will normally be ratified by Canada only after the necessary enabling legislation has been enacted, in order, I suspect, to avoid the embarrassment of inadvertently breaching treaty obligations. Such implementing legislation usually, although not always, follows relatively shortly after signature of the treaty, depending

[11] By a regulation under the *Loi sur le Ministère du revenu*, LRQ, c. M-31, r. 2.1.

[12] *A.G. Canada v. A.G. Ontario*, [1939] AC 326, cited by Bowman, J (as he then was) in *RMM Canadian Enterprises Inc et al v The Queen*, 97 DTC 302 (TCC), n. 4. See also *Louis Francis v. The Queen*, 56 DTC 1077 (SCC).

[13] Regarding the legal process, see Maurice Copithorne, "National Treaty Law and Practice: Canada" in Duncan B. Hollis, Merritt R. Blakeslee and L. Benjamin Ederington, *National Treaty Law and Practice: Dedicated to the Memory of Monroe Leigh* (Leiden: Martinus Nijhoff, 2005), 91 – 122. On some of the nitty gritty of tax treaty negotiation, see Jean-Marc Déry, "The Process of Tax Treaty Negotiation," in *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2000), 2:1 – 2:16.

[14] *Department of Foreign Affairs and International Trade Act*, RSC, 1985, c. E-22, s. 10. Treaties are not expressly mentioned, but the "conduct of external affairs" is.

on Parliamentary scheduling. Some treaties are initialed but never signed, and occasionally a treaty may be signed but its enactment substantially or even indefinitely delayed (e.g., Lebanon, signed in 1998).[15]

C. Canadian income tax law

1. Statutes. The primary statutory instruments are the *Income Tax Act* (the "Act"), *Income Tax Application Rules*, *Income Tax Regulations* (the "Regulations") and *ITCIA*. Various other statutes contain ancillary or procedural provisions relating to income taxation (e.g., *Federal Courts Act* and *Tax Court of Canada Act*, *Cultural Property Export and Import Act*, *Bankruptcy and Insolvency Act*, *Interpretation Act*, *Constitution Act*).

2. Case law. Cases may determine the manner in which the statutory instruments are interpreted and applied. Statements of administrative practice and academic writing may be entitled to some weight in making such determinations.

3. Tax conventions. These instruments, as enacted by statutes, add a further dimension. They are inter-state agreements stipulating taxpayer rights, enforceable directly by taxpayers, and thereby modify the scheme otherwise established by statutory instruments comprising the law of income tax. Treaties have their own case law, administrative practice and doctrine. Foreign practice and jurisprudence may also be relevant to their interpretation and application.

D. The Canadian tax treaty network

1. Number and scope

a) At the time of writing, 86 Canadian tax treaties are in force, 3 have been signed and are awaiting enactment, and negotiations are underway with 9 additional countries.[16] The coverage is world-wide and includes both developed and developing economies. Probably the only jurisdictions with which Canada has substantial volumes of trade and investment that are not covered by the treaty network are Taiwan and Hong Kong.

b) Compared to other countries, Canada is relatively well-endowed with treaties. The Netherlands has about 65, the United

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[15] Even a court can mistake a signed treaty for one that has been ratified. The Tax Appeal Board cited provisions of the Canada-Belgium Income Tax Convention signed on April 10, 1958 in *Entreprises Blaton-Aubert Société Anonyme v. MNR*, [1969] Tax ABC 68 even though that particular text never actually entered into force. The decision was upheld without reference to the (non-) treaty, 73 DTC 5009.

[16] Finance Canada: http://www.fin.gc.ca/treaties/treatystatus_e.html#status

States 57 covering 65 countries,[17] and the United Kingdom 120.[18]

c) The 2007 federal budget placed a new emphasis on exchange of information and announced an initiative to negotiate free-standing conventions, following the OECD model exchange of information agreement (TIEAs), with countries that are not parties to comprehensive tax treaties with Canada. Under the budget proposal, the existence of a TIEA will be sufficient to fulfil the requirements for earning exempt surplus.[19] This could reduce the incentive for Canadian businesses to press for comprehensive tax treaties with countries in which they have subsidiary operations, where a TIEA would do. That could have implications for further extension of the tax treaty network.

2. International models

a) Organization for Economic Cooperation and Development (“OECD”)

(1) The 1977 OECD Model Tax Convention on Income and on Capital (the “OECD Model”), as amended, is widely used and forms the basis of Canadian tax treaties. Perhaps as much as 90 % of the text of Canadian treaties is identical to this Model, depending on the particular treaty.

(2) This commonality of text suggests both a role for the official Commentaries on the OECD Model (the “OECD Commentaries”) in construing particular conventions and the potential authority or influence of foreign court decisions and international practice.

b) United Nations (“UN”)

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[17] Testimony of Patricia A. Brown, Deputy International Tax Counsel (Treaty Affairs), United States Department of the Treasury Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, February 6, 2006.

[18] http://www.hmrc.gov.uk/si/double.htm .

[19] Bill C-28, which received first reading in the House of Commons, includes provisions dealing with the FAPI side of the equation, in particular, the conception of a “non-qualifying business” that includes a business carried on by the foreign affiliate through a PE in a “non-qualifying country.” The definition of this latter expression confirms the conception of alternative reliance on either a tax treaty or a comprehensive TIEA (although, strangely, the rules would seem not to change for a country that has neither if no negotiations were ever commenced and no invitation for such negotiations was sent). A proposed amendment to s. 5907(11) of the Income Tax Regulations sweeps into the “designated treaty country” the non-treaty countries that enter into a TEIA.

(1) The 2001 UN Model (the "UN Model") is based on the OECD Model but modified, in particular, to address some concerns of developing countries. Due to lack of resources, the UN Model and its commentaries are inevitably behind OECD developments, and this can be detected in a number of treaties.

(2) Canada has accepted parts of the UN Model that differ from the OECD Model, sometimes in altered form, in treaties with less developed treaty partners. This brings into play the possible relevance of UN Commentaries and additional international case law and practice.

3. Canadian "model"

a) The United States has published its own model treaty[20] for use in its treaty negotiations. In practice, that model is not kept entirely up to date so that US treaties, and even opening positions, seem to differ from the published version. Perhaps in part for this reason, Canada has no official model of its own. However, it is clear that substantial portions of the OECD model are considered to form the Canadian standard, since they appear either verbatim or with only very slight variations in our treaties. As well, there are specific deviations from the OECD model that recur and thus may be inferred to reflect a Canadian "model." There are changes over time, suggesting that the Canadian opening or preferred negotiating position evolves to meet changing circumstances.

b) Notable differences between Canadian treaties and the OECD Model include:[21]

(1) the Canadian treatment of gains (e.g., jurisdiction over indirect gains from partnership interests as well as companies with, in some cases, exclusion of "business assets" from immovables in this case, preservation of departure taxation and potential deferral for internal reorganization transactions);

(2) preservation of the power to impose branch tax, a limitation on its rate and perhaps a threshold exemption;

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[20] United States Model Income Tax of November 15, 2006. http://www.treasury.gov/press/releases/reports/hp16801.pdf

[21] A useful catalogue is found in David A. Ward, QC, "Canada's Tax Treaties," (1995), vol. 43, no. 5 *Canadian Tax Journal*, 1719-1758. See also, the IFA Canada *Special Seminar*, *supra*, note 1.

(3) retention of source country jurisdiction to tax royalties;

(4) preservation of jurisdiction to tax FAPI;

(5) a watered down non-discrimination provision;

(6) recognition of foreign taxes specifying exempt surplus treatment, although these provisions have more recently been replaced with general foreign tax relief language.

II. Enactment and Construction of Treaties

A. Legal implementation and effect of tax treaties in Canada

1. Enactment of treaties and protocols

a) The typical implementation Act, under current practice, contains 6 sections with the convention itself appearing as a schedule (several conventions may be enacted together, each as a separate Schedule to the implementation Act). The statute approves the annexed convention and gives it the force of law in Canada (s. 3), authorizes the Minister of National Revenue to make necessary regulations for carrying out the convention or giving effect to any of its provisions (s. 5) and establishes the priority of the convention over any other law except for the ITCIA (s. 4; see II.A.3.a) below).

b) Amending protocols are normally implemented by statute. However, although no longer the current practice, some treaty implementing legislation provided for amendment by order-in-council. This procedure still applies to a substantial number of treaties implemented into the early 1980s, e.g. the Canada-France Convention.[22]

c) Entry into force and termination

(1) In Canada, entry into force is generally stipulated for amounts paid or credited following a particular date and for other taxes for a stipulated taxation year beginning after the convention enters into force. That, in turn, occurs upon notification of mutual ratification under the laws of each contracting state.

(2) Termination similarly occurs from a date (for taxes

[22] Part IV of the 1976 implementing legislation enacting the treaties with France, Belgium and Israel provides for declaration by order-in-council to alter, revoke, replace or add to these conventions: SC 1974-75-76, 23-24-25 Eliz. II, c. 104. There have, in fact, been two protocols to the French treaty implemented by orders-in-council SI /88-237 and SI/99-19.

withheld at source) or for a taxation year (for other taxes) commencing after notification. The only income tax treaty that was terminated (without immediate replacement with a new treaty) appears to have been that with South Africa, in 1985. A number of estate tax treaties, however, were terminated at Canada's instigation following the repeal of the federal estate tax in 1972, leading to some unfortunate traps (such as a lack of situs rules). See, e.g., Article XXX(8) of the Canada-US Convention.

2. Provincial taxation

a) Agreeing provinces

(1) Provinces that have entered into collection agreements with the federal government base the provincial income tax liability for both individuals and corporations on taxable income, as determined under the Act.[23] Paragraph 110(1)(f) provides for a deduction in computing taxable income of an amount exempt from income tax in Canada because of a provision contained in a tax convention or agreement with another country that has the force of law in Canada.

(2) Most treaty provisions that protect items of income from Canadian tax do not use the word "exempt" but where the treaty provides that the item may be taxable only in the other state, s. 110(1)(f) should apply and its indirect adoption in provincial legislation of the agreeing provinces should ensure that the item of income falls outside the provincial tax base as well. For example, if a non-resident carries on business in Canada without a permanent establishment (as defined in Article 5, not as defined in the Regulations), Article 7 protection should apply both federally and provincially. Similarly, a gain that Canada may not tax under Article 13(4) should be free of both levels of taxation.

(3) What about provisions in the treaty that do not "exempt" an amount from income tax?

(a) Some do not matter for provincial purposes,

[23] E.g., *The Income Tax Act* (Manitoba), CCSM 1988, c. I10 as amended: for individuals, through the charge on "Manitoba income" and the definition of that expression in s. 1(1) by reference to s. 120(4) of the Act and, for corporations, the charge on taxable income earned in Manitoba and the definition of that expression in s. 7(5) by reference to s. 124(4) of the Act.

such as limitations on withholding tax rates in Articles 10, 11 and 12.

(b) Treaty provisions relating to taxation of capital have no application provincially.

(c) The situation regarding transfer pricing adjustments is subtle. While s. 247 applies provincially, Article 9 and the result of competent authority settlements are not expressly incorporated. If the transfer pricing result is considered to reflect the proper interpretation of s. 247, the proper result applies.[24]

(d) Article 23 of the treaties concerning elimination of double taxation does not bind the province to provide any relief. Since recognition of foreign taxation on foreign affiliates is afforded through deductions in computing taxable income, these are incorporated by reference. For s. 126 foreign tax credits, obtaining the full credit depends upon provinces enacting appropriate provisions in their own legislation.[25]

(e) Purely administrative provisions (such as exchange of information or assistance in collection) do not apply directly to the provinces.

b) Alberta – corporations

(1) The statute[26] adopts the s. 115 definition of "taxable income earned in Canada" which, indirectly, incorporates s. 110(1)(f).

(2) For a more perfect and complete incorporation of the treaties, s. 3 of the Alberta statute provides that if Canada has entered into an income tax treaty that is inconsistent with the federal Act and the federal implementation legislation provides that that treaty prevails to the extent of that inconsistency, that treaty is, to the extent of the

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[24] In this regard, a provision such as s. 1(5) of the PEI *Income Tax Act* (RSPEI 1988, c. I-1) is interesting: "In any case of doubt, the provisions of this Act shall be applied and interpreted in a manner consistent with similar provisions of the Federal Act."

[25] See, for example, ss. 34 and 40 of the PEI *Income Tax Act.*

[26] *Alberta Corporate Income Tax Act*, RSA 2000, c. A-15, as amended.

inconsistency, deemed to apply for the purposes of the Alberta statute in the same manner as it applies for the purposes of the federal Act. This is quite broad, and helpful. It would not, however, seem to extend to purely administrative provisions (exchange of information, assistance in collection).

c) Ontario – corporations

(1) The Ontario situation is in flux given the transition to its becoming an agreeing province.[27]

(2) Under the current legislation treaty protection should generally be available (again, without reference to administrative matters).

(a) The charging provision in the Ontario statute[28] is broad and refers to its own definition of permanent establishment. However, that definition does contemplate treaty relief by stating, in s. 4(12), that if the liability of a corporation for tax under the federal Act is determined with reference to a tax treaty, the corporation does not have a permanent establishment in Ontario for the purposes of the provincial statute if it does not have such an establishment for the purposes of the tax treaty. This provision was added only in 2002. Before then, a non-resident corporation earning business income in Canada could be taxable in Ontario but not federally due to differences in the definitions of "permanent establishment". Resolving the meaning of PE does not, however, incorporate the supporting provisions of Article 7, including the allocation of profits.

(b) This addresses one of the three charges in s. 2(2) of the Ontario statute. The others are owning real property in Ontario, even without a permanent establishment, or disposing of taxable Canadian property deemed to be situated in Ontario.

(c) There used to be a double tax problem concerning capital gains. Ontario regulation 504 provided situs rules including, for example, shares

[27] "Memorandum of Agreement Concerning a Single Administration of Ontario Corporate Tax," signed May 13, 2004.

[28] *Corporations Tax Act*, RSO 1990, c. C.40, as amended.

of a corporation "resident in Ontario." But s. 504(2) comes to the rescue, deeming property otherwise situated in Ontario not to be if, for the purposes of the federal Act, a treaty has determined that no tax is payable for a taxation year by the corporation in respect of the disposition by it of taxable Canadian property. In addition, Ontario has adopted the transitional rule in Article XIII(9) of the US treaty through s. 37(3) of the Ontario statute and Ontario regulation 801, and in at least a general way, competent authority arrangements by s. 37(4) and (5).

(d) Finally, s. 1(8) of the Ontario statute also provides a rather generic although curious adoption, or potential adoption, of treaties. It states, in effect, that where a corporation's federal tax liability is subject to and modified by the application of the provisions of a treaty, the provisions of the Ontario statute "may be modified and applied in the manner prescribed by the regulations for the purpose of giving effect to a provision of such a [treaty] for the purposes of this Act, and regulations related to this subsection may have retroactive application if they so state." I am not aware of any such regulations having been made.

d) Québec

(1) The Québec Taxation Act[29] does not expressly incorporate the provisions of Canada's tax treaties. However, s. 16.1.2, adopts the treaty definition of "permanent establishment" in preference to the provincial definition. This effectively incorporates the Article 7 threshold, but not the remaining Article 7 (or other business profits) provisions, such as rules regarding the allocation of profits.

(2) For capital gains, Québec has always presented a trap, although perhaps not quite so deep as might appear at first blush. The charge on "taxable Québec property" takes one to the definition of that expression in s. 1094. It looks quite a bit like the federal definition. However, the provincial equivalent to s. 115(1)(b) refers only to property described in the first few paragraphs of the TQP definition,

[29] *Loi sur les impôts,* LRQ, c. I-3.

essentially Québec situs immovables and property used in carrying on business in Québec. The text is not, of course, identical to Article 13 of the treaties, but it is close enough that the potential for double taxation is limited.

(3) Québec entered into an "entente" with France (see reference in I.B.2.b) above) that generally follows the OECD Model, although with a number of differences that relate to the peculiarity of an agreement governing only provincial tax. For example, it does not address outbound withholding taxes, as there are none imposed by the province. Some of the benefits it extends to provincial income taxation, such as the permanent establishment threshold, would apply anyway given the regulation discussed immediately above. Similarly, Québec resident taxpayers are also Canadian resident taxpayers and can rely on the Canada-France Convention for some protections also provided in the Québec-France Entente (e.g., withholding tax rates).

3. Priority and Choice

a) Article 27 of the Vienna Convention provides: "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty." This suggests a degree of priority of treaty obligations over national law, although it is intended to protect other contracting states, not taxpayers.

b) Section 4 of the usual Canadian treaty implementation statute provides that "in the event of any inconsistency between the provisions of this Act or the Convention and the provisions of any other law, the provisions of this Act and the Convention prevail to the extent of the inconsistency."[30] But in implementing statutes since enactment of the ITCIA, this is made subject to s. 4(2), which provides that in the event of any inconsistency between the provisions of the Convention and the ITCIA, the latter prevails.

c) There are implementing statutes that predate the ITCIA. To deal with priority, the interpretive provisions of the ITCIA are prefaced by: "Notwithstanding the provisions of a convention or

[30] It may be observed that no such provision is found in the implementing regulation for the Québec-France entente. Section 17.3 of the *Taxation Act* provides, however, that where a tax agreement between Québec and a particular country that has force of law in Québec (which the French entente does under the aforementioned regulation) provides for an income tax privilege, other than an income tax exemption, this Act and the regulations shall be applied on the assumption that they contain such provisions as are necessary for the granting of such a privilege.

the Act giving the convention the force of law in Canada." This is not so much a reversal of the priority of treaties over the Act, but a modification of the meaning of the treaties that, as altered, retain their priority. Query: is this sufficient to give the ITCIA priority? The older version of s. 4 of the implementing legislation refers to "any other law," which obviously includes the ITCIA, so there is an open conflict between this statement of priority and the text of the ITCIA itself. Perhaps the idea is to rely on the fact that the ITCIA is posterior and more specific but I imagine, if the issue ever arises, there will be a thorny question to decide. It would have been more prudent, I should think, to have made an omnibus amendment to s. 4 of all the outstanding income tax convention implementation statutes.

d) The Act itself contains a limited incorporation of treaty benefits in ss. 81(1)(a) and 110(1)(f). There are mechanical reasons for this methodology that need not concern us here.[31] In effect, to the extent a treaty benefit is incorporated by reference, there is no "inconsistency" and so no need for priority. To the extent the treaty provides more beneficial treatment, or treatment that is not so incorporated because it is not an exemption from tax, the priority established by the implementation legislation applies.

e) Conceptually, the taxpayer does not have a choice whether to invoke the convention. Its priority over the Act is a matter of law. Since treaties only limit and do not increase taxation, in practice they are normally viewed as providing the option between the better of the two possible tax treatments. (See the discussion of the "domestic tax benefit" rule below, XI.B.)

f) There are circumstances in which more than one tax treaty may apply.

> (1) Suppose a corporation is resident in each of two treaty partners (and that no provision of either foreign law analogous to our s. 250(5.1) applies to prevent that result). The tax liability of the corporation is the least of the amounts determined applying the Act and each of the two applicable conventions.
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> (2) An entity resident in a treaty country other than the US (Forco) earns income from Canada subject to non-resident withholding tax, the rate of which is limited by Articles 10

[31] See Stephen R. Richardson, "The Interaction Between Bilateral Income Tax Conventions and Canadian Domestic Tax Law," in *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2000), 4:1 – 4:36.

– 12. Forco is owned by US residents and, for US purposes, it is fiscally transparent. Under the hybrid entity provision of the 2007 fifth protocol to the US treaty, those US residents may be considered to have earned Canadian source income of Forco. It is, therefore, possible that both treaties could apply, although the mechanics are not crystal clear.

(3) A corporation resident in a treaty country has a permanent establishment in the US, and deals with its Canadian subsidiary through that PE. The US treaty provisions on transfer pricing apply to PEs, not just residents (see IV.G.5.c), so both the US and the other treaty could be relevant (e.g., regarding notification rules).

B. Interpretation

1. General. A great deal has been said and written regarding the interpretation of tax treaties.[32] In general terms, the SCC has insisted upon a consideration of the object and purpose in construing any international treaty and that is not, perhaps, terribly dissimilar from the modern rule applied by it in tax cases generally.[33]

2. Vienna Convention. The basic principle of construction is expressed in Article 31(1): "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." This may be read together with the definition of the obligation of the contracting states in Article 26: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

a) Article 31(2) stipulates that "context" shall include related agreements and instruments accepted by both parties. Article 31(3) expands the context to include subsequent agreements and "practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation," as well as "any relevant rules of international law." Associated with some

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[32] It was the subject of the first IFA Canada lecture by Brian J. Arnold in 1999, and another by David Ward in 2006. See his related publication, David A. Ward, et al, *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (Kingston, ON and Amsterdam: IFA Canada and IBFD, 2005).

[33] The language employed in a case such as *Pushpanathan v. Canada (Minister of Citizenship and Immigration)*, [1998] 1 SCR 982 does not seem dramatically different from that in *The Queen v. Canada Trustco Mortgage Company,* 2005 SCC 54. However, the "edge" of certainty and some deference to specificity in taxing legislation is lacking, and the openness to travaux préparatoires is, of course, different.

treaties are supplementary interpretative documents styled as protocols or exchanges (e.g., the exchange of notes with the UK in 2003 regarding withholding tax rates and other matters). In other cases, a later exchange of notes is used to clarify or confirm the contracting parties' views regarding a matter of construction (e.g., the exchange organized during the course of the *Kelly Edwards* litigation[34] to express agreement that Hong Kong was not part of China for purposes of the Canada-China Convention). Such notes may also be used in the mutual agreement procedure. The US Technical Explanation, to which Canada expressly adhered,[35] may be regarded as "context."

b) Beyond context, Article 32 provides for recourse to supplementary means of interpretation, including the preparatory work of the treaty (so-called "travaux préparatoires") and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31 leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable. In Canada, I imagine Department of Finance notes, CRA publications, Hansard, and perhaps certain government correspondence could be appropriate sources of supplementary means of interpretation. In practice, there is rarely much on the Canadian side but there may, of course, be documentation from the other treaty partner.

3. OECD Commentaries. A number of Canadian cases have referred to the OECD commentaries but do not provide much guidance regarding the precise weight to be accorded them. The commentaries have been regarded as *travaux préparatoires*[36] and "legal context."[37] The relevance of commentary that post-dates the relevant treaty is yet to receive an authoritative and definitive judicial consideration. It has been applied without considering the problem,[38] totally rejected,[39] and approached ambiguously.[40] The commentaries to the UN Model are rarely referred

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[34] 2003 FCA 378 (FCA).

[35] Finance Canada News Release, August 16, 1984.

[36] *The Queen v. Dudney*, 2000 DTC 6169 (FCA, leave to appeal to SCC dismissed), para. 10.

[37] *Cudd Pressure Control Inc. v. The Queen,* 98 DTC 6630 (FCA, leave to appeal to SCC dismissed), para. 23.

[38] *Sumner v. The Queen,* 2000 DTC 1667 (TCC).

[39] *MIL (Investments) S.A. v. The Queen,* 2006 TCC 460, para. 86 (affirmed, 2007 FCA 236; the crown did not seek leave to appeal to the SCC).

[40] *Cudd Pressure, supra.*

to.[41]

4. Article 3(2) of the OECD Model.[42] This provision specifically addresses undefined terms.

a) It provides that as regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State. Note that

(1) The reference is to terms not defined, as opposed to terms not fully defined (cf. the ITCIA).

(2) "At that time" seems to make the provision ambulatory.

(3) It may be difficult to know when the context otherwise requires.

(4) The domestic law to which reference is made is general law, not tax law, but if there is a specific tax law meaning, it has precedence.

b) The Canadian version of Article 3(2) is similar, but not necessarily identical. It is often missing the last bit referring specifically to tax law definitions. In the Canadian context, one must also consider the relationship between private law and tax law, since private law is largely under provincial jurisdiction. Under the 2007 US treaty protocol, in the Exchange of Notes (B), there is an additional twist in that the domestic law reference applies to a term that is not defined "unless the competent authorities otherwise agree to a common meaning." This is apparently intended to allow the treaty partners to pre-empt domestic law by choosing a meaning through the competent authority consultation procedure. The interaction with the ITCIA rule discussed below is not self-evident, but presumably the intention is that the competent authority agreement constitutes a

[41] They were mentioned in *The Queen v. Crown Forest Industries Ltd*., 95 DTC 5389 (SCC), para. 62, although with limited impact.

[42] See, generally, John F. Avery Jones, "The interaction between tax treaty provisions and domestic law," in Guglielmo Maisto, ed., *Tax Treaties and Domestic Law* (Amsterdam: IBFD, 2006), 123 – 160; Michael N. Kandev, "Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model," (2007), vol. 55, no. 1 *Canadian Tax Journal*, 31-71.

treaty meaning. Otherwise, the new rule would seem to have no effect. There could be some tricky legal issues regarding delegated legislation.

c) There must be limits on definitional freedom, or the conventions become meaningless. Can the Act define a guarantee fee to be interest? The SCC in *Melford*[43] construed a particular form of words in a convention to mean that the parties intended to adopt the ordinary usage of the term "interest", which did not include a guaranty fee. The addition of s. 214(15) to the Act after conclusion of the relevant treaty was ineffective to expand the scope of the meaning of the term: the definition was not ambulatory. A decision to the contrary would permit each contracting state to "unilaterally amend the tax Treaty from time to time as their domestic needs may dictate."

5. ITCIA. This statute presents a series of "treaty overrides," general rules meant to change the application of a bilateral convention as otherwise determined. Scholars have questioned the validity, or at least the advisability, of a statute that declares the law to be different, or potentially different, from that in a binding international agreement.[44] In Canada, absent constitutional or charter concerns, Parliamentary supremacy permits such an override. Where the implementation statute expressly affords priority to the ITCIA, the effectiveness of the override seems clear (see II.A.3.c) above).

a) The ITCIA includes an expanded version of Article 3(2) of the usual bilateral tax treaty. To the extent that a term in a convention is not defined, not fully defined, or to be defined by reference to the laws of Canada, that term has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the Act, as amended from time to time. This text is quite explicitly ambulatory, and indeed the ITCIA was initially a response to the *Melford* decision (there is a grandfather saving provision in s. 6). It is also broader than Article 3(2), through the inclusion of partially defined terms, and more precise in its reference specifically to the Act (rather than general law, or even tax law).

b) The ITCIA also provides some specific definitions, or expansions of definitions, affecting permanent establishment, immovable property, pensions and other matters. These supplement or replace, as the case may be, the text of the tax

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[43] *The Queen v. Melford Developments Inc.*, [1982] 2 SCR 504.

[44] E.g., Jan Wouters and Maarten Vidal, "The International Law Perspective," in Guglielmo Maisto, ed., *Tax Treaties and Domestic Law* (Amsterdam: IBFD, 2006), 13 – 37, at 25 – 30.

conventions.

c) Section 6.2 is a pre-emptive strike against the situation that arose in the UK *Padmore* case,[45] in which a UK resident individual successfully claimed treaty protection against UK taxation of his share of UK source business income earned by a foreign partnership of which he was a member. (See the discussion in III.E.7.e).

d) Section 6.3 is a source rule for capital gains. Except where a convention expressly otherwise provides, income, gain or loss in respect of the disposition of taxable Canadian property is deemed to arise in Canada.

(1) This is not relevant to the jurisdiction to tax under Article 13 of most treaties, as the article does not normally refer to where gains "arise." Rather, the Canadian right to tax gains realized by a non-resident on a disposition of TCP generally depends on the character of the property. However, in a couple of treaties, the geographical source does matter for this purpose: Article 13(4) may refer to gains derived by a resident of a contracting state "and arising in the other state" (see Japan and China conventions). In these cases, the source rule in s. 6.3 could be determinative of treaty relief.

(2) The more common effect of s. 6.3 of the ITCIA is likely to be in the application of Article 23, concerning relief from double taxation. Canada need not provide relief in respect of tax imposed by the other contracting state on a gain, in accordance with the convention, if the gain relates to TCP (See IX.B.5).

(3) Another example of its application could be Article XXI(6) of the US treaty, which permits a Canadian resident to claim a charitable contribution to a US charity that could qualify as a registered charity in Canada were it resident here, but the tax relief is limited to the amount that would be determined under the Act if the taxpayer's only income were his or her income "arising in the United States." This suggests that the gain arising on a gift of TCP to a US charity would not form part of the base for purposes of this calculation even if that gain would otherwise be sourced in

[45] *The Queen v. Padmore*, [1989] STC 493 (CA). This explanation of s. 6.2 is expressed by the CRA in RID #9313615, September 14, 1993.

the US under general principles.[46]

e) There do not seem to be additional treaty override provisions in other statutes. However, see the discussion below of the amendments to the GAAR that extend it to tax treaties (III.F below).

6. Language. Canadian treaties are always plurilingual. The form of execution always states that the convention is "done in duplicate at [place] this [date] in the English, French [and other] language, each version being equally authentic" (see Vienna Convention, s. 33).[47] Unlike unilingual jurisdictions, we are used to the challenge of construing multilingual statutory texts. The international principles seem to be consistent with our domestic law. For example, if one of the linguistic versions of a treaty bears a wider meaning than another, the more restricted meaning will normally be chosen which can be consistently and harmoniously applied, on the theory that this is likely to be in accordance with the common intention of the parties.[48]

7. Common and civil law. Canada is not only juridically bilingual, but also bijural: "Both the common law and the civil law are equally authoritative and recognized sources of the law of property and civil rights in Canada and, unless otherwise provided by law, if in interpreting an enactment it is necessary to refer to a province's rules, principles or concepts forming part of the law of property and civil rights, reference must be made to the rules, principles and concepts in force in the province at the time the enactment is being applied."[49] This rule of construction applies to treaties.

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[46] As set out, for example, in Interpretation Bulletin IT-395R, para. 3 – 4.

[47] There is usually, but not invariably, a third language where the principal language of the other contracting state is neither English nor French. In a few cases, there may be a fourth language (the Finnish treaty is authenticated in English, French, Finnish and Swedish). Some countries that might be expected to add languages do not (the Swiss treaty is authenticated only in English and French, as are treaties with Malta, Morocco, Philippines, Singapore, South Africa).

[48] See *Mavrommatis Palestine Concessions, Judgment No. 2, 1924,* PCIJ, Ser. A. No. 2, p. 19 cited in Fitzmaurice, "The Practical Working of the Law of Treaties," *supra,* note 3, 203. The language is quite similar to that adopted by the Supreme Court of Canada in a domestic context in *Schreiber v. Canada (Attorney General)*, 2002 SCC 62, para. 56. See generally Guglielmo Maisto, ed., *Multilingual Texts and Interpretation of Tax Treaties and EC Tax Law* (Amsterdam: IBFD, 2005), including the contribution by Jacques Sasseville, 35 – 62.

[49] *Interpretation Act*, RSC 1985, c. I-21, as amended, s. 8.1. See also s. 8.2 which provides that generally civil law terminology in a statute is to be adopted in the province of Québec and common law terminology in the other provinces.

III. Scope and application of treaties

A. The preamble

1. Text. “The government of Canada and the government of X, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, have agreed as follows.”

2. Double taxation. Article 23 is directly addressed to this task, although it is largely confirmatory of Canadian, and often foreign, law. Some other provisions, such as dispute resolution, could also fall within the goal of preventing double taxation.

3. It is difficult to argue that the treaty network as a whole is designed to prevent double taxation given the existence of treaties with countries that impose virtually no income tax (e.g., the United Arab Emirates).[50] Furthermore, articles that do not prohibit but merely limit the extent of source state taxation, for example on dividends, interest or royalties, do not prevent double taxation but rather divide the taxation pie.

4. Fiscal evasion. Very few provisions of the treaties directly address this preambular goal. Exchange of information and assistance in collection provisions might be examples.

5. Yet, the treaties as a whole seem more intent upon goals other than eliminating double taxation and preventing fiscal evasion. “Tax treaties… have two main purposes. First, to expand opportunities for international trade and investment by reducing income tax related barriers such as double taxation and withholding taxes. Second, to ensure that governments collect the revenue due to them by dividing the sums due from taxation and combating tax avoidance and evasion.”[51] The allocation of taxing jurisdiction appears to occupy most of the actual text of the treaties.

6. “Double non-taxation.” The treaty may be invoked to prevent taxation in one state of an item of income that is not taxed in the other state. The preamble has sometimes been viewed as authority or direction to prevent that result. Whether such a principle is conceptually valid, or exists, is

[50] According to the UAE web site: “The UAE does not have any enforced federal income tax legislation for general business. An income tax decree has been enacted by each Emirate, but in practice, the enforcement of these decrees is restricted to foreign banks and to oil companies. This practice is not likely to change in the near future as the relevant mechanisms with which to implement the tax decrees have not yet been established. The decrees indicate, however, that if taxation were enforced, taxes could be imposed retroactively.”

[51] *Chua v. The Queen*, 2000 DTC 6527 (TCC), para. 13.

considered below (III.F.4).

7. Application. How important is the preamble in interpreting treaties? It is part of the text (Vienna Convention, art. 31(2)). In the case of a statute, the preamble is a part of the enactment "intended to assist in explaining its purport and object."[52] Canadian courts have often cited the tax treaty preamble although it is rarely clear how much this matters. Perhaps the strongest statement is in *Cudd Pressure*, where McDonald JA says (para. 30): "I would also dismiss the appeal on the ground that the purpose of the 1942 Convention is to prevent double taxation and to prevent tax evasion" (citing the preamble). An "also dismiss" is not quite an obiter but one wonders whether the learned judge really means he would have dismissed the appeal even if he had reached a different conclusion in the rest of his reasons. In a case where the resolution of an ambiguity would lead to double taxation in one direction and in the other not, the preamble may well be given some weight.

B. Article 1

1. OECD Model: "This Convention shall apply to persons who are residents of one or both of the Contracting States." Presumably, "persons" takes its meaning from Article 3 and "residents" from Article 4. Article 1 is meant to mean that the convention shall apply <u>only</u> to persons who are resident in one or both states[53] and, if the parties desire to extend its application to third country residents, they may use the word "taxpayer" instead of resident.

2. Canadian practice. All Canadian treaties but one follow the OECD format. Article 1 of the Canada-US treaty is slightly and subtly different: the convention "is generally applicable to persons who are residents of one or both" states. This is likely because in this treaty, certain provisions do apply to third-country residents with a permanent establishment in one of contracting states, including the transfer pricing rules in Article 9 (see IV.G.5.c) and Article XI(8).

3. Application to Canadian residents. Generally we consider the application of the convention in Canada to a resident of the other state. But Article 1 does not so restrict treaty benefits and there are circumstances in which a Canadian treaty can apply to a Canadian resident (for the US treaty, see XI.C). For example, Article 15(3) addresses remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of the other Contracting State. The

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[52] *Interpretation Act,* s. 13.

[53] OECD Commentary to Article 1, para. 1. The US 1996 Model Income Tax Convention ("US Model") does add the word "only."

current Canadian approach is generally to provide for concurrent taxing jurisdiction to both states but a number of older treaties provide exclusive jurisdiction to the state of residence of the enterprise. Thus, a Canadian resident employed by a foreign carrier could claim a treaty benefit. This is what the taxpayer unsuccessfully attempted (unsuccessfully because he failed to demonstrate that the China treaty "applied," in the relevant sense, to Honk Kong) in the *Kelly Edwards* litigation.[54]

4. Dual residence. The reference to application of the treaty to a resident of *both* states is necessary to ensure that the tie-breaker rules in Article 4 may apply. Regarding the possibility of dual treaty residence, see III.E.6.d) below.

5. Timing. Article 1 is silent regarding timing – there is no reference to either "throughout the year" or "at any time in the year." Does the person have to be resident for any particular period or at any particular time in order to claim benefits under the treaty? Presumably not. Each distributive article must be read from this perspective, but generally it seems that the application of the treaty depends upon the circumstance at the moment of such application.

C. Article 2

1. The treaties expressly apply to named, existing taxes. There are several variations. "The existing taxes to which the Convention shall apply are, in the case of Canada"

a) "…the taxes imposed by the Government of Canada under the *Income Tax Act*." This potentially includes all Parts of the Act and does not include any tax imposed otherwise than under the Act.

b) "…the income taxes imposed by the Government of Canada under the *Income Tax Act*." Some taxes imposed under the Act cannot reasonably be regarded as "income taxes." Aside from obvious cases like Parts III, V, and various penalty and over-contribution levies, what about Part VI? Of course, this is only relevant if a specific treaty provision might otherwise apply to such a tax. Indeed, one might wonder why Part XIII tax is an income tax, given that it is a tax expressly imposed on a gross payment (s. 214(1)), other than the fact that it has to be because everyone has such a tax and allows foreign tax credits for each other's version.

c) "…the income taxes imposed by the Government of Canada." This extends beyond the confines of the Act, but with a similar restriction to income taxes as in the second version.

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[54] See note 34 above.

d) The US treaty is more specific: "the taxes imposed by the Government of Canada under Parts I, XIII, and XIV of the *Income Tax Act*."

2. More generally, the treaties apply to all taxes on income (and capital, where stipulated), namely, those imposed on total income or an element thereof, and on gains and capital appreciation. In many but by no means all cases, the Canadian treaties specify, following the OECD Model, the base of wages or salaries paid by enterprises. Article 2 also provides for application to future taxes that are identical or substantially similar.

3. The OECD and UN Models include taxes imposed by political subdivisions and local authorities but Canada's treaties do not, and cannot for the constitutional reasons previously noted (Canada has duly recorded a reservation to the OECD Commentary to Article 2 to this effect). As for the treaty partners, the practice varies. Some exclude political subdivision taxes either expressly (Mexico) or by silence, while others include them (Germany, Czech Republic).

4. Beyond Article 2. Although Article 2 states that the convention "shall apply" to the listed taxes and the additional categories specified, it may also apply to other taxes. The exchange of information provision in the OECD Model and Canada's treaties generally provides that its application is not restricted by Article 2.

D. Definitions: Article 3 – selected items

1. "Canada". Most treaties define "Canada" "used in a geographical sense" in order to include the area of Canada's claimed territorial waters and the sea and airspace above such area.[55] Some have more restricted wording, like s. 255 of the Act, linking the expanded territory to natural resource exploitation. These distinctions are moot, however, given the broad language s.5 of the ITCIA.

2. "Company". In Canadian conventions, "company" is generally limited to entities treated as bodies corporate "for tax purposes." "Person" is broader and may include a "body of persons." It may expressly include (e.g., Switzerland) or exclude (e.g., UK) a partnership, or may be silent on the matter (US). This is not quite as important as it might seem. For even if a partnership is a "person" it is unlikely to qualify as a "resident" so the implications are restrained.

3. "Enterprise". This is an ambiguous expression. It may refer to either an

[55] Not quite the old *usque ad coelum et ad inferos* as it never seems to point down, only up.

entity or an activity. This has been a source of some controversy.[56] An interesting if somewhat confusing trio of Canadian cases in the 1970s suggested that under the then applicable US treaty, a US resident could not avoid Canadian taxation on profits from a business carried on in Canada even if he had no permanent establishment in Canada where the individual had no business in the US because, in that case, he failed to qualify as a "US enterprise."[57] The OECD Model and Canada's treaties, however, no longer use this definition and it seems clear that a resident of the other state that carries on business in Canada is an enterprise of that contracting state.

4. Other terms are defined in specific articles of the convention for purposes of those articles (such as "interest" and "dividend"). The fact that these definitions do not apply to the treaty as a whole may be critical.[58] There are also, however, important definitions elsewhere that do apply for purposes of the convention generally, e.g., "resident of a contracting state" in Article 4, "permanent establishment" in Article 5 and "immovable property" in Article 6.

5. ITCIA. Recall that there are additional or amended definitions effectively incorporated into the treaties by the ITCIA, including "immovable property", "annuity" and "pension." That statute also contains a "negative definition" in s. 6, to the effect that "interest" as used in pre-November 19, 1974 conventions does not include guarantee fees under pre-June 23, 1983 agreements. This preserved the *Melford* judgment on a transitional basis (there are no longer any such pre-1974 treaties).

6. General law. The definitions in Article 3, in other articles of the conventions and in the ITCIA do not, of course, exhaust the scope of terms employed in the treaty. Section 3 of the ITCIA requires a residual reference to definitions contained in the Act (on an ambulatory basis). What happens if a term is not defined there either? In particular, is there still scope for the application of Article 3(2) of the treaty if it is of the type that refers to the general law, rather than tax law? It is unclear whether s. 3 of the ITCIA means to remove references to general law in favour of tax law, or merely give a preference for the latter over the former. This could be relevant to expressions in the convention that do have a legal meaning (e.g. "domicile" in Article 4(1), "agent" in Article 5(5), "debt-claim" in Article 11, "employer" in Article 15).

[56] The matter was the subject of a panel at the 2006 congress of the International Fiscal Association in Amsterdam, wittily entitled "Do Enterprises Mean Business?"

[57] *Abed v. MNR*,, 78 DTC 6007 (FCTD); *Masri v. MNR,* 73 DTC 5367 (FCTD); *Rutenberg v. MNR*, 79 DTC 5394 (FCA) affirming 78 DTC 6140 (FCTD).

[58] The English case of *Memec PLC v. IRC*, [1998] STC 754 (CA) turned, at least in part, on the restriction of the definition of "dividend" in Article 10 to that Article.

E. Residence

1. The usual version of Article 4(1) defines treaty residence, in the first instance, by reference to domestic law: a person is resident in a state if liable to tax there under its laws. In addition, such liability to tax must be by reason of the person's domicile, residence, place of management or any other criterion of a similar nature. I permit myself to refer to my 2002 IFA Canada Travelling Lectureship on corporate residence which dealt with a number of the questions raised by Article 4(1) in the context of incorporated companies.[59] A few remarks are, nonetheless, in order.

a) Like other *renvoi* rules, this one raises complex conceptual issues. For example, s. 250(5) must, presumably, be read after one is finished with Article 4 or the inquiry will become an unending loop.[60]

b) "Liability" to tax has raised a number of questions.[61] "Liability" cannot be equivalent to subjection to immediate cash taxation or else a taxpayer sheltered from taxation by earlier losses would fail to achieve treaty protection. The Canadian practice is generally to accept foreign charities as treaty residents (which, incidentally, is assumed by the drafters of Article XXI of the US treaty) who may benefit from lower withholding tax rates in Article 10 – 12, so "liability" must have something to do with a potential liability, being "liable to be liable" to tax. On the other hand, Canadian practice generally denies treaty residence status to complete flow-through entities. Collective investment vehicles present difficult problems that should ideally be dealt with in specific treaty provisions but rarely are. Note also the odd US treaty rule for trusts and recent provisions concerning transparent entities, both discussed below.

c) Liable "to tax" seems a bit clumsy, but one would imagine it refers to the taxes referred to in Article 2.

d) The list of criteria is sometimes expanded.

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[59] An expanded version was published as Robert Couzin, *Corporate Residence and International Taxation* (Amsterdam: IBFD, 2002). A more recent study, focussed specifically on treaty definitions, is provided by Judith Freedman, "The Definition of Company Residence in early Tax Treaties," 2008 *British Tax Review* [in press].

[60] It may be useful for the student of Article 4(1) to consider the types of problems that often arise in private international law. Indeed, the Article 4(1) reference to Canadian domestic law and the s. 250(5) reference back to treaties is a classic example of so-called "double renvoi" in PIL cases.

[61] Consideration is rarely given to the French version (of the OECD Model and Canada's treaties): "assujettie".

e) Since *Crown Forest* there has been some debate about the type of taxation intended by Article 4(1) and, in particular, the suggestion of "comprehensive taxation" in that case. This cannot be a strict criterion for the determination of treaty residency. It would, for example, conflict with the treatment of remittance basis individuals, subject to specific treaty provisions that assume they are residents (UK Article 27(2), Singapore Article XXI).[62] Perhaps the best counter-example to the "comprehensive taxation" notion is Article 4(5) of the Swiss convention which provides: "Where by reason of the provisions of paragraphs 1 and 2 an individual would be a resident of a Contracting State but is not subject in that State, with respect to all income generally taxable from sources from the other Contracting State, to the generally imposed income taxes, then such individual is not a resident of the first-mentioned State for the purposes of this Convention." Neither a special low rate nor particular base restrictions should prevent treaty residence qualification although one does wonder where (if anywhere) a line should be drawn.

2. Not all Canada's treaties follow the OECD Model in Article 4(1).

a) The Australia treaty, for example, takes a shortcut that avoids a number of these issues. It provides, simply, that "a person is a resident of a Contracting State if that person is a resident of that State for the purposes of its tax."

b) Where the treaty partner does not impose income tax, the OECD Model Article 4(1) test is not workable. Thus, in the UAE treaty, the liable to tax test applies only to determine if a corporation is a resident of Canada; for the UAE, the test is based on ownership, presence or activity. For individuals, it is essentially a sum of the factors mentioned in the usual tie-breaker (substantial presence, permanent home, habitual abode, personal and economic relations); for corporations, treaty residence is recognized for companies wholly-owned by UAE residents and those meeting a "substantially all test applied" to both income and assets of an active business conducted in the UAE.[63]

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[62] Compare, however, *McFadyn v. The Queen,* 2000 DTC 2473 (TCC; this aspect was not subject to comment on appeal, 2003 DTC 5015 (FCA)). Although perhaps an extreme case, the trial judge did cite the "comprehensive taxation" test in order to find an individual apparently excluded from Japanese tax liability by reason of his marriage to a diplomat as not qualifying for treaty residence in Japan.

[63] Essentially the same rule applies but not through the residence definition in the Oman treaty. There, treaty benefits are denied to companies entitled to benefits in tax-free zones but then the benefits are restored if at least 90% of the tax-favoured income is from an active business or the company is wholly-owned by Oman residents.

3. Corporate residence.

a) Canada recorded a reservation in the OECD Commentary to Article 4 in order to protect its right to use place of incorporation as the tie-breaker test (see below) but not regarding the text of Article 4(1). In fact, although place of incorporation is, of course, the criterion for corporate residence of corporations incorporated in or continued to Canada (s. 250(4), (5.1)), it is added to the itemized list in Article 4(1) in a somewhat haphazard manner, in less than ½ our treaties. Presumably, Canada is satisfied that the place of incorporation test is subsumed in "residence" or "domicile" or that it is a criterion of a similar nature.

b) A minority of Canada's treaties also expressly include governments, local authorities, their agencies and instrumentalities among Article 4(1) residents. This is a helpful confirmation but does put into further relief the problem in determining the scope of "liable to tax."

c) An important case subsequent to my earlier Lecture is *Wood v. Holden*.[64] It contains a strong affirmation of the *De Beers* principle and a careful limitation of the *Unit Construction* exception to cases where the constitutional organs of the company (the board of directors) are "usurped" or "by-passed." The fact that board and corporate activity may not be intense is no justification for situating residence elsewhere than where the directors in fact meet and execute the relevant documents. Making a single decision (to acquire and sell some shares) is sufficient to determine residence, even if it is made in conformity with a tax plan developed elsewhere. The lack of information or close consideration does not render the board decision irrelevant or ineffective to determine residence. "Ill-informed or ill-advised decisions taken in the management of a company remain management decisions." (para. 43 – a principle well understood, alas, in the non-tax context). Note that the court applied the identical tests to the UK-Netherlands treaty Article 4 reference to "place of effective management."

4. Individual residence

a) The OECD Model version of Article 4(1) ends with the qualification that a resident of a contracting state "does not include any person who is liable to tax in that State in respect only of income from sources in that State." The Commentary (para. 8) contrasts this condition with "full" or "comprehensive" tax

[64] [2006] EWCA Civ 26 (CA); leave to appeal to the HL refused. Followed by the Special Commissioners in *News Datacom Limited v. Atkinson*, [2006] UKSPC SPC00561.

liability, and gives the example of diplomatic or consular staff liable to local taxation only on income from sources in the host state. It is a fair question how Canada regards this condition in the second sentence of Article 4(1) since it is included in only a few conventions (less than 10).

b) Reference has already been made to certain special cases in which individuals who are subjected to a special and beneficial regime in the other contracting state are, for this reason, expressly denied the status of being a resident of that state for purposes of the treaty. This includes the classic UK remittance basis of taxation and analogous regimes referenced in a paragraph of the "miscellaneous rules" Article in a number of conventions (including Bulgaria, Cyprus, Ireland, Malaysia, Malta and Singapore). A similar approach has been taken to the *forfaitaire* regime in Switzerland (Article 4(5)).

5. Trust residence

a) The treatment of the institution of the trust presents difficulties. Under Canadian law (outside Québec), the trust derived from the English law of equity is an obligation, not an entity, and in Québec it is a *patrimoine d'affectatio*n, not an entity either. Subsection 104(1) helpfully allows one to read the Act by stating that a reference to a trust is a reference to the trustee having ownership or control of the trust property. This does not seem to be a "definition" that would apply to a treaty under Article 3(2) or the ITCIA. Thus, while almost all Canadian treaties state that "person" includes a trust, the real meaning of this is not evident. The trustee is a person, but in the treaty context one cannot simply identify the two unless we mean the trustee *es qual*, in his/her/its capacity as trustee under a particular trust arrangement.

b) Difficulties also may arise on the other side, depending on how the other contracting state regards a "trust" (if at all). Suppose an English law trust is validly constituted and, under the tax law of a civilian jurisdiction that does not recognize the institution of a trust, tax is imposed on what we would regard as the trust income (due to applying an effective management test, or perhaps the residence of beneficiaries). Is the trust, recognized and treated as a separate unit of taxation under Canadian tax law, a resident of the other contracting state, even though that other state does not think there is any "trust" that is liable to tax?

c) Assuming we have managed to establish that something we call a trust is liable to tax in the other state (perhaps in the simpler case where it does recognize the trust institution), this trust will often be

subject to a limited or general flow-through of tax attributes and liability. Only the US treaty addresses the issue, in a curious gloss in Article 4(1). An estate or trust is a treaty resident only to the extent that income derived by it is liable to tax in the state in which it would otherwise be regarded as resident, either in its hands or in the hands of its beneficiaries. Effectively, a trust can be "a little bit resident." The treaty does not elaborate on how the "to the extent that" concept actually applies to particular items of income. This curious approach seems based upon the US Model provision dealing more generally with fiscal transparency (see III.E.7.h), but that provision operates on items of income, not residence.

d) A peculiarly (and peculiar) Canadian issue concerns s. 94 trusts.

> (1) Under the old version, a s. 94 discretionary trust is deemed for purposes of Part I to be a person resident in Canada with a specially defined tax base, while a non-discretionary trust is treated as a non-resident corporation. If the trust is liable to tax on the basis of its residence in a treaty partner state, a question arises how to apply Article 4(1). Presumably, the non-discretionary trust could be a resident of the other state, if liable to tax there under the requirements of Article 4(1). The more important but thorny question concerns the discretionary trust that meets the residence test in the other treaty state. Is it liable to tax in Canada by reason of its residence or a similar criterion? If so, we turn to the tie-breaker. Apparently, the official view is that the old s. 94 trust is a resident of Canada under Article 4(1) because it is liable to tax by reason of its deemed residence, and that this deemed residence meets the requirement. I understand some taxpayers have contended that the trust fails the test. There are several different arguments. Perhaps "by reason of the person's residence" as used in Article 4(1) refers to the ordinary meaning of "residence" and cannot include the deemed residence of s. 94 (which presupposes that s. 3 of the ITCIA does not apply, perhaps because the context indicates otherwise); alternatively, it has been contended that the restricted tax base under s. 94 is not the comprehensive taxation suggested in *Crown Forest.*[65] The matter may well proceed to litigation.[66]

[65] *Supra,* note 41.

[66] I thank Nat Boidman for bringing this matter to my attention.

(2) Under the new version, a s. 94 trust is deemed to be resident in Canada for certain defined purposes, rather than fully resident but with a narrower tax base. The drafter does appear to treat consider the trust as a resident for purposes of the Act as, for example, in the the cessation of residence rules. If so, the same issues probably arise regarding the tie-breaker.

e) Although this is not a residence question, it is convenient to pause here to consider certain basic questions of how the distributive articles of the convention apply to a treaty resident trust.

(1) Where an item of income is earned by the trust, presumably the applicable treaty Article applies as if the item were earned by any other treaty resident, notwithstanding the legal character of the relationship between trustee and beneficiary. The most often remarked issue in this regard concerns the "beneficial owner" requirement for dividends, interest and royalties. A trust lawyer would cringe to hear a "trust" described as the "beneficial owner" but this certainly seems consistent with the intentions of the contracting states. The alternative would be to treat the beneficiaries as the beneficial owners which could yield a better or worse result. A concern must be that a treaty resident beneficiary of a non-treaty resident trust may at some point argue for that alternative and convince a traditionally-minded judge.

(2) The other side of the coin is the treatment of the distribution of trust income to beneficiaries. Does it retain the character of its source? That does not appear to be the Canadian approach. The "Other Income" Article almost always specifies that income from a trust that arises in Canada may be taxed here, at a rate up to 15% of the gross amount. This implies that such income is regarded as distinct from the underlying source. That is consistent with s. 108(5)(a) of the Act, which might indeed apply to effect this result by characterizing the income before the treaty applies to it.

6. Dual residents/tie-breakers

a) The definition of residence in Article 4(1) permits a person to be resident in both states. There are a few possible solutions:

(1) allow treaty benefits to the person in its capacity as a

resident of both states;

(2) deny benefits entirely;

(3) agree on or stipulate which benefits the dual resident should get; or

(4) break the residence tie.

b) The last-mentioned is the OECD approach. The Model establishes a sequential series of nexus tests for individuals and opts for place of effective management for persons other than individuals. Canadian treaties adopt a variety of tie-breakers. Generally, the sequential nexus approach is used for individuals. There may then be a single rule for all other persons, or separate rules for companies and a residual category (for our purposes, trusts). The rule can look to a single test such as place of effective management or place of incorporation, a sequential test such as place of incorporation failing which place of effective management, or a "best efforts" reference to the competent authorities, with or without guidance on certain factors to be considered. There is considerable variety in the choices made.

c) Tie-breakers almost always leave open the possibility of an unresolved tie. This is obviously the case under the best efforts approach if the competent authorities do not reach agreement. It is also the case under a fixed rule like place of effective management if that place is located in neither contracting state. Some treaties address unresolved ties while others do not. For example, sometimes the best efforts rule prescribes what happens absent agreement: no treaty relief at all (France, India), no relief under certain treaty Articles (Italy, Malta), or no relief except what the competent authorities do agree upon (Finland, Ireland). Or, there may be no denial of benefits and the person left, presumably, as a dual resident (Hungary, Indonesia).

d) Subsection 250(5) denies Canadian residence status under the Act where a person otherwise resident in Canada is exclusively resident in another country under a treaty. The tie-breaker in Article 4 can apply only if the person is, first of all, liable to tax as a resident of both states. In order to avoid a circle, the operation of these provisions must be afforded an implicit ordering: (i) the person is resident in Canada and state X applying the terms of Article 4(1), without regard to s. 250(5); (ii) the convention tie-breaker then assigns treaty residence to state X; (iii) the person is deemed for purposes of the Act, but not for purposes of item (i) in this chain of reasoning, not to be resident in Canada.

e) While s. 250(5) generally prevents simultaneous residence in Canada (for purposes of the Act) and another country (for purposes of a treaty), that is only the case if the person is exclusively resident in the other jurisdiction under the relevant treaty. If the person is left as a treaty dual resident under the tie-breaker, s. 250(5) does not apply due to the final phrase: "and not resident in Canada." In the case of treaty tie-breakers of the best efforts type, one might anticipate that any potential untoward tax advantages for the taxpayer would inspire the competent authorities to settle their differences. In the corporate context, the "place of creation" approach in the US treaty is welcome as it provides a clear means of breaking the tie if the corporation is created under the laws of one or the other contracting state. That left open the issue of third-state companies, a situation that has been addressed with a best efforts rule in the 2007 fifth protocol.

f) Dual residence under Article 4(1) is perhaps more likely to arise for individuals than corporations. The test of "permanent home" should not be too difficult to apply, but "centre of vital interests" is a bit fuzzy. The TCC used an arboricultural metaphor: "The depth of the roots of one's centre of vital interests is more important than their number."[67]

7. Fiscally transparent entities (or non-entities)

a) The Canadian and OECD view is that a fully fiscally transparent arrangement cannot constitute a treaty resident.[68] If the arrangement does not rise to the level of being a "person" (not a body of persons, for example) this is clear enough. If there is a person, then this conventional view is based on the conclusion that the person is not liable to tax.

b) Whether partnerships or other flow-through arrangements, or their members, are residents of a contracting state under a Canadian treaty depends on both a legal and a fiscal analysis. First one must consider the legal rights and obligations to decide whether the arrangement is a "person," having regard to the definition in the particular treaty (e.g., whether it includes "partnership" – which raises a sub-question of what "partnership" means, of course). One must then consider in what manner or circumstances the entity is or can be liable to tax in the other contracting state, how the flow-through works, and generally the

[67] *Hertel v. MNR,* 93 DTC 721 (TCC).

[68] Paragraph 5 of the Commentary to Article 1. The Canadian position is well known in connection, especially, with US LLCs (before the application of the fifth protocol).

fiscal regime applicable to the entity and its members.

c) An attempt to sort out the permutations particularly in connection with partnerships was made in the well-known OECD partnerships report.[69] While conceptually helpful, this document reaches some policy-oriented conclusions that may not be justified under our treaties and applying our case law and administrative practice. The OECD Commentary now contains an extended catalogue of problems relating to the treatment of partnerships in the commentary to Article 1 (para. 2 – 6.7).

d) One should not assume that foreign arrangements the name of which is translated as "partnership" are either legally or fiscally familiar. In each case, a careful analysis is required to determine if the arrangement is a person for Canadian domestic purposes, and for purposes of the treaty, and whether the members or owners are in a position to claim treaty benefits, perhaps under a number of different treaties.

e) Recall s. 6.2 of the ITCIA (see II.B.5.c). The *Padmore* mischief was a UK resident avoiding UK tax on UK business income earned by a Jersey partnership of which he was a member. The Jersey partnership was found to be a person for purposes of the UK-Jersey treaty, protected from UK tax by reason of its having no permanent establishment in the UK. The partner was allowed to escape taxation because, the court held, the treaty protection applied to the "enterprise." However, the ITCIA provision overreaches in its indiscriminate use of the word "partnership" (société de personnes). Suppose that the foreign entity is regarded by Canadian practice as a "partnership," and that its name is normally translated in this way, but that it is fully liable to taxation in the other state. There seems no policy reason to apply a rule such as s. 6.2 in that case. An interesting example is the French *société en nom collectif* (SNC). This organization is a separate legal person but, having regard to its other attributes, has some affinity to the Canadian notion of partnership. Under French tax law it is generally regarded as fiscally transparent; however, it may opt to be taxed under the corporations tax. The CRA has opined that the SNC is a partnership for purposes of the Act whether or not it has made that election.[70] A Canadian partner of a SNC that has not so elected would be denied any treaty benefits that might otherwise be claimed due to s. 6.2 of the ITCIA, and

[69] "The Application of the OECD Model Tax Convention to Partnerships," *Issues in International Taxation, No. 6* (Paris; OECD, 1999).

[70] RID 2005-0148311E5, February 15, 2006.

this seems to be the intended result (although presumably unnecessary in this case, as the SNC could not claim such benefits). But if the SNC elects to be taxed as a corporation, the denial of benefits under s. 6.2 seems inappropriate.[71] Section 6.2 seems to be unnecessary in the case of the US treaty due to Article XXIX(2) (see XI.C).

f) A common problem arises where Canada recognizes the foreign entity as legally non-transparent but, because of its foreign fiscal transparency, denies it the status of a treaty resident. This, of course, has been the dilemma of the US limited liability company (that does not elect to be taxed as a corporation under the Internal Revenue Code). Prior to the 2007 fifth protocol, the interposition of the LLC between a treaty resident and Canadian source income prevented both the entity and the member claiming treaty benefits (permanent establishment protection, lower withholding tax rate on dividends, branch tax exemption). The new Article IV(6) addresses this issue and, in concept, facilitates treaty benefits to a US treaty resident who derives income through an entity that is not considered a resident of Canada where, by reason of the entity's fiscal transparency under US law, the income is treated for US purposes as if it had been derived directly by the US resident. The quid pro quo for Article IV(6) is Article IV(7) which denies treaty benefits where the interposed entity is not treated as fiscally transparent so that the income is taxed differently than it would be had it been received directly or, if it is fiscally transparent, the resident is treated as receiving the relevant amount from the entity but, having regard to the transparency, the treatment is, again, different. These new provisions are complex and the consequences may be counter-intuitive.

g) The treatment of a fiscally transparent non-entity, an arrangement that Canada regards as both legally and fiscally transparent, must also be considered. Generally, Canadian practice is to look through to the partners, members or owners and assess their entitlement to treaty benefits. This may require careful analysis of the legal arrangement, however. For example, reduced withholding tax rates on interest and royalties depend on the treaty resident being the "beneficial owner" of the item of income, and

[71] It is instructive to compare the fix the UK adopted in response to its own case. Where a partnership is relieved from UK tax by virtue of a treaty, a resident partner shall be taxed without regard to the treaty. See s. 112(4) and (5) ICTA 1988. Furthermore, recent UK treaty practice is to insert a provision to the effect that nothing in the convention shall prevent the UK from taxing a resident of the UK who is a member of a partnership of the other state on his share of any income, profits or gains of that partnership. See, for example, Article 2 of the Protocol to the UK-Macedonia treaty, signed November 8, 2006.

this may depend on how the foreign law achieves transparency. As well, and as previously noted, the definition of "person" in some treaties does include a partnership. I am not aware of whether the CRA has ever focussed on this in applying their administrative position. Finally, there is also a potential cash flow issue. Paragraph 212(13.1)(b) of the Act deems a partnership to be a non-resident person for purposes of Part XIII so even if treaty protection is available for the partners or members, at first blush one would expect the payer or withholding agent to be fixed with a responsibility to withhold at the non-treaty rate. However, I am aware that the CRA has administratively approved a blended rate withholding (based on the treaty or non-treaty residency of the ultimate recipients of the income), subject to a residual responsibility fixed on the withholding agent.

h) A number of other countries have begun to address at least some aspects of fiscal transparency, in particular the reluctance to grant treaty benefits in respect of items of income earned by, but not taxed in the hands of, entities that do qualify as residents. Transparency is not a binary quality; an entity may be liable to tax and still flow through various types of income. The US Model approach is to treat the item of income as derived by a resident of a particular contracting state only to the extent it is treated for purposes of the taxation law of that state as income of a resident (Article 4(1)(d)). A similar provision appears in recent UK conventions. No such general rule has yet emerged in the Canadian "model" and it is not yet apparent whether the US fifth protocol will become a precedent in future negotiations. The French treaty has a very particular provision (Article XXIX(7)(a)) presumably targeted at a form of French investment vehicle: it permits a mutual fund not subject to tax in France to claim treaty benefits to the extent it is held by French residents and the income is taxable in their hands (effectively, another version of being partly resident).

F. Tax avoidance

1. I will merely recall the broad issues, which have been discussed at length by others.[72] Essentially, these have been conceptualized in Canada

[72] See, for example, Richard G. Tremblay, "GAAR and Treaty Shopping," in *Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report* (Toronto: Canadian Tax Foundation, 1996), 38:1-41; Jinyan Li and Daniel Sandier, "The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties" (1997), Vol. 45, no. 5 *Canadian Tax Journal*, 891-958; James R. Wilson and Jillian M. Welch, "The GAAR and Canada's Tax Treaties: Which is Trump?" in Brian Arnold and Jacques Sasseville, eds., *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2000), 5:1 – 5:30; Richard G. Tremblay and Peter MacDonald, "GAAR and Treaties," (2004) vol. 17, no. 1, *Canadian Petroleum Tax Journals.*

as a two-pronged potential challenge to treaty benefits.

a) The notion of a free-standing doctrine of "treaty abuse" has been argued by the CRA. In *MIL Investments*[73] the Crown unsuccessfully pled a doctrine of "inherent abuse" distinct from the GAAR. The concept has been addressed in other jurisdictions and other contexts.[74]

b) The 2005 amendments to s. 245 and the addition of s. 4.1 to the ITCIA put the GAAR cat among the treaty pigeons. In *MIL*, Bell J reluctantly (having regard to the distasteful retroactivity) concluded: "In my view, the impact of the amendments to section 245 is that tax treaties must be interpreted in the same manner as domestic legislation when analyzing potentially abusive avoidance transactions."[75] The jury is still out on how or in what circumstances the GAAR actually will apply in the treaty context. There are both mechanical and conceptual issues to be dealt with.

2. OECD Commentary to Article 1. This commentary includes a lengthy (para. 7 – 26) discussion of "Improper use of the Convention" and refers to a number of potential treaty provisions that might be adopted to counter it, such as language directed against conduit companies.

a) One type of provision is the limitation of benefits ("LOB") rule. The United States commonly demands such provisions in its treaties (see Article 22 of the US Model) as a defence against so-called treaty shopping, although they appear in a baffling range of varieties. Until recently, the official Canadian position, as expressed in para. 3 of the Technical Explanation to Article XXIXA of the Canada-US convention, has been that we do not need the LOB because of the GAAR. This is consistent with the US treaty rule having been negotiated as unidirectional, applicable only in the US. It was suggested at the time that Canada may have preferred not to have the LOB apply in order to avoid any negative inference by the absence of such a rule in other treaties. This position has been reversed in the 2007 fifth protocol. The LOB clause will henceforth apply to Canada. While this may have been

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[73] *MIL (Investments) SA v. The Queen,* 2006 TCC 460 (TCC), affd. 2007 FCA 236 (FCA).

[74] *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London Branch*, [2006] EWCA Civ 158 (UK CA).

[75] Para. 31. While one would think the retroactivity relatively obvious if unpleasant in result, the comments by the SCC in *Canada Trustco, supra,* para. 7 leave some doubt. See Benjamin Alarie, "Retroactivity and the General Anti-Avoidance Rule," paper presented at a symposium held on November 18, 2005 at the University of Toronto, Faculty of Law, "The Supreme Court of Canada and the General Anti-Avoidance Rule: Tax Avoidance After *Canada Trustco* and *Mathew*."

prompted by concerns over third-country access to the nil withholding tax rate on interest, the change suggests that concern over the *MIL* reasoning and result may have trumped any worries about possible negative inferences being drawn from the presence of the provision in one treaty but not in others.

b) Another approach targets preferential regimes in a contracting state. A number of Canada's treaties do list such regimes and deny treaty benefits to entities that operate under them (such as Article XXX(3) of the Barbados treaty (IBC) and Article 28(3) in the Luxembourg treaty (holding companies)). It may be difficult to specify the regimes one intends to exclude, even with language referring to subsequently enacted regimes of similar effect, as one finds in some of the Canadian provisions.

c) The OECD therefore helpfully provides draft language for a generic provision intended to sweep in "ring-fenced" preferential regimes (para. 21.2 of the Commentary to Article 1). It refers to a company, trust or partnership owned by non-residents of the contracting state that bears tax substantially lower than would be the case if it were owned by residents. Canada has adopted versions of this anti-avoidance rule, unusually in the miscellaneous provisions Article, in some 35 conventions (Argentina, Chile, Germany, Iceland, Slovenia, Vietnam). This appears to be the current "model." In a few recent treaties (e.g., Korea, Article 27(3), Finland 26(3)), the clause expressly states that measurement shall be made "after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust, or other entity or to any other person." This is likely intended to prevent the kind of result that occurred in the case of *Bradley Holdings*[76] (settled before trial) in which a refund to a shareholder appeared to escape the "substantial reduction" test. A "substantially all" active business exemption is found in the Korean version.

d) Canada has also included specific "anti-abuse" provisions in tax treaties. Best know is Article XXIXA(7) of the US treaty which was inserted when the LOB provision was unilateral and was presumably intended to reinforce the potential application of the Canadian GAAR (later more potently reinforced by retroactive legislation). It is of some interest that this treaty provision persists even in the fifth protocol, when the LOB rule has become bilateral. It is also found in Article 29(6) of the German treaty.

3. Low-taxed branches. Another Canadian treaty anti-avoidance treaty

[76] The facts and the issues are revealed in a procedural decision, 2004 TCC 221.

provision specifically addresses certain types of branch planning. Article XXIX(8) of the French treaty applies where an enterprise of a contracting state is exempt on foreign branch profits (i.e., a French company subject to the French domestic territorial system for taxing business profits). If the foreign branch profits are taxed in the third state at less than 60% of the French rate, treaty benefits are limited. Canada may in this case impose tax at 15% on dividends, interest and royalties, and other items of income receive no treaty protection. The rule does not apply if France applies its CFC taxation rules to the income, Canada taxes the income as FAPI, or the income arises from an active business (defined in its own way here) in the third country.[77]

4. "Double non-taxation." This ungainly and inaccurate expression is used to describe, or stigmatize, the situation in which the application of a treaty has the result of granting relief from taxation on an item of income in one state even though there is no taxation of the income in the other state.

a) It is sometimes claimed by proponents of the concept that providing relief without taxation on the other side would be inconsistent with the preambular goal of avoiding double-taxation, or at least it achieves a result that is not demanded by that goal. Alternatively, such double non-taxation is an instance of fiscal evasion that treaties are intended to prevent.

b) However, it is clear that treaties often prohibit taxation by one state in order to create "space" for taxation in the other without regard to the actual or current level of the latter liability. This is by design, not indirection and, therefore, cannot be defeated by reference to the preamble. The OECD Commentary expressly recognizes such intentional "double non-taxation." See, for example, para. 3 of the Commentary to Article 21. Canada agrees, for example, to forego its otherwise applicable tax on gains from the alienation of certain taxable Canadian property without asserting any condition that this gain is taxable, or fully taxable in the other state. Many states exempt classes of gains, including Canada. In this situation, it cannot seriously be argued, save perhaps in cases of abusive behaviour by the treaty partner, that treaty relief is intended to be limited to the circumstance in which the other country imposes a tax let alone a particular level of tax.

c) There are, of course, instances in which treaty relief is made to depend upon taxation by the other state. This is the case with the hybrid entity provisions of the recent Canada-US Protocol or, in a more direct and simpler way, can be found in the peculiar

[77] Such a provision is also in the Lebanon convention, not in force.

provision of the US treaty regarding the residence of trusts (III.E.5.c). Remittance provisions would be another example (XI.D). As there are other instances in which treaty relief clearly does not depend on taxation by the other state, it seems impossible to erect these special cases into a principle of construction.

d) In "structured" situations, where the lack of offsetting taxation seems to have been unintended or at least unforeseen by the treaty negotiators, general principles of treaty interpretation or the GAAR should be considered. There is, in my view, no independent notion of double non-taxation.

5. Future directions in the anti-avoidance area are difficult to predict. The CRA loss in the *MIL* litigation,[78] as well as the earlier withdrawal of the *Bradley Holdings* claim, may well be causing some close reflection in Ottawa. It will be interesting to see if some more coherent and consistent approach to anti-avoidance provisions creeps into the Canadian negotiating position.

IV. Carrying on business in Canada – Canadian taxation of branch profits

A. The Act

1. Act and treaties. It is worthwhile pausing to recall the key provisions of the Act (ss. 2, 3, 4, 115, 247, 253) atop which perch the treaty rules (Articles 5 – 9 and 14). This is not only because the treaty begins relieving where the Act leaves off taxing, but also because certain aspects of the construction of the treaties is illuminated by the provisions of the Act.

2. Charging provision. The charge on a non-resident person in s. 2(3) applies to a base defined in s. 115 to include incomes from businesses carried on by the non-resident person in Canada.

3. "Carrying on business in Canada". "Business" is not quite the same as "carrying on business," as pointedly observed in *Tara Exploration*.[79] The determination of the level and character of the activity required, as well as the location of the geographical source of the income, depends on case law. Older cases tended to emphasize the place where the profit-making contracts are made, as well as certain physical connections such as location of inventory, delivery, and production. The focus was almost exclusively on the sale of goods. A more modern approach emphasizes the

[78] See, *supra*, note 39.

[79] *MNR v. Tara Exploration and Development Company Ltd.*, 72 DTC 6288 (SCC), affirming 70 DTC 6370 (Ex.Ct.).

place where the operations from which the profits arise are located.[80] This should be kept in mind when we return to Articles 5 and 7 of the treaties.

4. Section 253. This provision extends the meaning of the expression "carrying on business in Canada" both with respect to the nature and the locus of the activity. Its drafting leaves something to be desired.

a) The substantive expansion of "carrying on business" is perhaps clearest in subparagraph (c)(iii): a non-resident person who disposes of real property other than capital property is deemed to be carrying on business in Canada. This is a reversal, for real property, of the *Tara Exploration* decision. As well, it is not obvious that "soliciting orders through an agent" would in all cases otherwise constitute carrying on business. A common issue concerns the disposition of capital property, such as securities, that are offered for sale through an agent (as they generally are). Arguably, the taxpayer is deemed to be carrying on business in Canada, but the gain is not deemed to be business income. Does this mean that ½ the gain is potentially subject to tax under s. 2? Again, we should keep this in mind as we think about both Article 7 and Article 13.

b) The territorial impact of s. 253 is evident. Soliciting orders in Canada through an agent is deemed to be carrying on business in Canada even if, under traditional source tests, the business income might be regarded as earned outside Canada. But note that s. 253 does not tell us what income (if any) is earned from the deemed Canadian business activity. Is it still necessary to make an allocation between the profit-generating activities inside and outside Canada.

c) Curiously, s. 253(b) refers explicitly and exclusively to soliciting orders or offering anything for sale through an agent or servant. A non-resident individual who offers the property for sale without the intermediary of an agent or servant does not appear to be within the scope of the provision. This is likely because the original target was different, but it is a curious result.

5. Source computation. If a non-resident person is carrying on business in Canada, s. 115(1)(a)(ii) includes in the tax base the income (as determined under s. 3) from that activity. If the taxpayer engages in business activities

[80] See, for example, *Twentieth Century Fox Film Corporation v. The Queen*, 85 DTC 5513 (FCTD). A subtle and for our purposes probably not relevant distinction may exist between "carrying on business in Canada" for purposes, for example, of the charge in s. 2(3) and the activity of earning income from a business carried on in Canada, on the basis of *The Queen v. London Life Insurance Company*, 90 DTC 6001 (FCA).

within and without Canada, s. 4 establishes the manner in which the Canadian part of the total income is to be determined. Yet again, we must keep these domestic rules in mind when we read the treaties.

B. Articles 5 and 7 of the treaties

1. General. Assuming that a non-resident person is carrying on business in Canada, and has income from that activity, the treaty may apply to limit or eliminate the Canadian tax liability. Different rules apply to real property (immovables) under Article 6 and to shipping and transportation under Article 8.

a) The rule in Article 7(1) is double-barrelled. The first sentence establishes a condition for the taxation by a state (in our case, Canada) of the profits of an enterprise of the other state: they shall be taxable only if that enterprise carries on business in Canada through a permanent establishment situated therein. Absent a PE, the enterprise is not considered as "participating in the economic life" of the host state (Commentary to Article 7, para. 3). The second sentence is consequential and deals with quantum in the negative. Where the condition for taxation is met, the profits of the enterprise may be taxed in Canada but only so much of them as is attributable to that permanent establishment.

b) Commentators often regard the first sentence as a "threshold" test for claiming taxing rights (permanent establishment) that is different from the notion of "source."[81] Thus, it is said to be possible under the OECD Model Article 7 for a state to impose tax on the foreign (third country) source profits attributable to a permanent establishment in that state, although it is conceded that this rarely occurs under domestic law. It is not self-evident to me that the analytical model is truly rigorous; perhaps the "threshold" actually establishes, for this purpose, the meaning of source. For example, it has been argued that, in theory, the host country of a permanent establishment can, under the OECD Model, impose tax on foreign source income attributable to that permanent establishment (thus "proving" that the two concepts are different). In practice, this almost never occurs because domestic law (as in Canada) does not permit it. But if this is always the domestic law, perhaps that simply means the distinction is artificial. In any event, the two stage approach – threshold plus allocation of income – is useful in practice and will be followed here.

[81] See, for example, Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003), 55-108.

2. Permanent establishment ("PE") – Article 5

a) Physical presence

(1) For historical, pragmatic and perhaps geopolitical reasons, the essence of the PE definition is physical presence. Its central pivot in paragraph 1 is a "place" and, moreover, one that is "fixed." The term "includes especially" ("comprend notamment") in paragraph 2 a series of physical locations (or, at least, expressions that were undoubtedly considered physical when they were first listed). The expansion to include certain construction or installation sites is also physical. Finally, note that Article 7 refers to a permanent establishment "situated therein," i.e., in a state. Thus, the PE is normally and primarily conceived as an identifiable pile of bricks and mortar. Even the "dependent agent" PE is not really an exception to tangibility; although the non-resident enterprise in this case has no physical presence in Canada, someone else most likely does.

(2) There was considerable debate about physicality and PE in the consideration of electronic commerce. The upshot, at the OECD level, was a conclusion that there might be occasions when a server could, in and by itself, constitute a PE but even in this case, we are dealing with a physical, albeit non-human, presence (Commentary, para. 42.1 – 42.10). The e-commerce debate did highlight the pressure that modern business practices have placed on the PE concept.

(3) Apparently "fixed" is not absolute, but relative. The peripatetic PE has been accepted (*Fowler*),[82] but I am not aware of any broad application.

b) Services

(1) The UN Model adds a service category to the definition of PE: the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within the relevant state for a period or periods aggregating more than 6 months within any 12-month period. The explanation in the UN Commentary may

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[82] *Fowler v. MNR*, 90 DTC 1834 (TCC).

not be intellectually rigorous but it does have the virtue of candour: "It is believed that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money."[83]

(2) Canada has adopted a version of the UN provision on services in a number of treaties with developing countries in Asia, Latin America and Africa (and also with a few Central European states – Czech Republic, Slovak Republic and Slovenia – and service-attracting countries in the Middle East – Oman, Kuwait). The text generally grants permanent establishment status to the act of "furnishing services," including consultancy services, through employees or "other engaged personnel" in the other state provided that such activities continue for the same project or a connected project for a period or periods aggregating more than a specified number of months (usually 6, but it can be 3 – Algeria, India) within any 12-month period. While the purpose of the expanded PE definition is to protect the source tax base of the lesser developed treaty partner, the rule is, of course, reciprocal.

(3) Canada's contribution to international case law regarding PE is the *Dudney* decision of the FCA.[84] There are several important nuggets in the reasons, including the statement of equivalence between "fixed base" in Article 14 and PE in Article 5 (good news for the current OECD and Canadian position that Article 14 is unnecessary), the continued application of the traditional tests to services, and the comments regarding the nature of the connection between the service provider and the office (control, right to use) necessary to constitute a PE. *Dudney* may or may not be related to changes in the OECD Commentary and the services rules discussed below.

(4) Under pressure from certain members the OECD, while not adding anything to the Model, proposed new commentary to Article 5 includes an optional services rule.[85] It has two parts. First, the text stipulates that there is a deemed PE where services are provided through an

[83] UN Commentary to Article 5, para. 9.

[84] *Supra*, note 36.

[85] Paragraph 42.23 and following of the Commentary to Article 5.

individual who is present in the other state for at least 183 days in a 12 month period and more than 50% of the gross revenues of the enterprise during the period are derived from the services performed in that state through that individual. Second, there is a deemed PE if services are provided during such a period of at least 183 days for the same project or connected projects through one or more individuals who are present in the other state for this purpose.[86]

(5) Canada has adopted a version of this OECD text in the 2007 fifth protocol to the US treaty, as Article V(9). The drafting is a bit tighter, but the first branch of the test essentially follows the OECD approach. The alternative second rule is, however, rather different. It deems a PE if services are provided in the other state for 183 days or more in a 12 month period with respect to the same project or connected projects[87] for customers in the other state who are resident there or maintain a PE there. That is, under this rule the critical issue is the place of establishment of the recipient customers, rather than the individuals who perform the services. Apparently, the services provision was not pressed by the United States, which remains in general opposed to such rules.[88]

(6) The services issue remains of considerable importance in both theory (OECD Commentary revisions – consider the "painter example" in para. 4.5 of the OECD Commentary and hypothetical examples such as the remote surgeon) and practice. The CRA has expended some effort trying to fathom the implications of international service providers. The project likely began with s. 105 withholding and the somewhat gruesome waiver guidelines, but thereafter blossomed into a more far-reaching consideration of how these organizations should be taxed. There have been CRA settlements in which *Dudney* was followed notwithstanding the administrative attempts to limit its

[86] "The Tax Treaty Treatment of Services: Proposed Commentary Changes," public discussion draft, OECD, 8 December 2006. http://www.oecd.org/dataoecd/2/20/37811491.pdf

[87] An Exchange of Notes, Annex B to the Convention, defines "connected projects" by reference to "a coherent whole, commercially and geographically." The OECD Commentary provides examples, but no definition.

[88] According to Mike Mundaca, Deputy Assistant Treasury Secretary for International Tax Affairs, BNA Daily Tax Report, January 22, 2008, I-4. Thank you to Sandra Slaats for pointing this item out to me.

potential impact.[89] The rejection of any requirement that the foreign service provider have a "formal legal right" to use the domestic premises is reflected in amendments to the OECD Commentary to Article 5, in para. 4.1 (in which, not coincidentally, Canadians had a significant part). The jury is still out as to how far the *Dudney* reasoning may be taken by a Canadian court.

(7) The UN Model contains an additional rule to the effect that an insurance enterprise is deemed to have a PE in the other state if it collects premiums there or insures risks situated therein (other than through an independent agent, and not including reinsurance). About a dozen Canadian treaties also include this rule (Chile, Indonesia, Senegal).

c) Construction and installation, substantial equipment

(1) The OECD Article 5(3) is adopted in most Canadian treaties. A building site or construction or installation project constitutes a permanent establishment only if it lasts for more than 12 (or in some cases 6) months. On its face, and as confirmed by the Commentary (para. 16), this limits the scope for finding a PE to exist: if an office or workshop is part of a construction site, it is not a PE (assuming it serves no other purpose) unless the associated construction (there could be several projects) lasts for the designated duration.

(2) The language leads to a number of practical difficulties of application, including deciding what is a construction or, especially, an "installation" project and how one measures the 12 month period for complex projects. Some treaties include "supervisory activities" in paragraph 2, which also requires some definitional effort.

(3) A number of Canadian treaties do not follow the OECD Model in the important respect that the construction rule expands, rather than restricts, the scope of the PE definition. This is to be noted in particular in treaties with less developed countries. Generally, the idea is not to say that a building site or construction project is a PE only if it lasts for a certain duration, but rather to deem such a site or project to be a PE, either with a minimum duration (varying from 3 months in Pakistan to 12 months in Oman), or without any such minimum (Morocco).

[89] Income Tax Technical News no. 33, Sept. 16, 2005.

(4) To further illustrate the complexity of variable drafting, and the importance of reading the particular treaty with which one is concerned, the US rule is subtly different from either the OECD or the UN versions. Here, the construction project is a PE "if, but only if" it lasts more than 12 months. In the result, a situation in which the project would not otherwise constitute a PE and lasts less than the prescribed time is not a PE under any of the three forms of the rule; a project that is otherwise a PE and last more than the prescribed time always is a PE. However, the in between cases lead to differential conclusions:

	OECD	UN	US
No PE, < x months	No	No	No
No PE, > x months	No	Yes	Yes
PE, < x months	No	Yes	No
PE, > x months	Yes	Yes	Yes

(5) A few treaties go beyond construction and installation to the use of equipment. A PE is considered to exist if substantial equipment is being used or installed for more than 3 or perhaps 6 months within any 12-month period in the other state by, for or under contract with the enterprise (Kuwait, New Zealand). The Australia treaty also has such a rule but excludes the use of equipment in connection with a building site or construction, installation or assembly project.

d) Intermediaries

(1) The determination of PE status where a taxpayer participates in a business through an intermediate entity or arrangement should depend on the legal character of that arrangement.

(2) Partnerships. An inactive or limited partner in a foreign partnership that carries on business in Canada through a PE is considered so to carry on business.[90] If the governing

[90] See, for example, *Hollinger v. MNR*, 73 DTC 5003 (FCTD), affirmed 74 DTC 6604 (FCA), *No. 630 v. MNR,* 59 DTC 300 (TAB).

partnership law creates an agency relationship,[91] this conclusion seems difficult to escape. However, not everything called "partnership" necessarily has that characteristic.

(3) Trusts. Under Canadian conceptions, one would not expect that a PE would "flow through" a trust arrangement. The Australian treaty, however, provides that where a Canadian resident is beneficially entitled, whether directly or through one or more interposed trusts, to a share of the business profits of an enterprise carried on in Australia by the trustee of a trust other than a trust which is treated as a company for tax purposes, and the trustee would have a PE in Australia under Article 5, the enterprise carried on by the trustee shall be deemed to be a business carried on in Australia by that resident through a permanent establishment situated in Australia and that share of business profits shall be attributable to that permanent establishment. The rule does not apply in the reverse direction, presumably because Canada is satisfied with its system for taxing business income of resident trusts with non-resident beneficiaries (including Part XII.2).

e) Dependent agent PE, subsidiaries

(1) The rule is so called because it is an exception to the independent agent exception to PE status. In most Canadian treaties, following the OECD Model, where a person acting on behalf of an enterprise has, and habitually exercises in the host state, an authority to conclude contracts on behalf of the enterprise, the enterprise is considered to have a PE in that state. In a very few treaties the problematic expression, "in the name of" is replaced by "on behalf of." In a few treaties (Kuwait, Australia, New Zealand) the rule is further extended: a dependent agent PE also exists where the person is engaged in manufacturing or processing on behalf of the enterprise.[92] Another extension is the addition in about 10 treaties of the UN Model language to the effect that the agent who has no such authority, but habitually

[91] Under the statutes in the Canadian provinces, the partner is an agent for the other partners and the firm. See, e.g., *Partnerships Act*, RSO 1990, c. P-5, s. 6. In Québec, each partner is a mandatary of the partnership: Code civil, Article 2219. These rules apply to limited partnerships as well. A similar rule seems generally to apply in the United States. The partner is an agent of the partnership: *Delaware Revised Uniform Partnership Act,* Title 6, subtitle 2, ch. 15, §15-301(1).

[92] The New Zealand treaty includes yet additional categories of dependent agent.

maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise constitutes a PE (India, Philippines, Zambia).

(2) The dependent agent provision, even in its "regular" form, has engendered a great deal of debate and concern, particularly among business groups making representations to the OECD regarding the Commentary. In Canada, there seems very little experience in practice with the provision. This may be, in part, due to the limited use of certain tax-planning structures here, such as commissionaire arrangements.[93]

(3) Canadian treaties adopt the OECD and UN Model provision stating that the fact that a company is a parent or a subsidiary of a company which is a resident of the other contracting state, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other. The "of itself" is important. A problem that has often troubled Canadian practitioners (less so, it seems, their clients) is whether a Canadian subsidiary of a foreign parent might constitute a dependent agent PE, or even perhaps a PE *tout court* as a fixed place of business of the parent. The Italian *Philip Morris*[94] case heightened the concern, although the "group PE" concept has not, to my knowledge, been followed elsewhere and modifications to the OECD Commentary to Article 5 seem designed to prevent that from occurring (para. 41.1, 42).

f) Non-PEs

(1) As noted, Canada generally adopts Article 5(6), which provides that an enterprise shall not be deemed to have a PE in a state merely because it carries on business there through a broker, general commission agent or any other

[93] The conventional wisdom seems to have been that the avoidance of PE status through the "commissionaire" relies on the notion of undisclosed agency ("in the name of") and that this is only possible in civil law countries. For an example, see the Interhome litigation in France: *Ministre de l'Economie, des Finances et de l'Industrie c. Société Interhome AG*, Conseil d'Etat, no. 224407, June 20, 2003. The OECD view that "in the name of" should not be taken literally (para. 32 of the Commentary) would, if accepted in Canadian law, narrow the distinction. My civil law knowledge is a bit rusty, but I believe an undisclosed mandate is possible in Québec (Code civil, Article 2160, 2165).

[94] Corte suprema di cassazione, Sent. n. 3368, March 7, 2002.

agent of an independent status acting in the ordinary course of its business. A number of our treaties expand the exception to include another "merely:" merely because it maintains in that State a stock of goods with an agent of an independent status from which deliveries are made by that agent (Egypt, Algeria, Thailand). The OECD Commentary (para. 38) suggests that "independent" in this provision is a more demanding criterion than the Canadian sense of "related" or even "dealing at arm's length." A commercial requirement for detailed instructions or comprehensive control undermines independence. A number of Canadian treaties provide some specificity on the meaning of independence following the UN Model, denying that status where the agent acts exclusively or almost exclusively for the particular enterprise or others within a controlled group (Argentina, Chile, Jamaica, Kuwait, Thailand).

(2) Canada also generally adopts in one form or another the "notwithstanding" provision in Article 5(4) of the OECD Model. It excludes from PE the use of facilities or maintenance of a stock of goods solely for storage, display or delivery, and the maintenance of a stock of goods solely for processing by another enterprise (a key to the contract manufacturer planning in some cases). The UN Model does not include "delivery" in the list, with the intention that warehousing of goods for the purpose of delivery, for example, should constitute a PE (although the Commentary does concede that both the drafting and its consequences are controversial).[95] The UN truncated version is found in some ten of Canada's treaties (Algeria, Egypt, Vietnam). The usual exception extends to the maintenance of a fixed place of business solely for purchasing, collecting information or "any other activity of a preparatory or auxiliary character." That expression, of course, is open to some interpretation. There is a final collective category for a combination of the other activities and this final category contains a requirement that the overall activity of the fixed place of business resulting from the combination is preparatory or auxiliary. It appears one can draw several interpretative conclusions:

(a) the other listed activities do not have to meet an additional test of being preparatory or auxiliary (in a sense, they are assumed to be);

[95] UN Commentary to Article 5, para. 18.

(b) any combination of activities each of which is expressly excluded from the classification as a PE can be a PE if the combination fails the preparatory or auxiliary test;

(c) these exclusions only apply if we have captured the entire activity – i.e., they do not carve something out of an otherwise potential PE.

3. Attribution of profits: Article 7

a) Under OECD Model Article 7(1), a resident of one state that carries on business in the other through a PE situated therein may be taxed on the profits of the enterprise but only so much of them as is attributable to that PE. Article 7(2) provides modest guidance for making this determination by positing an assumption that the enterprise earns the profits it would be expected to make "if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE." As well, under Article 7(3), expenses incurred for the purposes of the PE are to be allowed as deductions, wherever they are incurred.

b) Although practitioners have generally considered that the "branch profits" determined under Article 7 should probably be close to the profits a subsidiary would have made, it has always been understood that there are some fundamental legal and economic distinctions between a hypothetical separate enterprise, which is actually part of a single entity, and a real group of companies. Until relatively recently, there was little talk, at least in Canada, of trying to apply rigorously the transfer pricing regime developed in connection with Article 9 to PEs. In tax audits, it was generally possible to reach a rough estimation of branch profits based on branch accounts and an implicit "profit split." The contentious issues were often related to "notional deductions," payments a subsidiary might reasonably make to a parent, and informational problems.

c) There are a few Canadian cases that both illustrate some of the issues and establish the current legal framework for the application of Article 7.

(1) In *Utah Mines*,[96] a US taxpayer tried to invoke the equivalent to Article 7(3) under the old US treaty in order to deduct royalties disallowed under former s. 18(1)(m) in

[96] *Utah Mines Ltd. v. The Queen,* 92 DTC 6194 (FCA), affirming 91 DTC 5245 (FCTD).

computing profits of its Canadian PE. The disallowance provision was added well after the treaty was implemented. The courts held that the "expenses" referred to in Article 7 were only the ones Canada chooses to allow as deductions in general; i.e., (although this language was not used), the provision effectively prevents discrimination against the branch rather than providing it with an advantage. The issue was of considerable financial importance and deals were cut with other corporations making the same claim, as can be seen in an earlier Remission Order granted to Chevron in consideration for abandoning such a claim.[97] While the litigation progressed, the ITCIA was enacted, including s. 4(b) that declares the law always to have been what the FCA later decided it was.[98]

(2) *Cudd Pressure* is, in a way, a further step along the same path. Here, the "expense" the taxpayer sought to deduct was not one disallowed by a statutory provision but rather one of which tax administrations have traditionally denied the existence altogether. The CRA position in this case, and on many audits, was that "notional expenses" are not deductible. These are amounts that a separate enterprise might well have paid to another enterprise dealing on arm's length terms, but that the PE in fact did not "pay" to anyone, because it is part of the same legal entity as the "recipient." The FCA decision is far from definitive on the conceptual point. One of the concurring justices (McDonald JA) rejected the deduction of this notional rent but left open the possibility that it might be allowed in an appropriate case. Robertson JA escaped the issue: "I do not find it necessary to deal with the issue of whether notional expenses are deductible as a matter of law in light of the factual findings…" (para. 3) and Strayer JA agreed with Robertson JA.

(3) Another way to look at the *Cudd Pressure* or notional expense problem is to consider not whether a distinct and separate enterprise would have incurred such an expense but rather, following the text of Article 7, how much it would have been expected to earn. If the computation of the

[97] Order-in-Council PC 1984-1758, dated May 24, 1984.

[98] A further ex post facto justification is found in para. 26 of the proposed Commentary to Article 7. It observes, curiously in my view, that Article 7(3) "only determines which expenses should be attributed to the PE" and not whether those expenses, once attributed, are deductible "since the conditions for the deductibility of expenses are a matter to be determined by domestic law."

business profits attributable to the PE ignores the elements that give rise to notional expense claims (such as the use of intangibles), then it seems the profits attributable are overstated. This seems to be the driving force behind a 180 degree reversal in the OECD and, presumably the eventual Canadian, position.

d) Until a flurry of activity over the past few years, The OECD Commentary to Article 7 generally adopted a rather loose attempt to determine the separate entity profit of the PE, and did not support the deduction of notional expenditures. However, a major project was undertaken by the OECD to pin down the allocation of profits to a PE with a level of detail to rival or even surpass the transfer pricing guidelines.

(1) It is important to grasp the institutional context. The attribution of profits project was undertaken by and, until its near completion remained within the province of, Working Party 6, the group that deals with transfer pricing. Working Party 1, whose remit is the Model Convention, kept or was kept (I make no judgment) out of it. This had a critical and predictable effect. The initial draft proposals and, although attenuated, the final product, is an attempt to import the transfer pricing guidelines into Article 7. Since there are no transactions to price within a single legal entity, a mapping is required – what was initially called the "working hypothesis" and eventually became the "authorized OECD approach."

(2) The details of the authorized OECD approach go well beyond the possible scope of these remarks. In general, it is necessary to identify within the single legal entity notional "dealings" to equate to transactions, and then price them. The PE must be allocated risks and functions as if it were a separate entity. Tangible and intangible property must somehow become associated with the PE, and the character of that association (e.g., lease versus ownership) ascertained or constructed. "Free capital," the equity of the PE, must be determined.

(3) The project has resulted in a series of reports, some dealing with financial industries in which branch trading is of particular significance and a statement of base principles applicable to all enterprises.[99] These have been commented

[99] Parts I (General Considerations), II (Banks) and III (Global Trading) were released in revised form in December 2006, Part IV (Insurance), in August 1007. See

upon in many fora and at great length.[100] I do not propose to review the substance of the approach at all. It is worth considering how Canada may apply the new rules.

(4) A problem raised during the course of the project – exacerbated by the conspicuous absence of WP1 – was the legal impact of such a substantial change to the interpretation and proposed application of Article 7. The drafters themselves had noted some issues, such as a difference of views among OECD member states as to the meaning of the phrase "so much of them" in Article 7(1): did this limit the attribution of profits to the profits of the enterprise as a whole? More generally, many expressed concern that a change of this magnitude could not be viewed as "commentary" on anything. This could put into question the status of the new approach (could it be applied under existing treaties?) and, indeed, the status of the Commentary in general. For example, what does one make of the reversal of position on (some) notional expenses? How can a "commentary" be so altered?

(5) In the result, revised commentary on Article 7 was released on April 10, 2007. No revised text of Article 7 has yet been proposed, although this may still be anticipated. The purpose of the new commentary is to reflect the conclusions of the attribution of profits project "in order to provide maximum certainty on how profits should be attributed to permanent establishments."

(6) There are several important practical issues arising out of the new approach.

> (a) The Report concludes that, while there are two views on the matter, Article 7(1) should be regarded as subsidiary to Article 7(2) so that PE profits may exceed the profits of the enterprise as a whole. This is adopted in the revised Commentary (para. 11). There could be a serious legal question in some countries whether this conclusion can be enforced

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http://www.oecd.org/dataoecd/55/14/37861293.pdf and http://www.oecd.org/dataoecd/46/6/39163765.pdf

[100] Not to provide an extensive bibliography, reference may be made to the IFA general and national reports in "The Attribution of Profits to Permanent Establishments," *Cahiers de droit fiscal international,* vol. 91b (Rotterdam: International Fiscal Association, 2006); "Policy Forum: Attribution of Profits to a Permanent Establishment," (2005), vol. 53, no. 2 *Canadian Tax Journal*, 396-416 (papers by Scott Wilkie, Robert Couzin and François Vincent).

without appropriate language in the treaty.

(b) There is an admission (para. 7) that the conclusions of the Report are inconsistent with the earlier Commentary. This raises the concern about the status of this Commentary as "commentary" and could put other elements of the Commentary into question.

(c) The business community is very concerned about the potential for increased double taxation. The PE state may determine local business profits applying a rather broad range of potentially "authorized" methodologies, and the residence state is expected to apply Article 23 to eliminate double taxation (proposed Commentary, para. 12). There is some scepticism how this will work in practice.

(d) Documentation requirements are a further concern. The proposed Commentary (para. 15) suggests that branch accounts will be the normal way of determining the PE profit, but whether tax administrations, including Canada, will agree remains to be seen. Documenting the "dealings" may be problematic. Documenting anything at all is problematic if the enterprise does not know it has a PE.

(e) The relationship between some aspects of the new approach and domestic law is tricky. Extracting assets from a PE may lead to a profit under the authorized OECD approach even though there is no legal alienation. This is partly reflected in aspects of Canadian law (ss. 10(12), 13(9), 14(14)). There is, evidently a timing concern if the residence and PE states take a different approach to taxation of such internal events.

(f) The new approach reverses the historical rejection of notional expenses at least in some cases. Goods transferred from the enterprise to the PE for resale should normally be considered to have been acquired at a price that leaves a profit with the enterprise ex-PE (para. 29). Internal or notional royalties for the use of intangibles are recognized (Report, para. 235 ff – cf. Commentary, ginger comments at para. 30). A line is drawn regarding

internal "interest" expense which, apart from the financial sector, continues to be rejected although, of course, the PE might be in a position to deduct a portion of the interest expense of the enterprise (Commentary, para. 37 – 39). In that regard, the panoply of rules relating to the determination of "free capital" must be applied to figure out what portion of that interest expense is properly attributable to the PE.

(7) Last June, the US Treasury indicated[101] that while it supports the authorized OECD approach it will not apply it under most existing US treaties because the "reasonable allocation" of expenses in Article 7(3) is not considered consistent with that new approach. Some recent treaties, however (or therefore), contain specific language which is considered to support the importation of the authorized OECD approach (UK, Japan). The confusing conclusion is that the new approach will either not be applied at all, will be applied in part or, in those few cases, fully applied. The US also rejected what it called the "symmetry" rule in para. 44 of the revised Commentary – the requirement for Article 23 relief – specifically with respect to the allocation of interest expense.

(8) What about Canada? I am not aware of any official position on the application of the authorized OECD approach under existing treaties. Canada is certainly invested in the project; Canadian representatives were heavily involved. However, I suspect that, like the US, Canada will feel uncomfortable attempting to apply the whole of the new approach with no additional treaty language or protocol. The prospect of only one of the two parties to a particular treaty accepting the revised Commentary is, of course, troubling. The deduction of notional royalties and other expenses for intangibles or certain services, beyond the reimbursement of actual expenses, is expressly denied under the UN Model and this is adopted in a significant number of Canadian treaties (Algeria, India, Mexico). Paragraph 9 of the 2007 Exchange of Notes (B) with the US does provide some guidance regarding the allocation of profits to a PE similar to other US exchanges of notes. This may suggest that the parties do intend to apply the authorized OECD approach;

[101] As reported in the BNA Daily Tax Report, no. 110, June 8, 2007.

however, the text does not refer to the OECD Article 7 work at all, but rather to the Transfer Pricing Guidelines and with some very generic supporting language. It remains to be seen whether, if challenged, this will have the effect of incorporating the OECD work in full (or, indeed, whether the CRA will agree that it does).

e) There has been a conceptual debate between tax administrations and the OECD on one side and some business and professional representative on the other as to whether there should ever be a "second" attribution to a dependent agent PE. Para. 22 of the revised Commentary explains the theory: the agent is first fairly remunerated, applying Article 9, for what it does and then the deemed PE is attributed a profit as well. Some argue that if transfer pricing rules are fully applied to the dependent agent, there would be no additional profit, and that this is a better approach. I have conceptual sympathy with the OECD analysis – compare, after all, the case of an independent agent. The practicalities are, however, difficult.

f) The OECD Model and the bulk of Canada's treaties reject the "force of attraction" principle, the notion that once an enterprise carries on business in a state through a PE, business profits other than those attributable to that PE should be taxable (proposed Commentary, para. 10). Whatever may be the theoretical merits of this position, it does not sit well with many developing countries. Thus, the UN Model includes a limited force of attraction. Business profits are taxable in the host state if attributable to a PE <u>or</u> to (b) sales in of goods or merchandise of the same or similar kind as those sold through that PE, or other business activities carried on in the host state of the same or similar kind as those effected through the PE. Applying such a rule, and highlighting the difference between the UN and OECD Models, an Indian court concluded that services rendered by a Canadian corporation in India were held taxable there because the corporation also maintained a PE.[102] Similar language is found in a number of Canadian treaties (Argentina, Jordan, Pakistan) and occasionally with a tweak to extend to similar services (Kenya). There is also a more restricted version, an anti-avoidance rule (recognized, or at least referred to in the OECD Commentary), that expands Article 7(1) to profits from the alienation of property similar to that alienated by the PE but not if the company establishes that such alienation has been carried out for a purpose other than that of obtaining a treaty benefit (Mexico).

[102] *SNC Lavalin/Acres Inc. vs. ACIT* (March 1, 2007), Delhi Income Tax Appellate Tribunal, published by Tax Analysts, Doc 2007-19105.

C. Real property – Article 6

1. General. Different rules apply to real property, reflecting an almost visceral nexus between such property and the jurisdiction in which it is situated. A permanent establishment is not necessary. Canada retains unrestricted taxing powers over income derived by a resident of the other state from immovable property situated here. There is no restriction on resident state taxation either, this being left to a matter of relief from double taxation under domestic rules and Article 23 which may, of course, provide for exemption.

2. Definition. Under the standard OECD Model language, "immovable property" is afforded the meaning it has under the law of the situs state and expressly includes (whether that law does so or not) "property accessory to immovable property," agricultural and forestry appurtenances (livestock and equipment), usufruct, and rights to variable or fixed payments as consideration for the working of or the right to work natural resources.

a) Canada generally adopts a version of this definition and recall that s. 5 of the ICTIA provides a further potential extension in the natural resource arena, in particular to any right to explore for or exploit mineral deposits and sources in Canada and other natural resources in Canada and any right to an amount computed by reference to the production, including profit, from, or to the value of production from, mineral deposits and sources in Canada and other natural resources in Canada.

b) The treaty definition refers to the law of the contracting state. Recall as well that s. 3 of the ITCIA provides that such a reference is to be taken as a reference to the Act "except to the extent that the context otherwise requires." Since the Act does not define immovable property, I should think that here the primary reference is to provincial private law. Since ss. 248(4) and (4.1) open with "in this Act," whether the ICTIA causes these rules to apply to the treaties or not depends on whether one thinks the provisions provide a "meaning" of "immovable property" for purposes of the Act. Generally, I find the interaction of private law of property, the treaty definition, the Act and the ICTIA somewhat confusing although in most cases, we will know "immovable property" when we see it.

c) Sometimes, the definition in Article 6 is stated to apply for purposes of the convention; in other cases, other references to immovable property expressly refer back to the Article 6 definition. There are, however, a few undefined references.

d) The definition does not generally refer to indebtedness secured by immovable property. The Commentary optimistically states that this is because "this question is settled by Article 11" (para. 2). This seems to mean that interest is dealt with in Article 11 and it is expressly observed in that connection that the interest, whether or not paid on a mortgage (and whether or not assimilated to income from immovable property by the particular state), is treated as "income from movable capital" and its taxation regulated by Article 11. Of course, one can realize income in relation to indebtedness other than by receiving interest (such as by alienating the indebtedness). In common law provinces, the interest of a mortgagee is realty, and in Québec the hypothec is a "real right" in the property[103] which is why s. 248(4) and 248(4.1) say that neither is an interest in real property or an immovable right for purposes of the Act. Therefore, income from trading in mortgages and hypothecs is within Article 6 or Article 13(1) depending on how one reads s. 3 of the ITCIA in connection with ss. 248(4) and (4.1).

e) Only a handful of treaties (notably the United States, also the Baltics and a few others) include "option or similar right in respect thereof" in the definition. Paragraph (l) of the definition of "taxable Canadian property" in s. 248(1) is careful to add "an interest in or option in respect of a property described in any of paragraphs (a) to (k), whether or not that property exists" so it is, perhaps, surprising not to find such a reference in other recent treaties. The reference to an "interest" is probably not absolutely necessary since, under private law, most (although not all) rights one would describe as interests in immovable property are themselves immovable property. The categorization of an option is more complex, although it seems that an option to purchase that provides the optionee, forthwith upon the granting of the option, a right to compel a conveyance of land upon the occurrence of certain events solely within the optionee's control is an interest in the land. In more complex contractual arrangements, this may not be so clear.[104]

f) The OECD Model excludes from the definition of immovable property "ships, boats and aircraft" and the Canadian practice is to repeat that exclusion but usually without the word "boats." The OECD exclusion is, at least on the Canadian side, for greater certainty, since these objects are not immovable property anyway. The explanation for it likely lies in their treatment as such under

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[103] Code civil, Article 2660.

[104] *Irving Industries (Irving Wire Products Division) Ltd. v. Canadian Long Island Petroleums Ltd.*, [1975] 2 SCR 715.

some other legal systems (apparently, for example, in Russia).

3. "Income derived from immovable property." This expression includes income from agriculture and forestry – a rather liberal use of the word "including" – and also income derived "from the direct use, letting or use in any other form of immovable property." The OECD Model and most Canadian treaties also include income from the immovable property of an enterprise (or, in treaties that still contain Article 14, the performance of independent personal services), to displace any possible presumption that such income could instead fall under Article 7 (or 14). Income from immovable property remains income from immovable property even if the immovable is used in a business. Canada recorded a reservation to Article 6 stating that it wished to be able to include a reference to income from the alienation of immovable property and, indeed, it has done so in about half the treaties. Given the inevitable reservation of taxing rights over gains from the alienation of immovable property in Article 13, the importance of this addition may be its connection not to Article 13 but to Article 7. If Article 13 applies only to "capital gains" (see V.B.6 below), this extension of Article 6 would be important to permit Canada to tax trading gains on real property in the absence of a PE.

D. Shipping and transportation – Article 8

1. General. This is too specialized an area to treat here. But note Canada's geography dictates a reservation regarding "inland waterways," generally replaced by a reference to transporting goods or passengers between places in a contracting state (i.e., whether or not "inland"). As well, probably about half the Canadian treaties expand the scope of Article 8 by defining "operation of ships or aircraft" to include charters, container rentals and alienation, where incidental to operation.

2. "Place of effective management." This is the test adopted in Article 8 of the OECD Model, in preference to the more usual requirement of residence. Only about a dozen Canadian treaties follow that lead. The rest refer simply to an enterprise of a contracting state. Curiously, international shipping corporations are afforded different treatment under the Act. Subsection 250(6) provides a unique corporate residence rule that looks to place of incorporation. I have never had occasion to study the interaction of the two rules, but presumably a corporation treated as a non-resident of Canada because of its place of incorporation but "effectively managed" in Canada could be a treaty resident of the other state if the "residence" rather than "place of effective management" version of Article 8 is adopted.

E. Management fees

1. If an item of income constitutes "profits of an enterprise" within the

scope of Article 7, and the income is not expressly dealt with in some other Article, then Article 7 *prima facie* applies. This is why "management fees" otherwise subjected to non-resident withholding tax under s. 212(1)(a) are normally exempt from tax if earned in the ordinary course of business by a treaty resident with no PE in Canada.

2. However, a few treaties with less-developed countries expressly permit a limited, fixed rate tax by the source state on the payment of management fees (see also, regarding India, V.A.4.c)(2)(d)).

a) The scope varies. It may be as simple as a two-word reference to "technical assistance" (Argentina) or rely on a full-fledged definition referring to industrial or commercial advice, or management, technical or administrative services (Barbados, Kenya). Additional descriptions such as "consultancy" services may be added (Zimbabwe). Sometimes professional services are included (in Barbados, they are carved out but also taxable, without the rate limitation).

b) The rate is usually 10% or 15% but can be lower (5% in Mongolia; 7.5% in Vietnam) or higher (20% in Tanzania).

F. Offshore Activities

1. Canada, Denmark, Ireland, Norway and the UK recorded reservations to Article 5 indicating that they may insert a special Article related to offshore exploration.

2. Indeed, there is such an Article in our treaties with the other reserving countries, and also in some others (Lithuania, Netherlands). The general idea is to override (or supplement) Articles 5 and 7 where defined offshore resource activities are carried on. The defined activities are deemed to be the carrying on of business through a PE situated in the relevant state. There is a time threshold (30 days in a period of 12 months). Naturally, there are variations among the particulars. These special treaty Articles are said to apply "notwithstanding any other provision of this Convention."

3. The Federal Court of Appeal considered that, in the particular circumstances of the case, owning a chartered vessel met the "activity" threshold in such a treaty article.[105] This finding depended in part on the precise division of rights and responsibilities under the contract but also reflected a generous (which the court considered a plain meaning) reading of the word "activity."

[105] In this case, the UK treaty Article 27A: *Gulfmark Offshore N.S. Limited v The Queen*, 2007 FCA 302.

4. The practice of inserting an Article of this sort seems to depend on the particular negotiating partner and it does not appear to be a consistent, or at least persistent, Canadian demand in treaty negotiations.

G. Transfer pricing: Article 9, Article 7 and s. 247

1. Article 9 of the OECD and UN Models contains two basic rules. Paragraph 1 provides authority for a state to include in the profits of an enterprise amounts that would have accrued to it if the conditions made or imposed in its commercial or financial relations with an associated enterprise had not differed from the conditions that would be made between independent enterprises. Paragraph 2 deals with a balancing adjustment in the other state. It is on its terms mandatory: the other state shall make an appropriate adjustment if it has taxed the profits so included in the taxable profits by the first state. However, it only has to do this if the first state has made the "right" adjustment, the adjustment that is justified by the failure of the enterprises to act like independent enterprises. Therefore, in real life, the second state may fail to make that second adjustment because it disagrees with the first adjustment made by the first state. In this case, the competent authorities may consult with each other (see XIII.A below).

2. The Canadian approach to Article 9 is generally consistent with these Models but there are important variations.

a) Many conventions add something about time limits, often stating that no initial adjustment under paragraph 1 shall be made after domestic time limits expire and, in any case, after some specified delay (generally 5 or 6 years). This provides some protection to enterprises against an initial adjustment that cannot be offset under paragraph 2.

b) Often, following the UN Model, Canadian conventions carve out from the balancing adjustment cases of fraud or wilful default. This is a different and more stringent test from that for imposing transfer pricing penalties under s. 247.

c) Reflecting concerns expressed in particular by developing countries about the potential cost of being required to make correlative adjustments,[106] about a dozen Canadian treaties (and not all with developing economies) do not include such a provision (Austria, Brazil, China, France, Germany, Norway, Pakistan). Indonesia nonetheless includes a time limit for the adjustment.

3. To bring some order to international transfer pricing practice, and to

[106] UN Commentary to Article 9, para. 8.

minimize the incidence of double taxation, both tax administrations and multinational enterprises seek harmonization or cooperation. The administrators wish to protect national tax revenues against potential manipulation by companies of the profits subject to tax under Articles 5 – 8. They also desire a consensual system to avoid aggressive “grabs” by other tax administrations. Enterprises are concerned about unrelieved double taxation, as well as compliance burden. The 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Guidelines”) expand upon the essential principles of the 1979 (much shorter) version. They are premised on the arm’s length principle. Its main competitor is formulary apportionment. The OECD Guidelines continue to privilege the transactional approach. The other key element of the OECD Guidelines is the explanation of certain basic methodologies – the comparable uncontrolled price method (CUP), resale price method and cost plus method – and the provision of guidance and examples for their application. The “transactional net margin” method was an attempt to appease the US by semi-accepting its then new comparable profits methodology (rejected by Canada). Profit split gets some minor recognition but, in practice, has become a very important alternative. These methods will undoubtedly be elevated in importance as a result of a current OECD project in this area.

4. Like the OECD Commentary, the OECD Guidelines have some claim to authority in Canada. The enactment of s. 247 was openly premised on the OECD work.[107] However, the acceptance of the OECD Guidelines in Information Circular IC87-2R, “International Transfer Pricing, ” September 27, 1999 seems nuanced: “This Circular sets out the Department’s views on transfer pricing and also provides its position with respect to the application of the” OECD Guidelines (para. 3). In fact, all the specific references to the OECD Guidelines in the Circular are instances of applying them; the only example I see where any disagreement is expressed is the Canadian preference for profit split over TNNM, as opposed to the official OECD stance of neutrality between the two (para. 60). The FCA noted in *SmithKline Beecham* that both the taxpayer and the CRA relied on the predecessor 1979 version of the OECD Guidelines, that the 1995 version is broadly similar, that the Information Circular also refers to the OECD Guidelines, and that “[i]t appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2)” (this being a pre-s. 247 case).[108] The Court did not challenge that approach and, indeed, itself applied the OECD Guidelines. The OECD Guidelines were also referenced in a non-tax case that considered the appropriate methodology

[107] February 18, 1997 Federal Budget, Annex 6 to the Budget Plan, Business Tax Measures, Review of Transfer Pricing Provisions.

[108] *SmithKline Beecham Animal Health Inc. v. The Queen*, 2002 FCA 229, para. 6 – 8.

of transfer pricing under the Act, although it is not entirely clear to me whether the Court actually endorsed their application.[109]

5. Section 247 applies more broadly than Article 9, since it also concerns circumstances where the taxpayer or the non-resident person referred to in subsection (2) is resident in a non-treaty country. I think – although the view is not universally accepted – it could also apply where treaties are not relevant at all, for example, to payments made between foreign affiliates. Section 247 includes documentation requirements and penalties, matters not expressly dealt with in Article 9 (but briefly alluded to in the OECD Guidelines). Although, as noted, s. 247 is generally meant to incorporate a transfer pricing regime much like Article 9, or at least like the OECD Guidelines' gloss on Article 9, note a few important distinctions.

a) Subsection 247(2) deals with the "first adjustment" in Article 9. There is no reference to a balancing adjustment resulting from, or even taking into account, any adjustment made by another taxing jurisdiction. Indeed, if there is a foreign adjustment, even if it is manifestly correct and would lead to a reduction in income of the Canadian participant, s. 247(10) prevents an offsetting adjustment under subsection (2) by the taxpayer unless the Minister considers it appropriate. This puts the matter squarely back into the dispute resolution system established by the treaties. Actually, it is not obvious that Article 9(1) itself is required in a treaty. Its real function seems to be to support Article 9(2) and, ultimately, the process of consultation and dispute resolution.

b) A corollary of the system of reciprocal adjustment is a time limitation. Section 247 contains no particular rules regarding limitation periods for reassessment. Most transfer pricing cases involve a reassessment "made as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length" within the meaning of s. 152(4)(b)(iii), in which case the normal reassessment period is extended by 3 years. Almost all Canadian treaties provide that a contracting state shall not make an adjustment under Article 9(1) after a fixed number (generally 5 or 6) of years from the end of the year in which the profits that would be subject to such change would have accrued to that enterprise. The 5 or 6 year period limits the flexibility otherwise available to the CRA.

c) The approach to time limits in the US treaty is a bit different. Notice of the first adjustment is to be given within 6 years and, if it is, and the other competent authority agrees with it, then relief will

[109] *Ford Motor Co. of Canada, Ltd. v. Ontario Municipal Employees Retirement Board*, 2004 DTC 6224 (Ont. Superior Court of Justice).

be given notwithstanding any time or procedural limitations. This last point, that correlative relief will be provided notwithstanding domestic limitation periods, does not appear in other treaties. Arguably, it should not be necessary since the treaty demands relief and has priority over the Act.

d) An important point to note is that the US Article IX unusually refers to a person "in" rather than "resident in" the other contracting state. This is both intentional and significant. As noted in the Technical Explanation to this treaty: "The term 'person' encompasses a company resident in a third State with, for example, a permanent establishment in a Contracting State."

H. Independent personal services: Article 14

1. General. The difference between the "fixed base" rule in Article 14 and the permanent establishment in Article 7 was never very clear. The FCA declared it non-existent.[110] The origin of the provision was a civil law rule that liberal professions are not commercial enterprises.

2. Elimination. In 2005, the OECD Model eliminated Article 14 and added a definition of "business" to include professional services, so that such profits may be treated under Article 7. Canada now follows this approach but, given the lead time, only in a few recent treaties (Finland, Mexico, US 2007 protocol).

3. Application. Article 14 refers to "income derived by a resident…in respect of professional services." Since a professional partnership may not be a "resident, " obtaining the benefit of the activity threshold in the partnership context depends on interpreting Article 14 as referring to income of ("derived by") the partner. The text provides a broad link to the professional services and does not, luckily, say "rendered by the resident." Life will be easier under Article 7.

I. Branch Tax under Part XIV

1. Article 2 – scope of taxes. Recall that the treaties apply to branch tax imposed under Part XIV either because Article 2 expressly refers to it, includes taxes "imposed under the Act" or includes "income taxes" (see III.C.1).

2. Canadian Article 10(6). The OECD Model Article 10(5) prohibits a tax on the undistributed profits of a company resident in the other state. Canada therefore reserved its position in order to preserve its right to impose branch tax. In our treaties, there is almost always a specific

[110] *The Queen v. Dudney*, 2000 DTC 6169.

provision – generally, although not always, in Article 10 (it may be tucked away elsewhere) intended to preserve branch taxation.

a) Generally, Article 10(6) provides that nothing in the convention prevents a state (or, sometimes, only Canada) from imposing an extra tax on the earnings attributable to a PE. In almost all cases, this is then expanded to include, as well, income from trading in immovables, without a PE. There could yet be examples where Canada's jurisdiction is not based on the existence of PE, or on alienation of immovables, and it seems questionable whether branch tax may then be applied. An example that has been brought to my attention[111] is taxation premised on Article 17 (loan-out companies for athletes or entertainers).

b) The branch tax treaty provisions control the rate of tax, set by s. 219 at 25%. Either the provisions specify a rate, in which case it equals the (lowest) dividend rate, or incorporate that same rate by reference. Section 219.2 of the Act ensures that if the treaty fails to adopt the direct dividend rate for the branch tax, the Act does. I am not aware of any treaties that still require this provision.

c) In addition, the branch tax treaty provisions generally provide a somewhat rudimentary definition of "earnings," the element on which the additional tax may be charged, namely, after-tax profits and gains attributable to the PE for the year and previous years. A minority of treaties (Kuwait, United States, Portugal, Sweden, Switzerland) establish a de minimis exemption of $500,000 on a group basis.

d) There are many variations in the treaty provisions, and some drafting errors. None are as detailed as s. 219. The "earnings" base is usually broader than that in the Act so that it actually provides no (current) protection. For example, only some treaties provide for an investment allowance (China, Belgium, Croatia) and

e) Section 219 was amended to refer to corporations not resident in Canada, rather than corporations other than Canadian corporations, but many treaties, even if entered into after the amendment, still use the old terminology (Tanzania, Algeria, China, Brazil).

f) The treaty provisions do not affect s. 219.1, the tax on corporate emigration. Presumably, it is felt that there is no need to preserve the jurisdiction to impose that tax since it is levied on a Canadian resident corporation.

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[111] By Steve Ruby.

g) There is an important restriction on the imposition of Canadian branch tax in some treaties, although an ever-diminishing number. An older version of Article 10(6) sometimes provides that the profits that may be subjected to the tax do not include profits attributable to a permanent establishment earned in a year during which the business of the company was not carried on principally in that state. This "principal business" rule would enable a non-resident corporation to escape Canadian Part XIV tax by ensuring that businesses carried on outside Canada outweigh (by some unspecified measure)[112] the Canadian business in a given year. This exclusion has been removed from a number of treaties in recent protocols (Austria, Switzerland) but still remains in a few others (Bangladesh, Italy, Malaysia, Sri Lanka, Tunisia).

J. Property income as business profits

1. Overlap. Under the Act, income from property may pass into the commercial sphere and be regarded as income from a business. An example is interest earned by a bank. Provisions such as s. 125 and the definition of FAPI grapple with the overlapping concepts. The same issue arises in treaties. Items of capital income may also constitute the profit of an enterprise within the scope of Article 7.

2. Dividends, interest and royalties. The particular rules in Articles 10 – 12 and their relationship with the corresponding provisions of s. 212 of the Act are considered below (see V.A below).

3. Other income.

a) Article 21 of the OECD and UN Models provide a potential expansion to the taxation of business-related profits beyond what is expressly contemplated in Article 7. (It also has other functions. See VII below).

b) Paragraph 1 establishes exclusive jurisdiction to the residence state for items of income, wherever arising, not dealt with in the other Articles of the convention. This could be because of the *type* of the income or its *source*. Consider, for example (a real example), a payment of interest with respect to a Canadian dollar indebtedness associated with a UK PE of a Canadian corporation to an unrelated UK lender. The interest is taxable under s. 212(1)(b); the exemption in s. 212(1)(b)(iii)(E) does not apply because of the currency (or, one could make it a GBP loan from a related party). Article 11 of the treaty does not prevent taxation

[112] The displeasure with this exemption from branch tax is apparent in the CRA's nuanced approach to defining "principally." See RID 9203006, April 2, 1992, concerning the Swiss treaty.

because it applies only to interest arising in one state and paid to a resident of the other. Paradoxically, this seems to mean that withholding tax is limited if the interest arises in Canada but not if it arises in the UK. Before 2003, the UK treaty did not contain a general "other income" Article. (This particular case was resolved favourably by a competent authority agreement). Article 20A now ensures that such an item of income, not being dealt with in any other Article – it is a business profit outside Article 7, not attributable to a PE in Canada, and interest not referred to in Article 11 – is taxable only in the residence state.

c) Article 21(2) qualifies this general rule expressed in paragraph 1. Under the OECD and UN Models, paragraph 2 preserves source country taxation of any income paid to a resident of the other sates in respect of a right or property effectively connected with a PE in the source state. Such income is lumped together with the business profits to be dealt with under Article 7 (or 14). Canada has adopted this provision in about 20 treaties (Germany, a number of developing countries). It would not normally extend to management fees (as there is no "right or property effectively connected with a PE") but it would reach items such as some elements in s. 212(1)(d) that fall outside the treaty definition of "royalty." The rationale for and scope of this provision are rather narrow. If the item of income *is* within Article 7, then it is not within Article 21(2) and does not need to be, as it can be taxed by the state in which the PE is located. However, some countries are apparently concerned that there may be items of income that are not "profits of an enterprise" but that are nonetheless derived from a right or property effectively connected with a PE. Article 21(2) ensures that such quasi-business profits are afforded Article 7 treatment.

d) The UN Model adds an additional, broad exception to preserve source taxation under which the source state may tax items of income "arising in" or "derived from sources in" that state. There is no requirement that the income be effectively connected to a PE. However, this rule is still an exception to paragraph 1 and therefore only relevant to items of income not dealt with in other Articles. Therefore, income that constitutes business profits, dealt with in Article 7, should not be caught. This is a case where Canada, consistent with its recorded reservation to Article 21, follows the UN approach. Canadian treaties may adopt such a source protection rule either in addition to Article 21(2), as in the UN Model, or in its place.

V. **Income from capital: Article 10 - 13**

A. Dividends, interest and royalties

1. General. Certain aspects of Articles 10 – 12 can conveniently be dealt with collectively.

a) The overall effect of all three Articles is to provide, in paragraph 1, for unlimited taxation by the residence state and, in paragraph 2, for limited taxation by the source state. Having regard to the requirement to provide recognition for taxes imposed in accordance with the convention by the other state (Article 23), this effectively divides up taxing jurisdiction by giving a prior but limited claim to the source state.

b) The restriction on source state taxation depends on the recipient, resident in the other state, being the "beneficial owner" of the item of income. This expression has been discussed at length by the OECD and commentators in many countries. One view is that "beneficial ownership" should be a fiscal concept, i.e., that the beneficial owner is the person who, in the relevant jurisdiction is the person to whom the income is attributed for tax purposes.[113] Another view, which has to my knowledge been the Canadian approach, is more legalistic or formalistic. Although not going quite so far as to adopt trust law notions, the "beneficial owner" is the person who, under the applicable legal system, owns the item of income, whether or not that person is subject to tax on the income. As I write, we are awaiting judgment in the *Prévost Car* litigation (heard by Rip J in the TCC in September) which may cast some light on this subject.[114]

c) Each Article provides a definition of the relevant item of income. These definitions are not coextensive with the meaning of the terms under the Act. Therefore, one should not equate the scope of Article 10 (dividends), 11 (interest) and 12 (royalties) with that of ss. 212(2), 212(1)(b) and (d) of the Act.

d) Dividends, interest or royalties may be business profits of an enterprise of the other contracting state. Some specific issues will be dealt with under those headings, but the general framework seems to be this.

(1) The OECD Model and, I believe, all Canada's treaties provide that where profits include items of income dealt

[113] See, in particular, the Partnerships Report, *supra*, note 69.

[114] *Prévost Car Inc. v. The Queen*, 2004-2006(IT)G. Another beneficial ownership case working its way through the courts is *Velcro Canada Inc. v. The Queen* 2007-1806(IT)G, concerning the effect (or lack thereof) of assigning a right to receive royalties.

with separately in other Articles, the provisions of those Articles are not affected by the provisions of Article 7. Articles 10, 11 and 12 then contain a reverse priority back to Article 7 where the holding (dividend), indebtedness (interest) or property (royalty) is effectively connected to a PE in the source state. This is similar, although not identical, to the domestic rule in s. 805 of the Regulations. A non-resident person carrying on business in Canada is taxable under Part I on income from that business. If the income includes an item that falls within the scope of Part XIII, both taxes could apply. Section 805 provides that Part XIII tax does not apply to amounts that may reasonably be attributed to the business carried on by the non-resident through a PE in Canada, as defined in s. 400(2) of the Regulations. Similarly, effectively connected dividends, interest or royalties should be dealt with under Article 7 and not under Articles 10 – 12.

(2) The interaction between the domestic and the treaty rules is not without subtlety. Suppose a non-resident has a PE in Canada and earns business profits in the form of dividends, interest or royalties (as defined in Articles 10 – 12) attributable to that PE and that meet the source requirement as discussed below. Suppose, as well, that the items of income are in respect of holdings, indebtedness or property effectively connected with that PE, as defined in the treaty. The income may, therefore, be taxable in Canada under Article 7(1). Under the Act, Part I (and Part XIV) tax applies but not Part XIII provided that the PE under Article 5 is also a PE under s. 400(2) of the Regulations. Those definitions are not quite the same. If the presence of the enterprise in Canada constitutes a PE under Article 5 but not under s. 400(2), an anomalous result follows. Canada has the right under the treaty to tax at whatever level it likes and, under the Act, tax would seem to be imposed under Parts I, XIII and XIV. The solution seems to be that s. 805 should refer to a PE under s. 400(2) <u>or</u> any applicable convention (compare s. 5906(2) of the Regulations.)

(3) Now suppose, *a contrario,* that the non-resident does *not* have a PE in Canada, or at least that the item of income is unrelated to any PE in Canada, and that Article 10, 11 or 12, as the case may be, permits Canada to tax the relevant amount up to a certain rate. Even though the income is part of the profits of the enterprise within the meaning of Article 7, these other Articles nonetheless apply because of Article 7(7). Under the Act, tax may be imposed under the

appropriate provision – s. 212(2), 212(1)(b) or (d) – on this business profit. Absent a PE in the s. 400(2) sense, s. 805 does not prevent that taxation. If, as would normally be the case, the income is from a business carried on outside Canada, the appropriate result obtains: Part XIII tax only. What if the income is earned from carrying on business in Canada but without a PE? The domestic result again appears to be tax under both Parts I and XIII (and XIV), but in this case the treaty rate restriction would apply. The right amount of tax appears to be due although it is somewhat confusing what tax it is.

2. Dividends

a) Rates. The OECD and UN Models propose a split rate system: a lower rate applies to "direct" dividends, paid by a company to a beneficial owner holding directly at least 25% (10% in the UN Model) of the capital, and a higher rate to other dividends. Canada has adopted this approach although a substantial number of our treaties do maintain a single rate.

(1) Where there is a split rate, the lower, direct investment rate is normally 5%, as recommended in the OECD Model, but occasionally higher (10% in China, Chile). Canada sometimes uses a 25% ownership threshold, sometimes 10%. The OECD "capital" test is often employed, but treaties also refer to "voting power" or "voting stock." Curiously, many treaties refer to holding the capital or voting power "directly" (Argentina, Denmark, Indonesia, Norway), and others are expressly the reverse, referring to holding "directly or indirectly" (Bulgaria, Nigeria – the last with a 12.5% rate). Still others are silent on the point. The low rate seems always to refer to ownership or control by a "company," leading to the well-known problem of ownership through a partnership. The 2007 US treaty protocol helpfully attributes ownership through such fiscally transparent entities.

(2) The rates specified in Part XIII are deemed to be the rate specified in an applicable treaty with respect to the item of income (s. 10(6), ITAR). One explanation for this rule is to permit a Canadian payer to deduct and withhold the reduced treaty amount under s. 215(1).[115] I believe it

[115] Alternatively, the Information Circular 77-16R4 may itself amount to an administrative exercise of discretion to accept a lesser withholding tax (para. 14 makes no mention of s. 10(6) of the ITAR).Indeed, such discretion is required where there is no specified "rate" in the treaty but

was also important to prevent some treaties inadvertently terminating (which could explain why the rule is in the ITAR rather than the Act).

(3) The split rate may be problematic in its application to amounts treated as "anonymous" dividends under the Act. Normally, a dividend is paid or deemed to be paid by a particular corporation. But s. 214(3)(a) simply deems a s. 15 benefit to be a dividend "from a corporation resident in Canada."

(4) Canada does not usually include the Models' exhortation that the competent authorities shall settle the mode of application of the split rate, perhaps because this is considered redundant with the competent authority agreement rules in general (strangely, such a provision is adopted in a few cases where there is a single rate).

(5) Canada's treaties do not generally provide any exemption from source country tax on dividends, but there are a few exceptions. Several treaties exempt pension-related organizations from tax, either in Article 10 itself or in the "Miscellaneous Rules" Article (Denmark, France, Luxembourg, Oman, Sweden, US). The US convention contains a very general exemption for charities that would also extend to dividends.

b) Exchanges of Notes – rate issues

(1) In a 2003 exchange of notes with the UK, it was agreed that in the event that Canada agrees to a rate of tax on dividends, interest, or royalties with an OECD member state that is lower than that provided for in the UK convention, the appropriate authorities of the states shall consult at the earliest opportunity with respect to further reductions in the withholding taxes provided for in the convention.

(2) A 1993 exchange of notes with the US deals with the Part XIII tax on natural resource royalties. Article 6 imposes no limit although the 1942 treaty did, at 15%. The parties agree to consult if Canada (the US) increases its statutory rate beyond 25% (30%).

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rather full exemption. See RID 9805075, 31 July 1998. I thank Dave Beaulne for bringing this issue to my attention.

c) Definition. The usual definition following the OECD Model refers to income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from shares or rights which is subjected to the same taxation treatment as income from shares by the laws of the source state.

(1) Most of this verbiage is not meaningful in relation to dividends from Canadian corporations, as our corporate law does not include these concepts. The CRA traditionally took the view that allocations in proportion to patronage as defined in s. 135 of the Act were “dividends” under the treaty definition,[116] although apparently they are reconsidering that view. Given the Canadian legal substance approach, there should not be an overlap between dividends and income from debt-claims (but see V.A.2.c)(5) below).

(2) “Dividend” seems to be “fully defined” so no recourse to Article 3(2) is required; however, by including income subject to the same taxation treatment as income from shares, the Article 10 definition itself incorporates deeming rules in the Act and, by reason of s. 3 of the ITCIA, this incorporation is ambulatory. Provisions such as ss. 84, 84.1 and 212.1 seem to be protected. Since s. 248(1) defines a dividend to include a stock dividend, those should be dividends for purposes of the treaties (the “amount” being determined by s. 248(1)). The “same taxation treatment” requirement presumably refers to treatment that is the same to this taxpayer or class of taxpayers. For example, a s. 15(1) benefit is not treated the same as a dividend for a resident, but it is for a non-resident under s. 214(3)(a).

(3) The text of the “same taxation treatment” rule is expressed in different ways and is sometimes confusing. A simple approach is to refer to “income assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident” (Austria, India, Singapore). In most cases, however, the text is: “income from shares or rights which is subjected to the same taxation treatment as income from shares.” This refers only to “income from shares or rights” so it seems that a receipt that is not income from shares or rights is not assimilated to a dividend, even if the income is taxed like a dividend in the source state. More problematic is the first

[116] Information Circular IC75-12R5, Nov. 26, 2001, Appendix A.

reference to “shares” in such a definition. It seems to have no content (“income from shares... which is subjected to the same taxation treatment as income from shares”). The French text is clearer.[117] Kenya adds to the definition “any other item which is deemed to be a dividend or distribution of a company by the taxation law of the Contracting State of which the company making the distribution is a resident.”

(4) The definition is asymmetrical: where the recipient is denied the treatment otherwise afforded dividends the amounts may still be dividends under the treaties, since the reference to domestic law treatment only expands, but does not contract, the scope of the treaty definition. Thus, e.g., dividends on term preferred shares are not excluded from dividend treatment to the non-resident recipient, either under the Act or the treaties, a harsh but undoubtedly intended result. The same applies to benefits conferred on shareholders within the ambit of s. 15(1).

(5) The interaction of some deeming rules in the Act with the definition in the treaties may require careful analysis. For example, certain dividends on shares are deemed to be interest (ss. 130.1(2), 137(4.1)) and, either expressly (s. 137(4.2)) or by implication, such payments are not considered to be dividends for purposes of the Act. What about the treaties? These (corporate law) dividends are taxed like interest under the Act but Article 11 in virtually all Canadian treaties (not, it seems, Australia) provides a “tie-breaker” in favour of Article 10 for income that could be classified as both dividend and interest. The Exchange of Notes with the US in 2007 ensures that dividends treated as such in Canada and distributed by income and royalty trusts will be considered “dividends” for purposes of the treaty.

d) Source. Under Article 10, dividends are, in effect, sourced to the state of which the company making the distribution is a resident. That is the same rule as s. 212(2). Dividends are not sourced to the place where the earnings are derived. On the one hand, this means that Canada could not (although it does not anyway) impose tax on dividends paid by a non-resident corporation to a resident of a treaty state on the basis that such dividends are derived from profits earned through a PE in Canada.

[117] The French version does not refer to “shares” twice as does the English: “ainsi que les revenus d'autres parts sociales soumis au même régime fiscal que les revenus d'actions…”

Such a so-called “second dividend tax” is prohibited by Article 10, usually paragraph 5. In this situation, Canada should impose Part XIV tax and get the appropriate result. On the other hand, the strict rule sourcing dividends based on the residence of the payer means that Canada can, and does, impose tax on dividends paid by a Canadian corporation derived in whole or in part from foreign earnings.

e) Mutual funds. The French treaty has a provision that restricts the benefit of the treaty rate in respect of dividends earned by a mutual fund. Article 29(7)(a) refers to a “mutual fund in securities” that is not subject to tax in the state in which it is constituted (and, therefore, not a treaty resident). Such a fund does benefit from the limited withholding tax rate on dividends (and interest) but only for the fraction of the income which corresponds to the rights held in that organization by residents of the state in which it is constituted and which is taxable in the hands of those residents.

3. Interest

a) After the amendment of the Act in conformity with the 2007 federal budget proposal is implemented, the charge in s. 212(1)(b) will effectively be limited to non-arm’s length payments (that are not “fully exempt interest”) and so-called “participating debt interest.” For future payments, therefore, most of the comments below are relevant only for such excluded classes of interest.

b) Rates. The most common rate for source country taxation of interest in Canadian treaties is 10%, as in the OECD Model, but 15% is also found, particularly in treaties with developing countries (with a couple at 12.5% and the rare 25%). The 2007 US treaty protocol represents a milestone in Canadian treaty policy, establishing a zero rate. This exemption is broader than the contemporaneous domestic change in s. 212(1)(b) in that there is no arm’s length requirement. However, proposed Article XI(6)(b) excludes from the zero rate certain categories of participating interest. Such interest (assuming that it is interest, of course) is henceforth subject to the portfolio dividend rate, 15%.

c) Exemptions. Paragraph 212(1)(b) contains numerous exemptions from the domestic charge to non-resident withholding tax on interest. Treaties may confirm or expand this list.

(1) It is relatively common to include in treaties an exemption for interest paid to or received by certain government institutions. The extension to Canadian government *payers* is mainly confirmatory of exemptions

in the Act, although it can be broader. The extension to foreign public *recipients* is likely to expand the scope of domestic exemptions. At the state level, it probably confirms the principle of sovereign immunity, but the exemption often goes further and includes interest paid to local authorities, which is normally more generous than the Act. Exemptions for interest received on loans from or guaranteed by specified or generically defined government banks or export development organizations may also expand the exemptions in s. 212(1)(b).

(2) Another prevalent exemption is for interest received by pension related entities. It is relevant to compare the treaty exemption with the "exemption certificate" system in ss. 212(1)(b)(iv) and (14) of the Act, to find which is broader. The domestic exemption extends to other entities that would qualify for tax-exempt status under s. 149 and to charities, something treaties rarely do (the US convention does include charities).

(3) Treaty-based exemptions may be valuable where a domestic exemption has strings attached. For example, if the interest is exempt under a treaty, the currency does not matter, as it would under s. 212(1)(b)(iii). Indeed, even if the treaty and domestic exemptions are co-extensive, such as for most pension plans, the claim of protection under the treaty may be broader because of the closing "postamble" to s. 212(1)(b), which denies exemption for contingent interest instruments. That denial would not apply to interest exempt under a treaty. This aspect remains important even after the enactment of the pending 2007 federal budget measures, since proposed s. 212(1)(b) continues to impose tax on "participating debt interest," which is to be defined in s. 212(3) in conformity with the existing postamble.

(4) A common complaint about interest withholding taxes is that since they apply to the gross amount, the effective rate on profit may be very high, indeed far greater than 100%, where the recipient is acting as a financial intermediary. The OECD Commentary notes this problem (para. 14 – 16) and suggests a potential fix in the form of an additional exemption for interest paid to banks and in connection with credit sales of equipment and merchandise. Some version of a credit sale exemption has been adopted in a number of Canadian treaties, excluding from the benefit transactions with related party (most European treaties, Argentina, US). The OECD proposal to exempt

interest earned on bank loans has not been adopted although in the Netherlands treaty, the parties agree to exempt interest paid in respect of a loan made, guaranteed or insured, or a credit extended, guaranteed or insured by any financial institution specified and agreed in letters exchanged between the competent authorities of the States. I am not aware that any such exchange of letters has taken place.

(5) An historically important Canadian exemption has been s. 212(1)(b)(vii). The Netherlands treaty contains a protection for Dutch creditors that essentially reproduces the Canadian domestic exemption, with transitional relief if it is repealed. Assuming enactment of the budget proposal, this should become academic as I assume there will be no interest exempt under s. 212(1)(b)(vii) that is not exempt under the new provision.

d) Definition. The standard definition of "interest" in Article 11 refers (simplifying a bit) to income from debt-claims of every kind, whether or not secured by mortgage, as well as income which is subjected to the same taxation treatment as income from money lent by the laws of the source state, but not including income dealt with in Article 10 (dividends).

(1) Regarding the "same taxation treatment" test, most of the comments made concerning dividends generally apply. However, in this case, the drafting is more straightforward (and better): it refers to any income which is taxed like income from money lent. The categories of deemed interest evidently include the guarantee fees referred to in s. 214(15) that were the subject of *Melford,* (except on a transitional basis, under s. 6 of the ITCIA). Some provisions of the Act affect the timing of imposition of tax but do not really change the meaning of "interest," while others deem an amount to be interest that would not otherwise be so characterized (a non-exhaustive list includes ss. 16(1), 16.1, 212(6), (7) and (7.1), 258(3) and (5), 260(8)).

(2) As with dividends, amounts that are denied the treatment otherwise afforded a payment of interest may still be interest under the treaties. Thus, interest the deduction of which is disallowed under ss. 18(2), (3.1) or (4) is still income from a debt-claim to which Canada may (and does) apply tax up to the limitation in Article 11(2).

(3) The treaty definition is arguably broader than the general Canadian law. “Income from debt-claims” would not, it seems, have to meet any judicial tests of accruing per diem, reference to principal amount, etc. Questions about whether certain forms of variable payments are “interest” for purposes of the Act may not prevent such remuneration from being “interest” for purposes of the treaty.

e) Source. Article 11(2) limits source country taxation in respect of interest “arising in” that state.

(1) For these purposes, Article 11(5) of the OECD Model, adopted generally in Canada’s treaties, provides, first, that interest is deemed to arise in a contracting state if the payer is a resident of that state. This is consistent with the charge to tax under s. 212(1)(b).

(2) Article 11(5) goes on, however, to provide that if the interest is borne by a PE in a contracting state, wherever the enterprise is resident, then it is deemed to arise in the PE state. This proviso both contracts and expands the potential scope of Canadian taxation. If a Canadian resident carries on business through a PE in the other contracting state and the interest is borne by that PE, the rule may prevent Canada from taxing. That will be the case if the interest is paid to another resident of the treaty partner and there is a normal “other income” Article 21. This is not a surprising result. Paragraph 212(1)(b) also expresses a source requirement if one considers exemptions such as ss. 212(1)(b)(iii)(E), (v) and (ix).

(3) If, *a contrario*, the interest is borne by a Canadian PE of a non-resident enterprise, then the deemed source rule in Article 11(5) enables Canada to impose Part XIII tax, limited as to the rate by Article 11(2), which indeed it does under provisions such as ss. 212(13)(f) and (13.2). Those rules generally apply where the non-resident has a PE in Canada, but that need not be the case. There is a gap, albeit narrow, between the language of the Act and the source rule in Article 11(5).

(4) It is not clear to me whether the deemed source rule in Article 11(5) is or is meant to be exclusive. The OECD Commentary is silent on the point. Can interest “arise” in Canada even if not paid by a Canadian resident or borne by a Canadian PE? The question is unlikely to arise in practice because the Canadian charging provisions generally do not

apply in any other circumstance. But if one can imagine, for example, a non-resident person whose business was carried on principally in Canada, but without a PE, then the issue would have to be faced: s. 212(13.2)(a) could cause Part XIII tax to be exigible in respect of interest paid to another non-resident person (recognizing, of course, the broad scope for exemptions, particularly after the 2007 federal budget), and Article 11(5) would not deem the interest to arise in Canada. Nonetheless, it could be argued that it *does* arise in Canada and that the source rule does not exclude that possibility.

f) Pricing. Article 11 contains its own transfer pricing rule. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, only the last-mentioned amount is subject to the rate limitation and any applicable Article 11 exemptions. The excess remains taxable according to the laws of each state, due regard being had to the other provisions of the convention (e.g., if the amount is treated as something else, such as dividend). If the interest is also profit of an enterprise, it seems that both Articles 9 and 11(6) could apply. In Canada, s. 247 makes no such distinction. The overlap of rules determining the quantum of the amount (s. 247) and rules dealing with its taxation in the two contracting states (Article 11) requires some thought. It is also noteworthy that provisions such as time limits in Article 9 do not reappear in the simple rule in Article 11.

g) LOB. Article 27(6) of the Belgian treaty provides that interest arising in one state and paid to a resident of the other may be taxed in the source state at a rate up to 15% where (i) it is received by a company and one or more persons not resident in the residence state hold directly or indirectly, through one or more companies or otherwise, at least 50% of the capital of such company and, directly or indirectly, exercise the management of, or control such company, and (ii) it is not subject to tax in the residence state under the ordinary rules of its tax law. Thus, Canada can impose a 15% gross non-resident withholding tax on interest paid to a Belgian resident company meeting the foreign ownership and control test if the interest is not taxed in Belgium.

h) Mutual funds. Note the French treaty provision discussed above in connection with dividends (see V.A.2.e).

4. Royalties

a) Rates. The OECD supports a nil rate tax by the source country, although natural resource royalties falling within Article 6 may be fully taxed. Canada has, in effect, followed the UN Model and retained source country taxation rights at a general rate of at least 10%, often 15%. However, there are very significant exemptions so one might view the Canadian negotiating position as a kind of compromise.

b) Exemptions. The Canadian "model" includes an exemption for copyright royalties (excluding motion picture films and television) and royalties for the use of, or the right to use, computer software or any patent or for information concerning industrial, commercial or scientific experience (but not including any such royalty provided in connection with a rental or franchise agreement). In various forms, one or both of these appear in most although by no means all Canadian treaties. The precise scope, particularly for technical or other information, must always be examined. Not surprisingly, the "standard" form tends to appear in treaties with developed countries and either a narrower exemption or none at all in treaties with developing countries particularly concerned with source taxation. There are rare cases where, instead of exemption, the technical or software category is afforded a lower rate (Azerbaijan). In the US treaty, the exemption would extend to broadcasting if added by an exchange of notes. Recall, as well, the general US treaty exemption for income of charities.

c) Definition. The definition of "royalty" in Article 12 presents a much greater divergence from domestic law, i.e., from s. 212(1)(d), than the definitions of "dividend" and "interest" in Articles 10 and 11. The scope of the treaty royalty definition determines not only what payments may benefit from the prescribed lower rate of withholding tax but, often more important, what payments may escape Canadian tax altogether because they become non-taxable business profits.

> (1) The relationship between the treaty definition and s. 212(1)(d) is complex and varies considerably amongst the treaties. The OECD Model essentially includes copyright and related royalties, and payments for the use of or the right to use any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial commercial or scientific experience. In comparing this to the domestic charge, one notes a number of divergences, the most important of which may be the inclusion in s. 212 of payments for tangible property and services.

(a) Paragraph 212(1)(d) includes any payment that is a “rent, royalty or similar payment,” the rest of the provision being merely inclusionary. The OECD definition is exhaustive.

(b) The list is s. 212(1)(d)(i) is similar to but wider than the OECD list. The Canadian one includes “invention” and “trade-name” and, importantly, “property” plus a catch-all “or other thing whatever.”

(c) The information category in s. 212(1)(d)(ii) is the same as the OECD Model but with a notable restriction in that the domestic provision applies only if the consideration meets the defined test of being based on use, production or profits. There is no such restriction in the OECD Article 12.

(d) Subparagraph 212(1)(d)(iii) is similar to the information provision but applies to services. There is no extension to services in the OECD Model.

(e) Subparagraph 212(1)(d)(iv) refers to a payment for not using something. This is not in the OECD Model.

(f) The exceptions in subparagraphs (vi) to (xi) are not in the OECD Model. Two of these, subpara. (ix) and (x), are really reverse source definitions, to which we will return in a moment.

(2) Canadian treaties contain many variations from the OECD Model. Some of the more notable relate to tangible property and services. Consider the following illustrative examples.

(a) The UN Model definition includes payments for the use of, or the right to use, industrial, commercial or scientific equipment. This is standard in Article 12 of Canadian treaties and supports the charge in s. 212(1)(d) on “rent” and “payment for the use of…any property.”

(b) US: the definition extends to the use of, or the right to use, tangible personal property (which is broader than the usual “equipment” reference) and also gains from the alienation of intangible property or rights referred to in the definition. The Technical

Explanation to Article XII asserts: "Technical service fees may be royalties in cases where the fees are periodic and dependent upon productivity or a similar measure." It has never been clear to me on what basis this assertion is made.

(c) New Zealand: Aside from being structured rather differently, the definition in Article 12(3) includes a sweeping reference to "supply of scientific, technical, industrial or commercial knowledge, information or assistance (including management services)."

(d) India: The title of Article 12 is "Royalties and Fees for Included Services." The definition of "royalties" is not unusual – it extends to payments for industrial, commercial or scientific equipment and also proceeds of alienation of intangibles – but there is, as well, a definition of "fees for included services" in Article 12(4) that refers to the rendering of any technical or consultancy services if such services are ancillary and subsidiary to the application or enjoyment of the right, property or information covered by the "royalties" definition or "make available technical knowledge, experience, skill, know-how, or processes or consist of the development and transfer of a technical plan or technical design."

(3) The importance of the scope of the definition in Article 12 depends upon its interaction with other treaty Articles and provisions of the Act. The following cases are examples of the general consideration of property income as profits of an enterprise, already noted.

(a) Suppose that the income constitutes part of the profits of an enterprise and the enterprise has no PE in Canada. If the amount is not within the definition of "royalties" in Article 12, then Article 7 governs and there is no tax. It does not matter whether the amount is described in s. 212(1)(d).

(b) In the same circumstance, if the payment *does* fall within the scope of the treaty "royalties" definition (and arises in Canada), then Article 12 applies in preference to Article 7. If Article 12 exempts the payment from source state taxation,

then there is no Canadian tax. If it does not, and if the non-resident does not carry on business in Canada, the imposition of Canadian tax depends on whether the payment is within the scope of Part XIII, normally under s. 212(1)(d). It is possible that the payment is a "royalty" for Article 12 but is not mentioned in s. 212(1) (perhaps a payment for information without a contingent consideration), in which case it should not be taxable in Canada. In effect, these are cases in which Canada has been offered a right to tax by the other contracting state but has chosen not to exercise it.

(c) If the payment in question is *not* part of the business profits of an enterprise, different considerations apply. Assuming the amount is charged under s. 212(1)(d) and is also a "royalty" under Article 12, its taxability will be limited to the rate in Article 12(2) or eliminated entirely if an exemption in the treaty applies. However, if the payment is not a "royalty" under Article 12, then it is likely that 25% Canadian non-resident withholding tax will apply. For in this case, the only potential treaty protection is the "other income" provision in Article 21 and the almost universally adopted Canadian version of that Article preserves unlimited taxing rights for the state of source. Therefore, the inclusion of copyright royalties or payments for information in both the definition of "royalties" and the exemption from source state taxation in Article 12 is not redundant. It ensures exemption, which would not be the case if the payments were simply not referred to in Article 12 at all.

d) Source. Article 12 of the OECD Model refers to royalties "arising in" a contracting state but, unlike Article 11, here there is no source rule. This is logical since the OECD Model does not provide for any source state taxation. However, Canadian treaties do preserve source state taxation and therefore include a source definition similar to that for interest (see V.A.3.e). The US treaty provides, in addition to the usual source provision, a further deeming rule: royalties for the use of, or the right to use intangible property or tangible personal property in one of the contracting states that would not, by reason of the residence or PE deeming provision, be treated as arising in either contracting state, are deemed to arise in that state.

e) Pricing. As in the case of interest, Article 12 contains its own mini-transfer pricing rule (see V.A.3.f).

f) LOB. The Belgian provision referred to in connection with interest (see V.A.3.g) also applies to royalties, with a 10% rate stipulated.

B. Gains – Article 13

1. This treaty Article was the subject of David Smith's IFA Canada Travelling Lectureship in 2003 and I will, therefore, abbreviate these notes. However, the gains Article does reflect considerable Canadian departure from other models and therefore requires some consideration.

2. Indirect holdings. The OECD Model, in Article 13(4), permits taxation of gains from the alienation by a resident of one state of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other state by that latter state. The Commentary (para. 28.5, 28.7) recognizes that states may wish to broaden this rule to include indirect interests other than shares, and perhaps narrow it to exclude shares of certain listed companies. Canada has adopted several different versions of the indirect holdings rule.

a) The usual Canadian approach expressly expands the indirect holding beyond shares to include an interest in a partnership, trust or estate.

b) It is common, but certainly not universal, to exclude, in the case of shares, those listed on an approved stock exchange.

c) For obvious reasons, the properly drafted version reaches to multiple tiers of entities by deeming "immovable property" to include shares and interests referred to in the rule. Some older treaties do not do this (Barbados, Israel, Jamaica).

d) In some cases, Canada only retains jurisdiction to tax shares or other interests that constitute a "substantial interest" in the relevant entity. This limitation can be difficult to apply where there is no definition of that expression, as is often the case (Belgium, Hungary, Baltics). In some treaties, "substantial interest" is defined, on a group basis, at some particular level (10% in Luxembourg, Iceland; 25% in Bulgaria, South Africa). This percentage test refers to shares or interests of any class, which means that the interest need not really be "substantial" in economic terms.

e) A problem with the indirect interest provision is that many companies (manufacturers, utilities) could, arguably, derive their

value principally from immovables even though their shares are not, in substance, indirect investments in such property. Is the test one of relative asset values or, as in the corporate law notion of a sale of substantially all the business, is there a qualitative element? Since real estate (and other) values fluctuate, qualification may change from day to day. To avoid some of these problems and to focus the indirect interest provision on the avoidance of tax by the interposition of holding entities, where it belongs, some 30 Canadian treaties provide a restriction on the definition of "immovable" for this purpose. The term "immovable" is declared not to include any property, other than rental property, in which the business of the company, partnership or trust is carried on (Austria, Belgium, France, Hungary, Baltics, Italy, Mexico, Romania, Sweden, UK). Notably absent from the countries with such a saving provision is the United States, which opposes the exemption. Note that this restriction, where it appears, applies only to the indirect interest rule and not to the meaning of immovables in general. The language is not ideal because of the spatial qualification "in which." The intention seems to be a familiar concept of active business assets, but the literal application to enterprises such as forestry, mining or oil and gas is problematic. The administrative position is favourable.[118]

3. Reorganizations. The mismatch between corporate and other business reorganization rules in different countries can lead to deferral of tax in one and immediate taxation in the other. That, in turn, may result in double taxation. Although Article 23 should solve some of these cases, it would be more convenient to harmonize the timing of recognition of gains. A number of treaties contain an express provision intended to do (or, more precisely, permit) this in defined circumstances (Finland, Netherlands, US – there was such a provision in the French treaty but it was removed by a protocol). These provisions generally state that where a resident of one state alienates property in the course of a corporate or other organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that state, if requested to do so by the person who acquires the property, the competent authority of the other state may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property for the purpose of taxation in that other state until such time and in such manner as may be stipulated in the agreement. I have recited the full text because the specific conditions are important. Relief depends on discretionary competent authority agreement; conditions may be attached; the period of deferral is

[118] E.g., RID 9703965, June 12, 1997.

a matter of negotiation. In Canada, legal authority for the deferral of tax by competent authority agreement is provided in s. 115.1. The CRA practice in granting these agreements has become cumbersome and time-consuming[119] and I do not believe there have been very many.

4. Emigrants and immigrants. Canada's treaties often address or preserve certain aspects of our system of taxation relating to individuals who change residence between the contracting states.

a) One type of provision preserves Canada's jurisdiction to tax recent emigrants. Under s. 128.1(1)(b), an individual is deemed to dispose immediately before departure of each property other than, inter alia, taxable Canadian property (TCP). Canada cedes jurisdiction to tax gains from the alienation of many forms of TCP under Article 13 of its treaties. It would, therefore, be possible for an individual to leave Canada owning TCP, become resident in a treaty country that does not tax gains, provides an immigration step-up or otherwise permits a disposition in particular circumstances without undue tax cost, and then sell the property. To impede such tax planning, Canada has negotiated a provision in something under ½ its treaties that preserves its right to tax all or some gains from individuals formerly resident in Canada for an agreed upon period. Of course, the impact is limited to gains that Canada actually does tax when realized by non-residents. The look-back rule is sometimes based simply on residence within 5 or 10 years before the alienation (Baltics, Israel, Germany, Korea, Ecuador) or may add a conjunctive test with the additional requirement that the individual be a Canadian national or resident for more than 10 years prior to the alienation (Finland, France, Portugal, Switzerland). The US and Irish versions limit the extended jurisdiction to property owned when the individual left Canada. Strangely, this is not the case in most treaties, giving Canada a windfall jurisdiction to tax gains from the alienation of TCP merely because the seller is an individual who used to live in Canada. Under the 2007 protocol, the US version is tightened up to exclude as well property subject to a deemed disposition on departure. Buried in the miscellaneous rules article (XXIX(2)(b)), the protocol also expands the US jurisdiction to tax former citizens or long-term residents to include all income from source in the US, not just capital gains.

b) Exit taxes work better when the emigrating and immigrating countries have similar rules, so that the deemed realization event is matched by a step-up in cost for tax purposes. Canada has successfully negotiated a step-up provision in about 25 treaties.

[119] Information Circular 71-17R5, January 1, 2005, para. 72 – 85.

This is accomplished by a notional deemed sale and repurchase at fair market value (Algeria, Australia, Belgium, Senegal). Sometimes, it is elective (US, Mexico, Germany). It is, perhaps, surprising that countries that do not themselves impose an equivalent departure tax regime would agree to such a step-up rule and it is a tribute to the Canadian negotiators that they have managed to extract it.

5. Little or no protection. Some of Canada's gains Articles do not reflect the OECD Model approach to sharing jurisdiction at all. For example:

a) The treaty with Argentina provides that a state may tax property situated there, without providing any rules for determining situs, subject only to an exception relating to ships and aircraft operated in international traffic.

b) Simpler still are the treaties with Brazil and India. Gains from the alienation of ships and aircraft operated in international traffic are taxable only in the state in which the place of effective management of the enterprise is situated. All other gains may be taxed in both states.

c) The Japan treaty permits taxation of gains from immovables and business property of a PE in the situs state and restricts taxation of gains on ships and aircraft operated in international traffic to the residence state, like the OECD Model and most of Canada's other treaties. However, it then ends with a simple declaration that other gains may be taxed in the state where they arise. The Vietnam treaty is similar but provides that other gains may be taxed in both states.

6. Gains versus "capital gains." The title of Article 13 in the OECD and UN Models is "capital gains" while the text refers simply to "gains." Most Canadian treaties do the same, although there are variations. The Australia provision, entitled "alienation of property," refers in its text to "income, profits and gains… from the alienation" (New Zealand refers to "income or gains"). Do the "gains" referred to in Article 13 include income realized in the form of the excess of the sale price of property over its cost? (Compare the reverse issue referred to in connection with the remittance provision, XI.C below.) The OECD Commentary merely delegates the problem back to national tax systems (para. 2).

a) Suppose a non-resident disposes of shares that are TCP at a gain. If the gain is a capital gain, Article 13 determines whether Canada retains jurisdiction to tax. If the gain is on income account, and constitutes profits of an enterprise, then at first blush, Article 7 applies and the issue is whether the seller has a PE in Canada to

which the profit (gain) is attributable. But if the profit is an item of income dealt with in another Article, Article 7(7) cedes priority to that other Article. It could, therefore, be quite important to decide whether the income gain arising on the sale of the shares is a "gain" within the scope of Article 13. Structurally, and given the OECD commentary, one would think not. The Act does not expressly define the term "gain" but it seems from reading ss. 39 and 40 that a gain on income account is a "gain" but not a "capital gain" because it is otherwise included in computing income under s. 3. It is surprising there is not more clarity in the treaties on this rather fundamental point.

b) Same example, but the property is a Canadian situs immovable. As previously noted, a number of Canadian treaties include profits from the alienation of immovable property under Article 6. In these cases, the result is the same whether the property is on income or trading account. Under other treaties, the issue discussed in the preceding paragraph arises.

c) This question of whether Article 13 may apply to income gains is particular significance in the context of a treaties that do not provide much or any protection against taxation of "gains" by both states.

7. Exemption. Again, note the US treaty exemption in Article XXI relating to income of charities.

VI. Canadian source employment and similar income

A. Remuneration and Directors' fees: Articles 15 – 16

1. Article 15. With the slow disappearance of Article 14, the quaint title of Article 15 – "Dependent personal services" – is being replaced by "Income from Employment." It governs the treatment of "salary, wages and other similar remuneration…in respect of employment" but carves out directors' fees, pensions and government service, dealt with in separate Articles.

a) Paragraph 1 of the OECD and UN Models provides that this form of income is taxable only in the residence state unless the employment is exercised in the other state, in which case the income derived from such employment may be taxed in the source state. Paragraph 2 then prohibits source state taxation if three conditions are met: the remuneration is paid by or on behalf of an employer who is not a resident of the source state; it is not borne by a PE in the source state; and the recipient is present in that state for no more than 183 days in any 12 month period commencing or

ending in the relevant fiscal year. There is a separate rule for employment aboard a ship or aircraft.

b) The scope of Article 15 depends on the meaning of "salary, wages and other similar remuneration" and "employment," none of which are defined in the treaties. Having regard to Article 3(2) and s. 3 of the ITCIA, it might seem appropriate to look at the definition in s. 248(1) of "salary or wages," although judicial doubt has been expressed that this is a definition at all, or that it is of use in construing "remuneration" in Article 15. In the decision in question, a stock option benefit was considered to be a benefit received by virtue of employment but not "remuneration." [120] I am not altogether sure why the stock option benefit did not constitute "salary or wages."

c) Canadian treaty practice generally follows these models. The main class of departure establishes an alternative dollar threshold. There are essentially two types.

> (1) In about a dozen treaties, the provision permits taxation by the country of employment if the employee is present more than 183 days and either (i) the remuneration is paid by a resident employer or borne by a local PE, <u>or</u> (ii) it exceeds a stated amount (Bangladesh, Hungary, Indonesia (unusually, with 120 days instead of 183), Sri Lanka). The threshold amounts are quite low ($1,500 to $8,500). The effect is that employees sent from those contracting states to Canada for extended periods are likely to be taxable here.
>
> (2) In a few treaties (Barbados, Jamaica, Mexico, United States) the dollar threshold is an independent basis for taxation. That is, the employee is taxable in the state where employment is exercised regardless of the duration of presence or the identity of the payer if the remuneration exceeds the threshold. Alternatively, if the remuneration does not exceed the threshold, the OECD Model test applies. Given the level of the threshold, this amounts to full preservation of Canadian jurisdiction to tax income of a non-resident from employment with only a de minimis exception ($10,000 in the US).
>
> (3) In Papua New Guinea, the dollar threshold is an <u>additional</u> test to the OECD Model approach although, as a quid pro quo, the 183 days is shortened to 90.

[120] *Hale v. The Queen*, 92 DTC 6473 (FCA).

d) The most common version of Article 15(2) thus restricts, at least where the dollar threshold is not met, Canada's ability to tax temporary (less than 183 days in the year) employees on income that would otherwise be taxable under ss. 2(3)(a) and 115(1)(a)(i), on the basis that this employment income is not reducing the Canadian tax base of the employer – is not paid by a resident or borne by a local PE. This rule, and its conceptual basis, places some pressure on deciding who the employer actually is.

(1) The OECD Commentary has traditionally accepted the legal test of employment under domestic law, with a caveat that there may be abusive situations that warrant a different approach. However, recently proposed changes eliminate the abuse test and suggest a broader approach intended to deal with the perceived problem of "hiring out of labour" (as they call it). The revised Commentary alludes to "some countries" in which formal contractual relationships govern, and which may therefore want to include a provision that seeks out the "real" employer on the basis of who actually supervises or controls the employment activity, where the putative employer is not responsible for "carrying out the purposes for which the services are performed" (whatever that means – para. 8.2). Para. 8.3 refers to other countries in which domestic law permits the same result, ignoring the characterization in the formal contract where the nature of the services and their integration into the business carried on by an enterprise. Still other countries (para. 8.7) arrive at the same result not through the application of domestic law but rather by a purposive construction of paragraphs 1 and 2 of Article 15 read together.

(2) Canada does not have the proposed restriction on the application of Article 15(2) in any of its treaties. Would Canada look past the formal employment contract in the manner suggested in the various examples in the Commentary? Although our courts do talk about purposive construction, reaching the desired (by the Commentary drafters) result merely through construction of Article 15 may be a stretch, apart from cases of abuse (GAAR). However, it seems likely that the Canadian government representatives who approved the new Commentary, and presumably the CRA, would consider that Canada falls into the class of countries whose domestic law does look to the legal substance of the employment relationship. I note, in particular, the similarity of the expressions employed in the new Commentary and those found in Canadian case law on

the employment relationship.[121] Whether the Canadian case law would actually yield the results suggested in the several examples posited in the OECD Commentary is, however, open to question.

e) A perennial issue in connection with the taxation of migratory employees relates to stock option benefits. The main problem is how to allocate taxing jurisdiction between treaty states applying Article 15. That leads to problems in the relationship to domestic law, and potential double taxation.

(1) In Canada, the situation is governed by the *Hurd*[122] and *Hale*[123] decisions. They affirm that a non-resident individual is taxable in respect of s. 7 benefits arising out of a grant by a Canadian employer if the individual was employed in Canada at the time of grant, and that that result is not ousted by the usual version of Article 15(2) under an argument that the taxpayer is non-resident at the time of exercise.

(2) This position has led to significant difficulties because it is different from that of other treaty partners. In the most common situation, a Canadian moving to the US with unexercised stock options has often found him- or herself liable to Canadian tax on the full benefit, plus US tax on a portion depending on days spent in each country and the timing of vesting. Moreover, in at least some cases, the US took the position (with which I have some difficulty) that it was not required to provide a credit for the Canadian "excess" tax. The Canadian competent authority, on the other hand, took the position that it could not negotiate away jurisdiction in light of the Canadian case law, although I gather the matter was nonetheless resolved in some competent authority proceedings. This problem has finally been dealt with in the Exchange of Notes (B) with the 2007 protocol to the US convention. The approach is a simple day-counting allocation rule, running from grant to exercise (without regard to vesting). There is a protective or anti-avoidance provision that allows the grant of the option to be considered a disposition of securities where the competent authorities think this is more appropriate (a

[121] Compare the OECD Commentary, para. 8.11 to the widely-applied tests discussed in *Wiebe Door Services Ltd. v. The Queen*, 87 DTC 5025 (FCA) and other Canadian tax cases.

[122] *Hurd v. The Queen*, 81 DTC 5140 (FCA).

[123] *Supra*, n. 120.

possible example being in-the-money options).

(3) The OECD issued a paper effectively recommending an approach like the Canada-US protocol, but based on vesting.[124] At this point, the stock option issue remains open save with the US.

2. Withholding. A common problem in the international mobility context is double withholding of employment taxes. While treaties may assign jurisdiction, and relieve double taxation, they do not generally address the administrative problem of over-withholding. Exceptionally, Article XVII of the US convention prescribes that withholding in the source state in respect of remuneration of a resident of the other state (including entertainers and athletes) shall not exceed 10% on the first $5,000, and that the source state competent authorities may determine that lesser withholding is sufficient. The CRA has this ability anyway under s. 153(1.1).

3. Directors

a) Under s. 248(1) of the Act, "employee" includes "officer," "officer" means a person holding an "office" and "office" includes the position of a corporation director. Thus, domestically, distinctions are not drawn between the remuneration of employees and directors.

b) Treaties are different. OECD Model Article 16 provides that fees of company directors derived in that capacity may be taxed in the state in which the company is resident. Residence state taxation is not prohibited, but the impact of Article 23 is to give a prior claim to the corporate residence state. Canada adopts this provision in its treaties. Thus, the non-resident director of a Canadian corporation is liable to tax in Canada, as determined by the application of s. 2(3) and 115(1)(a), without the limitations established for ordinary employees in Article 15.

c) The UN Model applies a similar rule to "top level managerial officials" as well, and this addendum appears in a number of Canadian treaties (China, Jordan, Mexico). The German treaty contains a similar extension (to an officer, or an official responsible under commercial law for the overall direction of the affairs of a company).

d) In the Netherlands treaty Article 16, there is a further provision

[124] "Cross-border Income Tax Issues Arising from Employee Stock Option Plans," 23 August 2004.

permitting taxation by a PE state. Where the directors' fees or similar remuneration is derived by a person who exercises activities of a regular and substantial character in a PE situated in the state other than the state of which the company is a resident, and remuneration is deductible in determining the taxable profits of that PE, then the remuneration, to the extent to which it is so deductible, may be taxed in the state in which the PE is situated.

e) In Belgium, the potential remuneration is split. The usual director rule applies to the directorship fee, and additional remuneration for day-to-day management or technical functions is subject to article 15. A similar rule applies under the Senegal treaty, to the effect that remuneration derived by directors in respect of any other capacity (i.e., other than that of being a director) may be taxed under the provisions of Article 14 or 15. While the tax treatment of Senegalese resident directors of Canadian corporations may, in and of itself, be of only modest practical importance, the principle is significant and, presumably, a the same result should apply as an inference in other treaties that do not contain this language.

B. Pensions.

1. The OECD Article 18 is unusually brief and simple. Apart from amounts received by government employees, pensions and other similar remuneration shall be taxable only in the residence state. The UN Model, on the other hand, provides two alternatives. Under the first, public social security pensions are taxable only in the source state, and other pensions only in the residence state. Under the second, public social security pensions are taxable only in the source state while other pensions are taxable in both the residence state and the source state. For these purposes, the "source state" is the state in which the payer is resident or has a PE that makes the payment.

2. The Canadian treaties present a bewildering degree of variation. I will only note a few examples here.

a) One approach is to permit the residence country to tax but also allow the source country to retain limited taxing rights. The limitation is the lesser of 15% of the pension amount and the tax that would be payable in respect of the pension if the recipient were a resident of the source state, effectively the rule in s. 217 of the Act (Algeria, Australia, Hungary, Israel, Latvia, Mexico, Poland). There are many variations, particularly the use of the 15% (or some other) limitation without the s. 217 type alternative (Bangladesh, Czech Republic, 20% in Finland, Netherlands, Norway – in which case the residence state grants exemption to the

extent the source state does).

b) The 15% limit is sometimes found applicable to amounts in excess of a threshold (Azerbaijan, Romania). Or, source state taxation may be nil up to a dollar threshold and unlimited thereafter (Brazil).

c) Some treaties express permissive taxation by the state of source without prohibiting residence state taxation as well (Austria, Sweden). This may be coupled with exclusive source state taxation of public pensions (Belgium). Full source and residence jurisdiction may be express (Cameroon, Egypt, Luxembourg – but only source state taxation for Luxembourg public pensions, South Africa, UAE).

d) There are several cases where source state taxation is exclusive (Denmark, France, India, Jordan, Russia, Singapore). Conversely, residence state taxation may be exclusive (UK).

e) There are often special rules for war pensions and other particular situations.

f) Recall the definitions in s. 5 of the ICTIA. There are also definitions or partial definitions in a number of treaties and, in particular, limited taxation is often reserved for periodic rather than lump sum amounts.

g) The bilateral situation with the US is of evident importance. In addition to existing provisions for deferral of RRSP and pension income, the 2007 protocol contains new rules to address deductibility of pension or retirement plan contributions in certain cases.

h) Not attempting to sort all this out, one can make a few general statements.

> (1) Pensions paid from Canada to a non-resident: The non-resident has the s. 217 alternative under the Act. He or she may do better applying a treaty percentage limitation, if applicable, or may be able to claim exemption altogether.
>
> (2) Pensions paid to a Canadian: Canada may have ceded taxation to the source state. If not, Canada may tax fully but will have to provide a credit for the permissible level (if any) of source state taxation.

C. Special cases: Article 17, 19, 20 (briefly)

1. "Artistes and sportsmen." Such individuals are liable to unlimited source state taxation under Article 17(1) of the OECD Model. To support this rule in the face of so-called loan-out companies, the rule is extended in para. (2) to Article 7 to the circumstance where the income accrues to another person. The UN Model is to the same effect. Canada generally adopts this provision (sometimes with the more politically correct "sportspersons" or the older, equally PC but arguably more limited expression "athletes").

a) Some treaties exempt publicly-funded events (Argentina, Bangladesh, India, Norway, Slovak Republic), non-profit organizations (Brazil), cultural exchanges (China, Poland) or some combination thereof.

b) Some treaties exclude unrelated persons from para. (2) (Australia, Denmark, Luxembourg, Spain, Tanzania) but others include any indirect payment situations, which may lead to difficult questions of allocation.

c) The US convention includes a $15,000 de minimis limit. Having regard to the particular situation of North American sports, there is also an exception for activities in the context of a league with regularly scheduled games in both states and a 15% cap on source state tax on signing bonuses for athletes.

d) One common problem is determining the scope of Article 17: who is an artiste, sportsperson or athlete? The partial definitions in the treaty provisions may limit the scope; for example, where the treaty refers to "entertainer" and provides a partial list of public performers, it would seem not to extend to technical staff or even directors.[125]

2. Government employees. Not surprisingly, states jealously guard their jurisdiction to tax their own employees. Salaries, wages and other similar remuneration, other than pensions, paid by a state (or political subdivision) in respect of services to that state are, under Article 19 of the OECD and UN Models, taxable only in that state. On the other hand, the rule is reversed, that is, such remuneration is taxable only in the other state, if the services are rendered there and the individual is a national of that state or did not become a resident there solely for the purpose of rendering the services (e.g., local hires). Canadian treaties generally follow this model (although, paradoxically, some do not have the nationality test (Israel) while others only have the nationality test (Germany)) but include an

[125] See OECD Commentary to Article 17, para. 3; RID 1999-0009997, March 2, 2000.

exception for remuneration in respect of services rendered in connection with a business carried on by the state. There are some outliers. For example, the French treaty provides exclusive taxation by the state employer if the employee is a national, with only the commercial business exception. The US treaty is worded a bit differently, but to similar effect.

3. Students. Students resident in one state who move to the other solely for the purpose of education or training (note the "solely") are, under Article 20 of the OECD and UN Models, exempt from taxation in the host state on payments made for maintenance, education or training that arise from sources outside that state. The old UN Model used to add that the student is also entitled to the same reliefs and reductions in the host state as are available to its residents. Canadian treaties generally follow the OECD Model and a number of them include the old UN Model addition. There is some variation in scope, from "student or business apprentice" (the OECD language), to "student, apprentice or business trainee" in a number of cases. The evolution of Canadian domestic law has made the treaty provisions less important, given the broad exemption for scholarships and bursaries since 2006.

VII. **"Other Income"**

A. Residence Taxation

1. Canada generally follows paragraph 1 of OECD Model Article 21, which provides that items of income, wherever arising, not dealt with in the other treaty Articles are taxable only in the state of residence.

2. There are exceptions. Some treaties provide for permissive residence state or source state taxation, or simply note that other income may be taxed by either state (Argentina, Brazil, Chile).

B. Source Taxation

1. See the discussion in connection with business income (IV.J.3 above). Non-business income is also, and perhaps primarily, the subject of the other income provision. As noted, the Canadian model Article 21 permits source state taxation of items of income not dealt with in other Articles and "arising" in Canada.

2. "Arising" is not a term of tax art in Canada. Since Canadian Part XIII tax is not imposed on a strict source basis but rather according to the residence of the payer (unless one considers that a rather crude definition of "source"), it may be important to decide if the determinations of where interest and royalties arise in Article 11 and 12 are applicable for the treaty as a whole, and not merely the particular Article. The easiest example is interest, although this will become moot for arm's length parties after the exemption under the 2007 budget is applicable. For example, suppose that

a non-resident person invests in commercial paper issued by a Canadian corporation with which it does not deal at arm's length, and that the paper is related to a foreign branch operation of the payer. Under Article 11(5), the interest does not arise in Canada and therefore Article 11(1) and (2) do not apply. Under the Act, if the indebtedness is denominated in Canadian dollars tax may be imposed under s. 212(1)(b). However, if the "arising" definition in Article 11(5) is applicable in Article 21, then only the residence state can tax.

3. One type of income that Canada considers not to be dealt with by other treaty Articles is income from a trust. This is apparent because most Canadian treaties add a restriction in Article 21(2) that the tax on such income will be limited to 15%. In a few cases, the application of the 15% limitation is premised on the income being taxable in the other state (Bulgaria). If the estate or trust earns income from foreign sources, one might contend that the income distributed to the beneficiary does not "arise" in Canada. For purposes of the Act, the attribution of a Canadian source to the trust distribution seems consistent with s. 108(5)(a); however, it is not clear that this would govern the treaty sense of "arise." The US treaty appears to be alone in addressing this matter, providing for complete exemption rather than a 15% source country tax in the case of income of a trust or estate distributed out of foreign source income (Article XXII(2)).

VIII. **Tax on Capital**

A. Models

1. Article 22 of the OECD Model cedes jurisdiction to tax capital represented by immovables and movables forming part of the business property of a permanent establishment to the state where the immovable or permanent establishment is situated. All other elements of capital may be taxed only by the state of residence (with a separate rule for ships and aircraft).

2. The UN Model is textually similar but includes a caveat that the question of capital is left to bilateral negotiation and parties may either adopt this approach or wording that allocates taxation rights to the State in which the capital is located.

B. Canadian treaties

1. Most Canadian treaties follow the OECD Model. Argentina provides exclusive jurisdiction to the residence state (apart from capital represented by ships and aircraft) while a few others do not include the residual reservation of jurisdiction to the residence state (Chile) or, more directly, expressly permit taxation by either state (India). The French treaty extends

immovables to include indirect interests, based on Article 13, and also permits taxation of a substantial interest (25%) by the country of residence of the company.

2. Perhaps two dozen Canadian treaties do not cover capital at all (Australia, China, Finland, Netherlands, Sweden, Thailand).

3. With the elimination of the Part I.3 tax on large corporations, these provisions are principally relevant to prior years and financial institutions. They do not apply to provincial levies.

C. Application

1. The US *Natwest* decision[126] might lead to speculation regarding formulary capital allocation provisions, although it concerned Article 7, not Article 22. The court ruled that Treasury Regulation 1.882-5 was inconsistent with Article 7 of the US-UK treaty and could not, therefore, be used for calculating interest deductions by US branches of UK banks. In summary, the decision states that the treaty does not allow for attribution of additional capital to the branch as measured by regulatory and marketplace capital requirements applicable to separate US bank corporations. Rather, it requires the government to use the properly maintained books of the branch to determine each element affecting the branch profits.

2. Thus, one should not assume that the treaty allocation of jurisdiction to tax capital represented by movable property forming part of the business property of a PE is axiomatically co-extensive with Canadian domestic determinations of branch capital. I think the conventional view is that the authorized foreign bank Part VI rules are sufficiently generous that they would not fall afoul of *Natwest* type arguments.

IX. Double taxation

A. General: exemption and credit systems

1. The two basic methods for providing recognition for foreign income taxes rely on exemption of qualifying foreign income or a credit against (deduction from) domestic tax for foreign taxes paid. The OECD and UN Models propose alternative Articles 23A and 23B to address the exemption and credit methods.

a) The basic exemption rule confirms that income or capital taxable in one state in accordance with the convention is exempt

[126] *National Westminster Bank, PLC v. The United States*, (2003) 58 Fed. Cl. 491 (US Court of Federal Claims).

from tax in the other. However, a credit (up to the residence state tax on this income) rather than an exemption is provided in para. 2 for dividends and interest (and royalties in the UN Model, since they are not exempt from source state tax, as they are in the OECD Model). The exemption is described as "with progression" since, under para. 3, the exempt income or capital may be taken into account in determining tax on the remaining income or capital. The OECD added an anti-avoidance rule in para. 4 (not yet in the UN Model) to prevent the residence state from having to exempt income where the two states have differing views on facts or on the interpretation of the convention.

b) The credit provision establishes a deduction from tax otherwise payable not exceeding the part of the resident state tax attributable to the relevant income or capital. Again, provision for credit "with progression" is made.

c) The Model Articles do not expressly refer to the numerous complexities inherent in real life exemption and credit systems, everything from the treatment of loss carryovers to recognition of taxes imposed on subsidiaries. An indirect credit or exemption is obviously fundamental to a properly operating international tax system, and many countries (including ours) have sophisticated provisions to address this. The OECD gave up the attempt to include language on this subject in the Model given the complexity and variety of the systems adopted. States are "free to choose their own solution" and a very simple alternative to be added if desired is provided.[127]

B. Canadian practice

1. Canada, of course, provides multiple forms of recognition for foreign taxes. Outside the foreign affiliate system, there is a relatively standard foreign tax credit under s. 126 of the Act. The foreign affiliate rules include exemption (for the distribution of exempt surplus to a corporate shareholder) and a grossed-up deduction that is like a tax credit but insensitive to domestic tax rates (for taxable surplus and FAPI). The Canadian treaty policy is not to provide enterprises of a treaty partner treatment more beneficial than the domestic system. Therefore, the realistic negotiating interest of other contracting states is to ensure that the benefits of the domestic system will be preserved if Canada were to change (adversely) the rules of the game, and (or) ensure most favoured nation treatment as regards whatever system Canada may adopt from time to time.

[127] Commentary to Articles 23A and 23B, para. 52.

2. For many years, the Canadian model Article 23 followed the domestic system by establishing two rules.

a) The credit granted in s. 126 is effectively promised to the treaty partner: tax payable in the other state on profits, income or gains arising there may be deducted from any Canadian tax payable in respect thereof. This is usually subject to three qualifications. First, the credit is subject to the existing provisions of the Act, and thus, in particular, to the proportionate and other limitations on foreign tax credits in s. 126. Second, it is subject to any subsequent modification of those provisions; i.e., the reference to Canadian tax law is ambulatory. An important aspect of this qualification is the addition in most treaties of something like "which shall not affect the general principle hereof." (The French and Moroccan treaties omit the word "general.") Absent such a qualification, and subject to a generic good faith requirement (see II.B.2 above), Canada could do most anything it liked with s. 126 short of repeal it. The scope of such "general principle" language is not well delineated.[128] The consistent use of "hereof" rather than "thereof," which appears in some other contexts, could be important. Third, the treaty rule is not meant to prevent any greater relief under domestic law from applying (which would not have been the case anyway).

b) With similar qualification regarding the existing provisions of the Act and subsequent modifications not affecting the general principle, these treaty Articles also provide that a company resident in Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate which is a resident of the other state.

3. At some point, the Canadian negotiators decided that granting a preservation of exempt surplus, even with the "subsequent modification" qualification, was giving away more than required. As noted, the OECD Model does not establish any indirect credit rule.

a) As a result, most, but not all, treaties signed after around 2000 do not include the exempt surplus rule (exceptions include Belgium in 2004).

b) These newer treaties may include only the direct foreign tax credit provision (Algeria, Czech Republic, Jordan, Luxembourg, Rumania, UAE) or may also specify an indirect credit. However, in the latter case, the indirect credit does not expressly preserve exempt surplus treatment. Rather, these provisions (Australia,

[128] For an example in a different context, see note 134 below.

Finland, Germany, Ireland) state that, subject to the existing provisions of the law of Canada regarding the allowance as a credit against Canadian tax of tax payable in a territory outside Canada and to any subsequent modification of those provisions – which shall not affect the general principle hereof – where a company which is a resident of the other state pays a dividend to a company which is a resident of Canada and which controls directly or indirectly at least 10% of the voting power in the first-mentioned company, the credit shall take into account the tax payable in the other state by that first-mentioned company in respect of the profits out of which such dividend is paid. I repeat the text because I find it curious. After all, Canada does not in fact allow such a credit. I imagine the intention is to promise that the treatment of treaty residents will be no worse than a credit, or perhaps that if there ever is a credit, then these treaty residents will get it. In any event, so long as Canada maintains (or, following the 2007 budget, expands) its exemption system, it seems unlikely that enterprises will be in a position to complain. If there is a case in which a credit would be more advantageous than an exemption, there could be a problem.

c) When treaties started to appear with this form of Article 23, there was a concern among practitioners that perhaps the new policy presaged a repeal of exempt surplus. Finance officials denied this and the 2007 budget, to the contrary, expands rather than contracts the scope of exempt surplus. Indeed, since it will no longer be linked to comprehensive tax convention status, the treaty provision in Article 23 may become of less interest.

4. There are always exceptions and an interesting one regarding Article 23 is Brazil (it is Article 22 in that treaty). It contains no qualification regarding Canadian law or subsequent modifications. Where a resident of Canada derives income which, in accordance with the provisions of the 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. This seems to establish an independent foreign tax credit that makes no reference to s. 126. There is no "general principle" to be attended to. The text itself contains some limitations but, for example, would ss. 126(4.1) or (4.2) apply? There is also a provision for relief in respect of underlying Brazilian tax on a corporation in which a Canadian corporation has a 10% or greater interest, again free-standing, without reference to Canadian domestic law.

5. The Canadian treaty Articles contain a sourcing rule providing that, for

purposes of the provisions regarding the elimination of the double taxation, profits, income or gains of a resident of one state which are taxed in the other state in accordance with the convention shall be deemed to arise from sources in that other state. In theory, this should eliminate source arguments. If the other state can and does tax the income, Canada must allow the credit provided in the treaty even if, in applying s. 126, a different source might be considered to be appropriate. However, Canada may still claim that the other state did not tax the income in accordance with the convention. Also, recall the source rule for gains in s. 6.3 of the ITCIA.

6. Many Canadian treaties contain "tax sparing" provisions, under which Canada agrees to provide relief for tax not actually paid. Of course, to the extent the underlying income is from an active business and is earned by a subsidiary corporation, rather than a branch, the exempt surplus provisions eliminate the need for tax sparing. This concept is, however, relevant to branches and to other forms of income, such as interest and royalties. The policy rationale for tax sparing is not universally accepted,[129] but Canada has agreed to it in some three dozen treaties, mainly but by no means exclusively with developing countries. The common mechanism is to provide that tax payable in the other state is deemed to include tax that would have been payable but for some particular, specified law. Brazil is, again, exceptional in that tax is generally deemed to have been paid at 25% on dividends and 20% on interest and royalties, and 25% on underlying profits for the indirect tax recognition rule, without any reference to particular incentive legislation. The character of the "independent" foreign tax credit under the Brazil treaty has been challenged by the CRA in a structured finance situation involving a claim for tax sparing credit.[130]

7. The number of tax sparing conventions has been declining. There are still more than 30, but in a few recent cases in which tax sparing treaties were replaced with new treaties, tax sparing disappeared (Mexico, Korea, Romania). I believe this is not mere coincidence, related to some change in the local law, but reflects rather a policy of Finance to restrict if not eliminate such provisions.

8. Article 23 is fundamental to the bilateral tax conventions. It gives effect to the preambular goal of eliminating double taxation. The Canadian

[129] Many of the arguments are canvassed in a policy statement issued by the International Chamber of Commerce, "Tax Sparing in Conventions," December 1, 2005, http://www.iccwbo.org/uploadedFiles/ICC/policy/taxation/Statements/180-486%20Final%201-12-05.pdf

[130] *6024530 Canada Inc. (formerly 595864 B.C. Limited) v. The Queen*, TCC 2007-2233(IT)G. Pleadings were filed in 2007. The appellant is an indirect subsidiary of Royal Bank of Canada.

approach limits its application by making it subject to ambulatory Canadian law. This partially reverses the superior authority of the treaty over the Act, such reversal being limited by the restriction on subsequent modifications affecting Article 23 if they do not conform to the "general principle hereof." Since Canadian domestic relief is normally at least as generous as the OECD Model credit system, and the likelihood of this changing is relatively small, this effective reversal of priority does not have too many practical consequences. It probably allows Canada to insert anti-avoidance provisions without resorting to the GAAR or treaty abuse concepts, and to tweak the mechanics of recognition. There is one aspect of the Canadian rules in s. 126 that is considerably less generous than the OECD Model. This relates to timing. The domestic foreign tax credit does not carry forward indefinitely. It appears that the OECD credit provision does. However, the limitation to "the existing provisions of Canadian law" would seem to import domestic restrictions on carry-overs. Unrelieved double taxation can, therefore, still arise.

X. **Non-discrimination**

A. International norms

1. Article 24 of the OECD and UN Models provide several anti-discrimination rules, including:

a) Nationals of one state, wherever resident, shall not be subjected in the other state to any taxation or any requirement connected therewith which is other or more burdensome than that to which local nationals in the same circumstances are or may be subjected. The Models clarify that the expression "same circumstances" includes residence (para. 1).

b) The taxation on a PE of an enterprise of the other state shall not be less favourably levied than the taxation levied on a local enterprise carrying on the same activities (para. 3).

c) Interest, royalties and other disbursements paid by an enterprise of one state to a resident of the other are deductible (para. 4)).

d) Enterprises of one state, the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of the other state, shall not be subjected in the first-mentioned state to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which similar local enterprises are or may be subjected (para. 5)

2. Non-discrimination under EU law, or what is really a broader, positive conception of the "four freedoms," has led to a multitude of judicial decisions that strike at the heart of various aspects of national tax systems

that distinguish between locals and "foreigners."

3. Non-discrimination is one of the main subjects of this year's IFA congress in Brussels.

B. Canadian practice[131]

1. Canada reserved its position regarding Article 24. It does generally adopt the rule in Article 24(1) of the Models. In many, but not most cases, this includes the express clarification regarding "residence" being part of the "same circumstances." The Act does not, of course, distinguish taxation or connected requirements based on individual citizenship. However, there are provisions that apply only to a "Canadian corporation." The definition of that expression, at least for corporations incorporated after June 18, 1971, requires domestic incorporation. The definition is conjunctive – the corporation must also be resident in Canada. I assume the official view is that the rules applicable only to Canadian corporations (including some rather important ones, such as ss. 87 and 88, although no longer s. 219) are not, therefore, examples of discrimination based on nationality; i.e., the additional language in Article 24 regarding residence is for greater certainty. Indeed, this position is important more generally to preserve discrimination based on residence.[132]

2. Canada also generally adopts Article 24(3). PE taxation under the Act is not generally less favourably levied, the major exception being Part XIV tax. That, however, is separately protected in the conventions (sometimes in the non-discrimination Article, more often in the dividend Article). Actually, branches are sometimes *more* favourably taxed (e.g., no thin capitalization rule). An interesting issue is whether the application of s. 247 (and Article 9) to inter-company transactions as against the application of the new attribution of profits to a PE system under Article 7 could ever be discriminatory. Article 24(3) merely refers to the "same activities" and does not otherwise define "sameness."

3. Most Canadian treaties do not include a version of Article 24(4), regarding deductibility of expenses, although some do (Bulgaria,

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[131] A useful, if somewhat dated discussion is found in Brian J. Arnold, *Tax Discrimination Against Aliens, non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom and the United States*, Canadian Tax Paper no. 90 (Toronto: Canadian Tax Foundation, 1991), at 134-157.

[132] Para. 3 of the OECD Commentary to Article 24 expressed the view that the addition of the reference to residence in the Model was for greater certainty. However, concern has been expressed that this may not necessarily be correct, particularly where residence is determined on the basis of nationality: see OECD, Centre for Tax Policy and Administration, Committee on Fiscal Affairs, "Taxation and Non-discrimination," 23 February 2005, CTPA/CFA/WP1/WD(2005)7, para. 7.

Denmark, Mexico, Sweden, US). Since the Model provision refers to interest, and Canada does discriminate under s. 18(4), the treaties include language intended to protect the thin capitalization rule. In most cases this is accomplished by an express exception that refers to rules relating to the deductibility of interest in force on the date of signature of the convention (including any subsequent modification of such provisions that does not change the general nature thereof).[133] These "general nature" or "general principle" rules are fraught with uncertainty. It has been decided that the amendment to restrict the equity calculation to equity held by specified non-resident shareholders did not alter either one.[134] I find it interesting that in one case (Uzbekistan), there is a more generic form of protection, a statement that the Article shall not affect the provisions of the domestic taxation laws designed to counter transactions or arrangements having as their objective the avoidance of taxation. Is this a description of s. 18(4)?

4. Where Canada deviates most markedly from the Models is in its version of paragraph 5. A Canadian corporation wholly or partly owned by residents of the other state is not to be subject to other or more burdensome taxation and connected requirements than similar companies owned by residents of *a third state*. This replaces the Models' non-discrimination between foreign and domestic controlled companies with a most favoured nation rule and is meant to preserve provisions of the Act such as those favouring CCPCs. Since Part XIII tax is imposed on non-residents and not on Canadian corporations, presumably it cannot be maintained that either the tax or the withholding regime (connected requirements) is more burdensome in respect of, say, dividends because the shareholder is resident in a state that does not have the lowest Article 10 rate of all treaties. However, is it clear that there is never discrimination affecting Canadian resident corporations having regard to treaty comparisons? For example, although perhaps this is a stretch, Article 9 defines the associated enterprises to which it applies by reference to, inter alia, participation in the management, control or capital of an enterprise. If a state A corporation participated in the capital of Canadian corporation A, and a state B corporation in the capital of Canadian corporation B, could this mean that the taxation and related requirements on corporation A cannot be other or more burdensome than those on corporation B? While the taxation would not be different, since s. 247 makes no such distinction, some other requirements could be, such as the notification rules in the respective versions of Article 9.

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[133] This structure does appear to be sufficient to preserve the application of s. 18(4): *Speciality Manufacturing Ltd. v. The Queen,* 97 DTC 1511 (TCC). The OECD is considering problems relating to thin capitalization rules and the interaction of Article 9 and 24, which would seem to support the prudent Canadian practice of including express language: see OECD, "Taxation and non-discrimination," *supra*, note 132, para. 7.

[134] *Ramada Ontario Ltd. v. The Queen*, 94 DTC 1071 (TCC).

5. The US treaty is somewhat more expansive regarding various matters, especially affecting individuals. A noteworthy restriction, however, is that para. (1) applies to citizens, rather than nationals.

6. Section 247 does not apply to transactions between residents (although ss. 67 and 69 do). In Europe, concerns that transfer pricing regimes cannot survive EU law scrutiny led the UK to apply its rules to domestic residents as well. Section 247 does not, of course, refer to nationality, and does not offend the Canadian version of OECD Model Article 24(5) that is restricted to most favoured nation treatment. But, although s. 247 does not directly address deductibility, it may alter the quantum of a deductible expense, such as a royalty, and could be subjected to scrutiny where the applicable treaty contains the equivalent of OECD Article 24(4). There is no specific protection for royalties and other expenses as there is for interest. Although Canada might argue that s. 67 has the same effect where the recipient of the payment is a resident, the standard is clearly different from s. 247(2).

7. The Ontario add-back for management fees and royalties (s. 11(5)) is analogous to thin capitalization and could well be a colourable attempt to deny a deduction, contrary to the non-discrimination Article in treaties that deal with deductions. However, this provision of the treaties has not been incorporated into Ontario law. Under the new collection arrangements, it would seem that this element of the Ontario base determination should not be allowed, not being "consistent with Canada's international obligations."[135]

XI. Miscellaneous Rules

A. FAPI

1. Most of the treaties expressly preserve Canada's jurisdiction to tax FAPI, sometimes broadly described as amounts included in the income of a resident of Canada with respect to a partnership, trust, or controlled foreign affiliate, in which that resident has an interest. The provision may be reciprocal, and may contain special language for other countries' CFC systems.

2. Absent this provision, there might be an argument whether, at least in some cases, the imposition of tax on FAPI is contrary to Article 7 or some other treaty provision. The contention would be that taxation of the resident on income earned by a foreign affiliate is a colourable attempt to tax income of the foreign affiliate that is not liable to tax in its hands

[135] MOU, *supra,* note 27, App. B, s. 3.4(c).

because of the treaty, such as business profits of the foreign affiliate not attributable to a PE in Canada. This kind of argument has been both successful[136] and unsuccessful[137] in the context of other tax systems. If the approach in those cases were followed in Canada, it seems likely that our FAPI rules would not present this difficulty, in which case the miscellaneous rule is for greater certainty.

B. Domestic tax benefit

1. Canadian treaties commonly provide that they shall not be construed to restrict any exemption, allowance, credit or other deduction accorded by domestic laws of the contracting states. This provision seems to derive from a long-standing US practice. It is not in the OECD or UN Models.

2. While confirming the often expressed principles that treaties only reduce rather than increase tax liability, the provision could have other effects which seem rarely to have been considered.[138] One can dream up circumstances in which double benefits might be claimed (such as two foreign tax credits) or inconsistent treatment of the same item of income.

C. Taxation of residents

1. The US treaty contains a rule that is, in a way, the flip side of the domestic benefit rule: nothing in the convention prevents the resident state from taxing its own residents and, in the case of the US, its citizens (Article XXIX(2)). This could prevent results such as that which obtained in the UK *Padmore* case (see III.E.7.e) and was attempted in *Kelly Edwards* (see III.B.3). There is more scope for the application of Article XXIX(2) in the case of US citizens, as they may well be Canadian treaty residents.

2. Article XXIX(2) extends, in the case of the US, to formers citizens where the loss of citizenship had as one of its principal purposes the avoidance of tax, for a period of 10 years. The 2007 protocol provides a more accurate reflection of current US law. It permits US taxation of all former citizens or long-term residents on income from source in the US for 10 years.

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[136] In France: *Schneider Electric*, Cour de Cassation, June 28, 2002, n° 232276.

[137] In the UK: *Bricom Holdings Ltd. v. CIR*, [1997] STC 1179 (Court of Appeal) and Finland: Decision of the Supreme Administrative Court 2002:26.

[138] An exception is the detailed analysis by Brian J. Arnold, "The Relationship Between Tax Treaties and the Income Tax Act: Cherry Picking," (1995), vol. 43, no. 4 *Canadian Tax Journal*, 869-905.

D. Remittance

1. Canada does not, of course, have a system of remittance-based taxation but it seems that about a dozen treaty partners do. These treaties (Bulgaria, Cyprus, Ireland, Malta, Singapore, UK) include a kind of limitation of benefits provision (sometimes so named) that limits any treaty relief in Canada. Where a person is subject to tax under the law in force in the other state in respect of income otherwise eligible for relief by reference to the amount thereof which is remitted to or received there, the relief applies only to so much of the income as is taxed in the other state. The reference to income "taxed in" could be problematic. Is it meant to be the same as "liable to tax" in Article 4? Would the remittance rule deny treaty benefits to a non-resident who remits the income but has offsetting losses? That is surely not the intent, and one would assume that "taxed in" includes reduction of other tax attributes, or taxed (or potentially taxed) eventually.

2. There has been debate as to whether the reference to "income" includes capital gains.[139] I imagine the CRA would take the view that under our Act, "income" includes capital gains so that such gains are within the remittance provision, under either (or both) Article 3(2) or s. 3 of the ICTIA. Although s. 3 of the Act is not really a definition, the term "income" does have a meaning for purposes of the Act and that meaning does include capital gains. The argument that the remittance provisions does not apply to gains may, therefore, be rather more difficult to make in Canada.[140]

E. Pension contributions

1. About 10 treaties (Chile, Germany, South Africa, Switzerland) include a rule to facilitate labour mobility by prescribing local treatment for certain foreign pension contributions.

2. The rules are quite similar. Contributions paid by, or on behalf of, an individual who is a resident of or temporarily present in a contracting state (the "host state") to a pension plan that is recognized for tax purposes in the other state shall, during a period not exceeding in the aggregate 60 months, be treated in the same way for tax purposes in the host state as a

[139] The only decided case I know of concerns what may be a slightly narrower question relating to the reference to "income from a source" in the remittance Article of the UK-Sweden treaty, which was the subject of a Swedish court decision. See JF Avery Jones and JDB Oliver, "How Others See Us," [1988] *British Tax Review* 437-440 and a rejoinder by Peter Sundgren, "Interpretation of Tax Treaties – A Case Study," [1990] *British Tax Review* 286-302. I thank Scott Wilkie for bringing these Articles to my attention.

[140] But recall the judicial doubt regarding computational rules and definitions expressed in *Hale*, supra, n. 120.

contribution paid to a pension plan that is recognized for tax purposes there, provided that the individual was contributing on a regular basis to the pension plan immediately before he became a resident of or temporarily present in the host state and the competent authority of the host State agrees that the pension plan corresponds to a pension plan recognized by that state for tax purposes.

F. Death

1. Canada imposed an estate tax until 1972 (the provinces persisted with succession duty thereafter until the last, Québec, gave way in 1986). The federal government had entered into estate tax treaties with a few other countries that imposed similar taxes. These were terminated following repeal of the federal regime. Canada continued to impose tax occasioned by death, but in a manner that was neither conceptually nor mechanically susceptible of easy integration with traditional estate tax or succession duty regimes. In theory, the taxation of accrued gains on death is unrelated to "death taxes." These same gains might have been realized earlier, and the tax is in the nature of a tax on income, broadly defined, rather than on capital wealth. Nonetheless, it "feels" like double taxation.[141]

2. Article XXIXB of the US treaty provides several rules intended to "coordinate" Canadian and US tax treatment of death.

a) On the US side, there is, first, a charitable credit rule for charities of the other state. As well, US aliens who are Canadian citizens are allowed a pro-rated unified credit based on the proportion of the decedent's US situs property. The estate of a US citizen or resident receives an estate tax credit for the Canadian income taxes imposed at the decedent's death with respect to property situated outside of the US. The spousal credit is effectively extended to Canadians. Finally, if a Canadian non-US citizen's estate is no greater than USD 1.2 million, US estate tax applies only to property any gain from the alienation of which would be taxable by the US under Article 13. Whether any of this matters in the long run depends on the future course of US estate taxes.

[141] See Wolfe D. Goodman, QC, "Death Taxes in Canada, in the Past and in the Possible Future," (1995), vol. 43, no. 5 *Canadian Tax Journal* 1360-1376 at 1371: "While there are theoretical arguments in favour of imposing both [income taxes] on deemed realizations at death and death taxes on the net capital value of property owned at death, on the basis that the income tax liability arising at death is merely a sort of 'catch-up' for taxes forgone while the decedent continued to own appreciated property, the argument against double taxation is seen by most experienced practitioners as extremely strong. If anyone were to doubt this, he or she should consider the tremendous uproar about the combined imposition of US estate taxes and Canadian income taxes at death on Florida condominiums and other US vacation properties owned by many Canadians."

b) On the Canadian side, the spousal rollover in s. 70 of the Act is extended to US residents, and US Federal and state estate or inheritance taxes in respect of US property are allowed as a foreign tax credit against Canadian tax on the deemed disposition of US property. Returning to the policy consideration, the curiosity of such a rule, relieving though it is, is that Canadians holding US property that is liable to estate tax pay less Canadian income tax if they die with an accrued gain (against the tax on which the estate tax may be credited) than if they realize the gain before death and reinvest in another US property.

3. Article XXIII(2)(c) of the French treaty also provides some rather simpler coordination rules.

a) The French inheritance tax in respect of a French resident decedent is reduced by a deduction from tax for Canadian tax on gains taxable in Canada under the convention, up to the French tax attributable to that property. For a Canadian resident,[142] the deduction is for Canadian tax on gains taxable only in Canada under Article 13(4) (carving out the former resident rule in 13(5)), again restricted to the applicable French tax.

b) For a Canadian resident, Article XXIII(1)(c) prescribes a foreign tax credit equal to French inheritance tax (after the credit for Canadian tax) in respect of property situated in France (the credit is computed on a combined basis with any credit for other French tax in the year).

4. Welcome as these provisions are, they are isolated and have not become part of the Canadian "model." Other treaties remain silent on the matter. Perhaps there simply has been inadequate pressure on the Canadian negotiators. It should be observed that coordination rules such as these are, in any event, not a substitute for the terminated estate tax conventions, which included other provisions of value to Canadian decedents (or their heirs), including situs rules.

XII. Administration – Fiscal Evasion

[142] In a rather shocking example of "lost in translation," unofficial publications, including the Finance web site, produce the English versions of both subparagraphs (i) and (ii) of Article XXIII(2)(c) as referring to a deceased person resident in France. The second subparagraph should, of course, refer to a person resident in Canada, as it does in the French language version. See http://www.fin.gc.ca/news95/data/95-099_1e.html. Luckily, the references are correct in the official text: SI/99-19, C. Gaz. 1999. II. 712.

A. Exchange of information

1. International practice

a) The OECD Model Article 26, as recently revised, is robust and mandatory. Paragraph 1 provides that the competent authorities shall exchange such information as is foreseeably relevant for carrying out the provisions of the convention or to the administration or enforcement of the domestic laws concerning taxes of very kind and description. The requested state is obligated to assist even if it does not need the information for its own purposes (para. (4)). Bank secrecy rules are not a defence (para. (5)). There is provision for protection of confidentiality and a limitation on the requirement to gather information to normal domestic law and practice, as well as protection for public policy, and trade or business secrets. Before the 2005 revision, the OECD Model was more focussed on carrying out the convention and protecting against taxation contrary to the convention. Importantly, the basic test was not "foreseeably relevant" but "necessary." The UN Model is based on the older OECD Model.

b) A joint OECD and the Council of Europe multilateral convention on mutual administrative assistance provides not only for mandatory exchange on request, like Article 26, but also automatic (predefined classes of information) and spontaneous (grounds for believing there is leakage in the other state) exchanges. It is in force with some 15 signatories, including Canada.[143]

c) The OECD, as an offshoot of its harmful tax practices project, has promoted the execution of tax information exchange agreements (TIEAs) and provided a model text in multilateral and bilateral versions.[144] There are perhaps 15 bilateral treaties of this sort now in place, most entered into by the United States. The US TIEAs are mainly with countries with which it does not have a comprehensive tax treaty (Brazil), or probably never will (Cayman Islands, BVI, Jersey, Guernsey), but also include one treaty country (Netherlands). Generally, these TIEAs provide for mandatory exchange of information on request to facilitate

[143] For details, see Robert Couzin, "Imposing and Collecting Tax," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003), 171-200 at 187. Since that paper, there have been more signatories. Canada signed April 28, 2004: http://www.treaty-accord.gc.ca/Details.asp?Treaty_ID=104994. For a general statement on anticipated practice under this multilateral convention, see Income Tax Technical News no. 34, April 27, 2006.

[144] Available at http://www.oecd.org/dataoecd/15/43/2082215.pdf.

administration and enforcement of tax laws (although the "exchange" is likely to be somewhat one-sided, in practice). The types of information are spelled out in some detail. There may be outs for privileged information, public policy, discriminatory taxes, etc.

2. Canadian agreements

a) The comprehensive tax treaties contain exchange of information provisions that generally reflect the OECD Model in effect at the time, primarily the pre-2005 version. Some older treaties are a bit sketchier but to the same general effect (Barbados, Dominican Republic, Malaysia). In these treaties (but also in a number of later ones, e.g., Portugal), the exchange of information provisions lack the common requirement that the requested state seek the information as if its own taxation were involved, and without regard to whether it needs the information. Canada is following the OECD 2005 revision in its most recent treaties (Finland, Korea, Mexico). The provision in the Netherlands convention is restricted to the carrying out of the convention and taxation not in accordance with the convention (effectively, the pre-2005 OECD approach) and is very brief; it was amended in 1997 to eliminate the usual rule excusing exchange for public policy and other grounds. The Swiss treaty is more restrictive. It only refers to information at the disposal of the states in the normal course of administration (effectively, the reverse of the OECD approach). Although the US treaty does not reflect the 2005 OECD update, it does use a test of "relevant" rather than "necessary." The 2007 US treaty protocol updates and expands the exchange of information rules. Lest there be any doubt on the matter, the Exchange of Notes (Annex B) stipulates that the standards and practices under the treaty "are to be in no respect less effective" than the OECD model.

b) Canada has recently followed the US lead, and OECD suggestion, announcing in the 2007 federal budget its intention to enter into TIEAs with non-treaty countries. The budget also indicated that both free-standing TIEAs and the exchange of information Articles in bilateral comprehensive tax treaties will henceforth include the revised OECD standards.

3. Statutory authority for collecting information in Canada for transmission to other governments under treaties is to be found in s. 231.2(1) of the Act. It refers[145] to tax treaties (as defined in s. 248(1), i.e., comprehensive tax conventions) as well as any "listed international

[145] Or will upon the passage of legislation pending at the time of writing.

agreement," defined in s. 248(1) to include an agreement with Mexico and the OECD/Council of Europe multilateral agreement referred to above. With respect to the reference to tax treaties, the amendment removes any doubt as to the CRA's legal authority to use its powers of information gathering in furtherance of a foreign rather than a domestic tax matter.[146] The inclusion of the multilateral convention was probably considered a necessary precondition to ratification. Subsection s. 231.2(1) is to be amended to refer to TEIAs.[147]

4. The Canadian practice is to engage in automatic, spontaneous and requested exchanges of information. An example of the first is routine exchanges of information reporting slips with other tax administrations. Spontaneous exchanges do occur, but it is not clear how often. Organized efforts such as the Joint International Tax Shelter Information Center are, in a way, offshoots of the spontaneous exchange concept. Specific exchanges are made in both directions under treaties. There is no legal or, it would seem, administrative requirement to exhaust domestic enforcement powers, including foreign based document requests, before having recourse to treaty exchange provisions, or vice versa.[148]

5. The dynamics of treaty policy, and the relationship between TIEAs and comprehensive treaties, will be affected by the proposed changes to the scope of exempt surplus.

B. Assistance in collection

1. Article 27 of the OECD Model dealing with assistance in the collection of taxes was added as part of the 2003 update. Essentially, it obliges each state to collect valid revenue claims (unrestricted by Article 1 and 2 of the convention) of the other state against anyone. This reverses the so-called "revenue rule" that has made enforcement of foreign tax claims difficult if not impossible in many countries.[149] There are various potential limitations or variations to Article 27 set out in the OECD

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[146] The power to use s. 231.2 for this purpose was affirmed by the FCTD in *Montreal Aluminium Processing Ltd. v. AG Canada*, 91 DTC 5424 but the decision was reversed by the FCA on the ground that the text of the demand was misleading, as it referred to administration and enforcement of the Act, rather than information gathering for the IRS under the treaty: 92 DTC 6567. The FCA did not comment on the underlying question of validity of a properly framed demand. This is presumably why the reference to a "tax treaty" is "for greater certainty."

[147] Bill C-28, s. 63, in first reading at the time of writing.

[148] In *Saipem Luxembourg SA v. CRA*, 2004 FC 113 (FCTD), affirmed without reference to this point at 2005 FCA 218 (FCA), the taxpayer unsuccessfully attempted to set aside a s. 231.6(4) requirement on the ground, inter alia, that it bypassed the provisions of the relevant convention.

[149] Including Canada. See Robert Couzin, "Imposing and Collecting Tax," *supra*, note 143, at 188-195.

Commentary. The Article is sufficiently controversial that it sports a footnote observing that in some countries, national law, policy or administrative considerations may not allow or justify such assistance.

2. Canada has gingerly adopted the concept of assistance in collection in some treaties, but not the full-blown OECD version.

> a) In a few treaties, (Germany, Netherlands, Norway) the Article adopts the OECD approach but crucially states that the requested state "may" rather than "shall" accept the claim by the requesting state. Nonetheless, this is a major step.
>
> b) Canada also adopts one of the OECD proposed "collection lite" versions, dealing only with assistance in collection to the extent necessary to ensure that relief granted by the convention does not enure to the benefit of persons not entitled to it (Austria).
>
> c) The US treaty contains both a provision for limited assistance to deny inappropriate relief (Article XXVI(4)) and a more expansive assistance in collection rule (Article XXVIA). Once again, the latter Article is facultative rather than mandatory. It also contains a curious limitation that no assistance will be provided in connection with claims against an individual for a period when he or she was a citizen of the requested state, or another entity when it derived its status from the laws of the requested state. Thus, a state is not obliged to consider a request for collection of taxes owing by its own citizens or domestic corporations.

3. The operation of the US treaty provision is illustrated in *Chua v. MNR.*[150] The taxpayer was pursued for taxes said to be incurred in the US before she had become a Canadian citizen. Canada accepted the request. The taxpayer unsuccessful raised various procedural and constitutional arguments against a certificate judgment obtained by Canada. She successfully, however, defended herself in reliance on s. 15 of the *Charter of Rights and Freedoms* because of her peculiar factual situation: she was a Canadian citizen at the time of the collection proceedings but, at the time of disposing of US real property (giving rise to the US tax liability), only a permanent resident. The Court decided that the protocol set up two classes of Canadian citizens, "Convention citizens" and other citizens, and purported to deprive the former of rights enjoyed by the latter. It is ironic that the inclusion of the citizenship rule, which was at US rather than Canadian insistence, prevented the IRS from resorting to assistance in collection. Nothing has yet been done about this issue. It seems that Canada must legislate in order to preserve the ability of the US to have recourse to the assistance in collection in Canada.

[150] 2000 DTC 6257 (FCTD).

XIII. **Competent Authority Procedures**

A. Competent authority mutual agreement procedure ("MAP")

1. Each contracting state names a "competent authority" to represent it in consultations and procedures as set out in the relevant treaty. Although particularly associated with dispute resolution, the competent authorities have several potential roles.

a) General consultation is foreseen in Article 25(3) of the OECD and UN Models: "The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention." While likely to arise out of cases involving particular taxpayers, such competent authority agreements address generic problems. An example is the competent authority agreement referred to above regarding the treatment of interest under the UK treaty before the "other income" Article was added (see IV.J.3.b). A second form of general consultation referred to in this same paragraph of the Models refers to the elimination of double taxation in cases not provided for in the convention. This seems to suggest a process of supplementing the terms of the treaty.

b) Each competent authority is unilaterally mandated by Article 25(1) of the Models to consider and attempt to resolve, outside the scope of otherwise available domestic remedies, cases in which it is alleged that the actions of one or both states results in taxation not in accordance with the convention. If such competent authority feels the taxpayer's concern is justified but it cannot itself arrive at a satisfactory solution, it shall endeavour to resolve the case by mutual agreement.

c) Outside the confines of Article 25, the competent authorities are afforded other areas of competence or responsibility. Best known is Article 9, the source of the MAP cases on transfer pricing (see IV.G above) but there are many other examples: dual residence determinations, the implementation of various limitations on withholding tax rates, exchange of information and assistance in the collection of tax, updating dollar limits in treaty articles such as the dependent services provision, the modalities of S corporation treatment under Article XXIX(5) of the US convention, and the treatment of reorganizations under Article 13(8). While s. 115.1 provides legal authority for some of these agreements, and others may be said to derive their force from the legislative instrument that is the treaty itself, the competent authorities appear to make, or be asked to make, agreements that are not evidently within the

scope of the legal framework of tax treaties. Thus, while undoubtedly welcome news to Norwegian teachers and professors in Canada who were caught by an unforeseeable change in the convention in 2002, the legal basis of the transitional relief offered by the competent authorities in 2003 might be questioned.[151]

d) Most competent authority agreements concern particular taxpayers, as in the resolution of transfer pricing disputes, and, not surprisingly, are confidential. However, many of the other classes of agreement referred to above are of general application. Presumably, it is appropriate that these be available to those who might have an interest. This is not always the case. The UK-Canada agreement regarding interest was never, to my knowledge, published. An agreement regarding the interpretation of Article XXI of the US treaty was made public by the IRS but, it seems, a request to the CRA was denied on the grounds that it is "information obtained in confidence" from the US![152]

2. Process can be important in competent authority proceedings. There are some particular rules and, indeed, competent authority agreements, regarding the process.

a) The best known recent example is the 2005 MOU between the Competent Authorities of Canada and the United States Regarding Factual Disagreements under the MAP.[153] This was an attempt to relieve perceived blockage in the transfer pricing MAP process between the two countries.

b) Some aspects of the competent authority process as set forth in the conventions gives direction to the deliberations. For example, the tie-breaker rule in Article 4 may direct the competent authorities to take certain stated matters into consideration. In the Austrian treaty, there is an express undertaking to endeavour to agree to the same attribution of profits to a PE and of income under Article 9.

c) The Article 25 MAP in the Models does not address domestic time limits. As previously noted, a time restriction is generally included in Article 9 of the Canadian treaties (see IV.G.5.b). Most

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[151] "New Competent Authority Agreement regarding the Professors and Teachers Article," CCRA News Release, December 3, 2003.

[152] See Paul Carenza, "Competent Authority Agreement?" (2002) vol. 10, no. 10 *Canadian Tax Highlights* 78. The document the CRA cannot release to preserve confidentiality is summarized in IRS Guidance, Notice 99-47, available at http://www.irs.gov/pub/irs-tege/n99-47.pdf.

[153] December 8, 2005: http://www.cra-arc.gc.ca/tax/nonresidents/comp/MOU_Appeals.pdf.

of these, but by no means all, include a similar restriction in Article 25, thereby applying a time limitation to matters outside the scope of Article 9. The Article 25 time limit in the Barbados treaty was recently considered by the FCA in a somewhat unusual context.[154] In this case, there was a potential conflict between this rule and the rather general language of the miscellaneous provisions Article that "nothing in this Agreement shall be construed so as to prevent Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91…." Did the language "nothing in this agreement" effectively override the time limit in Article 26(3)? The answer was that it did.

B. Arbitration

1. A matter may not be accepted for competent authority consideration, the competent authorities may not reach an agreement (or agree to disagree), or they may agree to something the taxpayer considers not to be in accordance with the convention. Such concerns have led over the years to calls for a supplementary dispute resolution regime, most often arbitration (although mediation or other ideas have been floated). Until relatively recently, the OECD and most of its members seemed to fall somewhere between uninterested and actively opposed. In 2006, however, there was a breakthrough with an OECD draft report proposing a mandatory, binding arbitration provision to be added to the treaties. It did not provide business groups and private practitioners all they had asked for, but it was a significant step forward. The report was adopted in February 2007.[155]

2. The new paragraph 5 of Article 25 applies where a case has been presented to the competent authority under paragraph 1 and no agreement has been reached to resolve it within two years. The provision requires that "any unresolved issues" shall be submitted to arbitration if the person who submitted the case so requests, but not if a decision has already been rendered by a court. The arbitration decision is binding on both states unless the taxpayer directly affected does not accept the mutual agreement that implements the decision, and shall be implemented notwithstanding

[154] *CanWest Mediaworks Inc. v. The Queen*, 2007 FCA **, reversing 2006 TCC 579.

[155] "Improving Mechanisms for the Resolution of Tax Treaty Disputes," February 2007, OECD (http://www.oecd.org/dataoecd/17/59/38055311.pdf). The build-up to this initiative includes activism by the taxation commission of the International Chamber of Commerce and a major study sponsored by IFA. See the ICC papers on "Arbitration in International Tax Matters" of 3 May 2000 and 6 February 2002 (at http://www.iccwbo.org/policy/taxation/id442/index.html and http://www.iccwbo.org/policy/taxation/id442/index.html); David R Tillinghast and William W. Park, *Income Tax Treaty Arbitration* (Sdu Fiscale & Financiële Uitgevers 2004). For an analysis of the OECD proposal, see Marcus Desax and Marc Veit, "Arbitration of Tax Treaty Disputes: The OECD Proposal," (2007) 23 *Arbitration International* 405 – 430.

domestic time limits. There is no procedure set out in the Model provision. This is left to the competent authorities but the OECD paper does provide a model for a procedural system.

a) Note that unresolved issues, rather than the case itself, are referred to arbitration. This has caused some concern with respect to what is meant by an issue and how the competent authorities might define (or limit) what can be the subject of arbitration. This notion of "issue arbitration" is meant to reinforce the government perspective that arbitration is merely an extension of the MAP, rather than an independent or parallel dispute resolution methodology. It is intended to remove a roadblock to the MAP after which the case goes back to the competent authorities to conclude an agreement taking the arbitration decision into account. Under the EU Arbitration Convention, the competent authorities are expressly permitted to pre-empt arbitration by reaching an agreement. While the OECD version does not say this, the same result may be inferred as once the "issue" is resolved, the arbitration becomes moot. That appears to be the intention, as is noted in paragraph 20 of the sample mutual agreement on procedure included in the OECD paper.

b) The scope of arbitration is not limited to transfer pricing, even though this is by far the most common subject of MAP determinations. Some countries may, in fact, choose to impose such a limitation but the OECD approach could extend to any issue of interpretation and application of the convention.

c) There is no express requirement to eliminate double taxation, although this is obviously what the process is all about. The business proposal that a taxpayer should be able to seek arbitration even if the competent authorities agreed, but did so in such a manner that double taxation was not fully relieved (or even where double taxation was relieved but the solution is not in accordance with the treaty) was not accepted.

d) Although the private sector did not get everything it wanted in terms of taxpayer participation, the sample mutual agreement on procedure does include a substantial level of such participation.

3. Canada can be expected to adopt the OECD form of tax treaty arbitration in conventions in the fullness of time, as they are amended or replaced. In the meantime, it is noteworthy that over a dozen Canadian conventions already contain an arbitration provision, albeit rather less robust. These clauses, included as part of Article 25, apply if there is doubt or difficulty interpreting the convention that cannot be resolved by the competent authorities and they both agree. No procedure is set out; this is

to be established by a subsequent exchange of notes. In most cases, the arbitration, if it occurs, is said to be binding (Germany, South Africa) and arbitration requires that the taxpayer agree to be bound (Mexico, Ecuador, Iceland). In a few treaties, this provision takes effect only following an exchange of notes (which has not, to my knowledge, occurred) (France, Kazakhstan, United States before the 2007 protocol). A fundamental aspect of the private sector arbitration proposals, gingerly but generally accepted by the OECD, is that arbitration must be available even if one of the competent authorities is not keen. One may, therefore, suspect that these existing treaty provisions will never be invoked.

4. The 2007 US treaty protocol contains an arbitration provision that reflects some, but not all, of the OECD Model. Arbitration under new Article XXVI(6) is mandatory and binding, but it is limited to cases that involve the application of Articles of the convention that have been agreed in an exchange of notes, and excludes cases that the competent authorities agree are not suitable for arbitration. The contemporaneous Exchange of Notes (Annex A) provides some of the missing information.

a) Arbitration may apply to cases under Articles IV, V, VII, IX, and the related person provisions of Article XII. They may only determine the amount of income, expense or tax reportable to a contracting state.

b) The competent authorities may resolve a case and terminate the arbitration. The taxpayer may also withdraw a request at any time.

c) The US was always concerned about a “judicial” style of arbitration, and the protocol certainly moves as far away from this as possible. Unlike the OECD Model, it foresees “baseball arbitration:” each state puts forth a specific monetary proposal and the arbitrators choose one or the other. Although the arbitrators may decide otherwise, the default procedure is purely by written communication. The taxpayer seems to have no role. The arbitration board “shall not state a rationale” and its decision “shall have no precedential value.”