

The Fifth Protocol to the Canada-U.S. Treaty - Part II

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I. New Permanent Establishment Rules for Cross-Border Services

II. Mutual Agreement Procedure and Binding Arbitration

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I. New Permanent Establishment Rules for Cross-Border Services

Changes Introduced by Protocol

4

- Deletion of article XIV (Independent Services)
- Follows deletion of corresponding article of OECD Model Convention in 2000
- Income derived from professional services or activities of independent character now dealt under article V and VII
- Introduction of article V(9) which deals explicitly with independent personal services and also with services of a commercial and industrial nature

Background

5

- With some departures of language and substance, new article V(9) is modeled after sample treaty provision suggested in 2006 OECD Public Discussion Draft "The Tax Treaty Treatment of Services: Proposed Commentary Changes"
- Sample provision was slightly revised in 2008 draft update to the OECD Model Convention

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Wording of Article V(9)

6

"Subject to paragraph 3, where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

- (a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or
- (b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment."

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OECD Sample Provision (with recent changes)

7

“Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

- (a) through an individual who is present in that other State ~~for~~ during a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
- (b) ~~for~~ during a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are **present and** performing such services in that other State ~~or are present in that other State for the purpose of performing such services,~~

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment ~~of that~~ the enterprise ~~situated~~ in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. ***For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.***”

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Background

8

- Sample provision is proposed as alternative to general PE standard for countries disagreeing with majority OECD position that current provisions of article 5 are appropriate to deal with cross-border services
- Sample provision intended to be mechanism that source countries could use to obtain more taxation rights but that would still follow certain basic principles
- Proposal has been criticized as inconsistent with role of OECD as consensus-building organization

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Background

9

- Sample provision is novel in the OECD context but its two prongs have roots in existing provisions of UN Model Convention
- First prong (and article V(9)(a)) transposes principles in article 14(1)(b) of UN Model Convention (which allows taxation at source if non-resident is present in source country for more than 183 days in any 12-month period)

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Background

10

- Second prong (and article V(9)(b)) is loosely based on article 5(3)(b) of UN Model Convention
- In past, Canada had frequently adopted provisions modeled after article 5(3)(b) of UN Model Convention when dealing with developing countries
- Recent tax treaty with Mexico was first instance where such a provision was incorporated in Canadian tax treaty with an OECD member country
- Article 5(3) of Canada-Mexico treaty went one step further by introducing provision for independent personal services modeled after article 14(1) of UN Model Convention

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Interpretative Framework

11

- Given the "roots" of article V(9), what extrinsic aids will have the most weight in its interpretation:
 - ▶ Commentary to UN Model Convention?
 - ▶ 2006 OECD Public Discussion Draft on Treatment of Services?
 - ▶ Final 2008 OECD commentary to article 5?
 - ▶ New Technical Explanation to Canada-US tax treaty?

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General Scope of article V(9)

12

- Application subject to article V(3) ("building site provision")
- Protocol amends article V(6) ("preparatory and auxiliary exception") so that article V(9) is added to list of provisions in article V that can be overridden by article V(6) where fixed place of business is used solely for certain specific preparatory and auxiliary activities
- Given that article V(6) will often apply to deem a PE in precisely situations where there is no fixed place of business, unclear how article V(6) could ever override article V(9) in those cases even when the services are of a preparatory and auxiliary nature

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General Scope of article V(9)

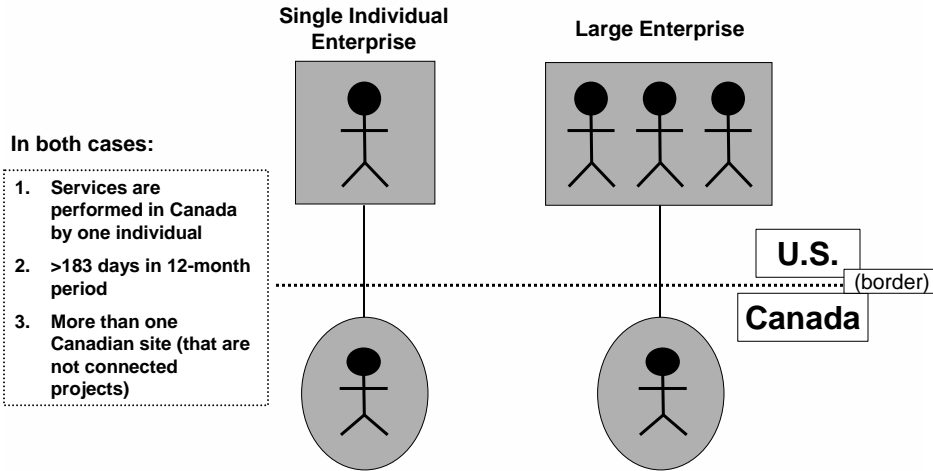
- Preamble specifies that article V(9) applies only where an "enterprise of a Contracting State" provides services in the other Contracting State in circumstances described in either (a) or (b)
- Meaning of "enterprise of a Contracting State" is left undefined
- OECD Model Convention and certain other Canadian tax treaties define term as "enterprise carried on by resident of a Contracting State" and "enterprise" as applying to the carrying on of any business

General Scope of article V(9)

- Paragraph 10 of the commentary to article 5 of the OECD Model Convention provides that the business of an enterprise is carried on mainly by entrepreneur or persons who are in paid-employment relationship with the enterprise (personnel)
- This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents) but would typically exclude independent agents and contractors
- Concept of service is left undefined and is pivotal to general scope of provision

General Scope of article V(9) Example 1

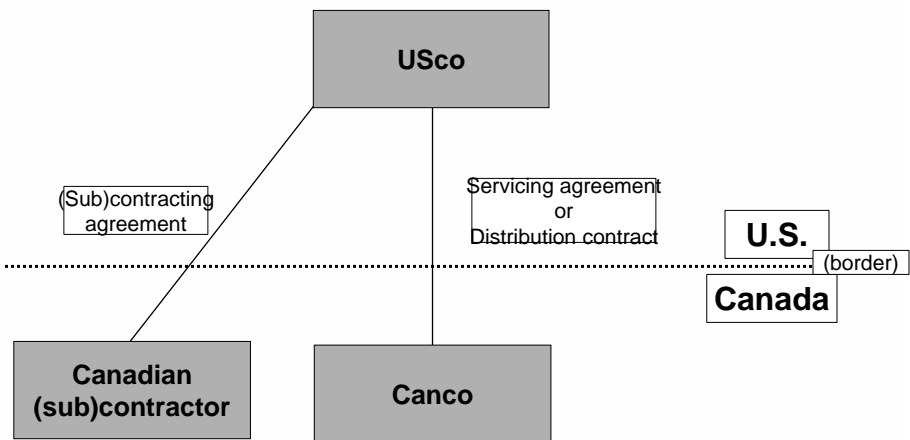
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General Scope of article V(9) Example 2

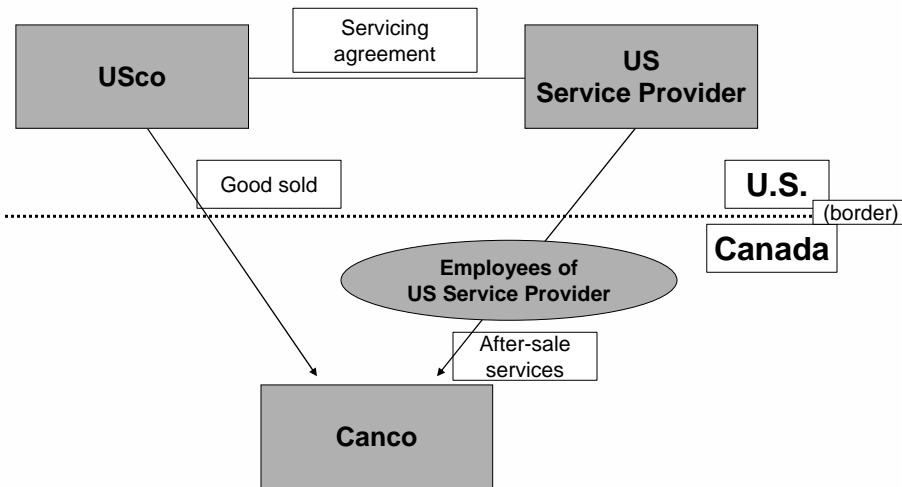
16



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General Scope of article V(9) Example 3

17



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Scope of article V(9)(a)

18

- Applies primarily to specific situations where US enterprise is carried on by single individual performing services in Canada
- Could cover exceptionally cases where US enterprise, whether in the form of a partnership or a company, derives most of its active revenues from services provided in Canada
- Two main conditions:
 - ▶ Individual by which services are performed be present in Canada during a period or periods aggregating 183 days or more in any 12-month period
 - ▶ More than 50% of the gross active business revenues of the US enterprise consist of income derived from the services performed in Canada by that individual

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Scope of article V(9)(a)

19

- First condition: individual by which services are performed be present in Canada during a period or periods aggregating 183 days or more in any 12-month period
 - ▶ Day count test for relevant 183 days threshold does not require that individual be performing services for compensation in Canada or even that its presence in Canada be for the purpose of performing such services
 - ▶ Simply includes all days of physical presence in Canada of individual by which the services are performed
 - ▶ Are "days of physical presence" method used for article 15(2)(a) of the OECD Model Convention applicable here?
 - ▶ Relevant 183 days threshold is linked to a "rolling" 12-month period

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Scope of article V(9)(a)

20

- Second condition: more than 50% of the gross active business revenues of the US enterprise consist of income derived from the services performed in Canada by that individual:
 - ▶ Gross active business revenues of US enterprise not necessarily limited to active revenues relating to provision of services
 - ▶ Revenues would exclude income from passive investment activities

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Scope of article V(9)(b)

21

- Applies primarily to specific situations where US service provider (i.e., US enterprise whose business is carried on by more than one individual) performs services in Canada through more than one individual
- May also apply to certain situations where a US service provider performs services in Canada through one individual and fails to meet the gross revenue test under article V(9)(b)

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Scope of article V(9)(b)

22

- Three main conditions:
 - 1) US enterprise performs services in Canada during a period or periods aggregating 183 days or more in any 12-month period
 - 2) Service are provided with respect to the "same or connected project"
 - 3) Services are for customers who are either residents of Canada or who maintain a PE in Canada and the services are provided in respect of that PE

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Scope of article V(9)(b)

23

- First condition: US enterprise performs services in Canada during a period or periods aggregating 183 days or more in any 12-month period
 - ▶ Two important differences between this test and one set out in article V(9)(a):
 - ◆ Focuses on actual performance of services in Canada rather than mere physical presence in Canada
 - ◆ 183 day threshold applies to the US enterprise itself rather than to an individual - not necessary that the same individual perform the services for 183 days through any 12-month period

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Scope of article V(9)(b)

24

- First condition: US enterprise performs services in Canada during a period or periods aggregating 183 days or more in any 12-month period (continued)
 - ▶ No anti-avoidance rule similar to one found in Canada-Mexico treaty or discussed in 2006 OECD Public Discussion Draft on Treatment of Services accompanies article V(9)(b)
 - ▶ Such rule would aggregate time spent by associated enterprises in performing substantially similar services in Canada for purposes of 183 day threshold
 - ▶ GAAR? If so, compare with Canadian position regarding treaty-shopping

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Scope of article V(9)(b)

25

- Second condition: Service are provided with respect to the "same or connected project"
 - ▶ Covers performance of services at multiple sites in Canada but only where these projects are "connected"
 - ▶ In paragraph 2 of Annex B to Protocol, Canada and the US have agreed that, for the purposes of article V(9)(b), projects will be considered "connected" if they constitute a coherent whole, commercially and geographically
 - ▶ Reference is presumably to corresponding concept used in OECD commentary to article 5 (although this is never stated)

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Scope of article V(9)(b)

26

- Second condition: Service are provided with respect to the "same or connected project" (continued)
 - ▶ Concept of "coherent whole, commercially and geographically" used initially to determine whether building site is an individual site or project for purposes of 12-month test in article 5(3)
 - ▶ 2003 changes to OECD commentary to article 5 then made concept relevant in applying concept of "fixed place of business" in article 5(1)
 - ▶ Separate projects involving the provision of services of a same or similar nature, with same or related clients, and are carried on within limited geographical area?

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Scope of article V(9)(b)

27

- Third condition: Services are for customers who are either residents of Canada or who maintain a PE in Canada and the services are provided in respect of that PE
 - ▶ Concept of "customer" is left undefined
 - ▶ Services provided to an associated enterprise?

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Dudney Decision

28

- Basic definition of PE contains three conditions:
 - 1) Place of business must exist
 - 2) Place of business must be fixed (i.e., established at a distinct place with a certain degree of permanence)
 - 3) Business of non-resident must be "carried on through" this fixed place of business
- Dudney decision focused on first condition: premises of PanCan were not a location through which Dudney carried on his own business because access to those premises was restricted and he could not do any work there, except that done under PanCan contract

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Dudney Decision

29

- Article V(9)(b) extends traditional PE definition by eliminating requirement that services be performed in US enterprise's own place of business in Canada but, at the same time, retains location and permanency tests that are not dissimilar to those already inherent in traditional PE standard

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Dudney Decision

30

- As it read at the time of the Dudney decision, commentary to article 5 of OECD Model Convention did not shed much light on "place of business" requirement
- However, 2003 revisions to commentary provided new guidance on when an enterprise has a place of business "at its disposal"
- Painter example hinted at concept of "place of business" that goes beyond one espoused in Dudney
- Purpose of article V(9)(b)?
- Implication for other Canadian tax treaties?

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II. Mutual Agreement Procedure and Binding Arbitration

Introduction

32

- Mandatory binding arbitration under the mutual agreement procedure introduced in articles XXVI(6), XXVI(7) and Annex A
- Builds on proposed articles 25(5) and 25(6) of OECD Model Convention and proposed Annex, with some differences
- Twin purposes:
 - ▶ provides competent authorities with an incentive to settle cases by negotiation before arbitration; and
 - ▶ ensures cases are resolved within a guaranteed time period

Arbitral Process

- "Baseball" arbitration approach
- Best suited to factual disputes, especially appropriate for transfer pricing cases
- Determination must not state a rationale and has no precedential value
- Possibility for the taxpayer to reject the final determination of the arbitration panel and pursue its rights under the domestic judicial system

Matters Eligible for Arbitration

- Not every case eligible for arbitration - three preconditions in article XXVI(6) must be satisfied
- Only the following matters are eligible:
 - ▶ Article IV (Residence, but only for natural persons)
 - ▶ Article V (Permanent Establishment)
 - ▶ Article VII (Business Profits)
 - ▶ Article IX (Related persons)
 - ▶ Article XII (Royalties - In certain circumstances)
- "Mandatory" binding arbitration may be a misnomer

Timeline For Referral to Arbitration

- Proceedings generally begin on later of two years after "commencement date" of the case (unless both competent authorities have previously agree to a different date) and earliest date upon which non-disclosure requirements met by the "concerned persons"
- "Commencement date" defined in article XXVI(7)(b), and "concerned person" defined in article XXVI(7)(a)
- Paragraph 16 of Annex A describes the information required to satisfy the definition "commencement date"

Applicable Legal Principles

- Four sources of legal principles applicable in making a determination under paragraph 9 of Annex A
- No hierarchy of applicable legal principles, unlike other bilateral tax treaties

Binding Nature of Arbitration

- Determination binding on competent authorities, not on the concerned persons
- Each concerned person must within 30 days advise competent authority to which the case was first presented whether they accept the determination
- Degree of taxpayer involvement in proceeding left up to the discretion of the arbitration board
- More participation improves transparency and provides the board with a direct understanding of taxpayer's position, but likely would increase length, cost and formality of proceeding

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