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Permanent Establishment under the Canada-United States Tax Treaties - The Old and the New

Michael G. Quigley

Permanent Establishment Under The Canada-United States Tax Treaties—The Old and the New*

by Michael G. Quigley**

On September 26, 1981, Canadian Finance Minister Allan MacEachen and U.S. Treasury Secretary William Miller signed a new convention with respect to taxes on income and capital gains.[1] In light of the substantial trade relations which exist between the two countries,[2] the new treaty may be of more importance to Canada, and possibly to the United States, than any of the other treaties that either of these countries has recently concluded. Although the new treaty will enter into force in the calendar year following its ratification by each of the contracting states,[3] more than a full year has now passed since the new treaty was signed and at the present time it is still unclear whether it will be ratified in the foreseeable future.[4] Once ratified, however, the new treaty will replace the provisions of the existing Canada-United States Convention,[5] which, although amended on a number of occasions, have

** Associate, McCarthy & McCarthy, Toronto, Ontario; B.A. 1973, University of Western Ontario; LL.B. 1977, and LL.M. 1983, McGill University.

[1] Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, Sept. 26, 1981, Tax Treaties (CCH) §1301 [hereinafter cited as New Treaty].

[2] U.S. Dept. of Commerce-Bureau of Economic Analysis, 61 Survey of Current Business No. 12, S-19-S-20 (Dec. 1981).

[3] New Treaty, supra note 1, art. XXX(2).

[4] The Financial Post reported that "[t]he most important bilateral tax convention ever signed by either nation is being held up in the U.S. Senate Foreign Relations Committee, and will not be dealt with until next February or March at the earliest." Apparently, the current treaty impasse stems from two different sources, namely, changes to the treaty which are being sought by the United States in the key area of foreign real estate taxation and in several other minor fields, and secondly, a jurisdictional squabble which currently exists between the administration and Congress over who has primacy in writing tax legislation. The report indicates that Canada is adopting a neutral stance for the time being and has agreed to hear U.S. requests for treaty revisions without ruling on their acceptability. Whether the two nations can find middle ground on the delicate real estate tax issue remains to be seen. Solomon, Happy New Year Unlikely for Canada-U.S. Tax Treaty, *The Financial Post*, December 19, 1981, at 5, col. 1. It now appears that even this prediction was overly optimistic. Observers of the negotiation process recently speculated that the treaty will not be signed before 1983.

[5] New Treaty, supra note 1, art. XXX(4). Note that the ratification of the New Treaty will also abrogate the provisions of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estates of Deceased Persons, Feb. 17, 1961, United States-Canada, 13 U.S.T. 382, T.I.A.S. 4995.

Article XXX(8) appears to implicitly recognize that this treaty has been in full force and effect notwithstanding the repeal by Canada of estate taxes for years after 1971 by enactment of applied to the taxation of transactions between the two countries since the early 1940's.

One of the most important concepts found in both the present Canada-United States Convention[6] and the new treaty is that of permanent establishment. In the present treaty, the term "permanent establishment" is defined in the Protocol[7] and is relevant to the conduct of cross-border trade since the Convention provides that an enterprise of one of the contracting states will be subject to taxation by the other contracting state only to the extent that its industrial and commercial profits are allocable to its permanent establishment in the latter state.[8] Unfortunately very little jurisprudence has developed to assist in clarifying the meaning of permanent establishment and the determination of when a permanent establishment will be found to exist in one or the other of the contracting states. Nonetheless, neither the manner in which permanent establishment is defined in the present treaty, nor the limited amount of jurisprudence in either Canada or the United States, has prevented a considerable number of cross-border tax plans from developing.

While the new treaty relies on the concept of permanent establishment in determining the locus of jurisdiction to tax industrial or commercial profits, it also incorporates many of the concepts contained in the draft convention of the Organization for Economic Cooperation and Development (OECD).[9] Thus, to the extent that discrepancies exist between the present treaty and the new treaty, the validity of current tax plans may be jeopardized while new cross-border ventures will have to recognize the new treaty.

This article will consider the provisions of the present treaty, the jurisprudence that has developed in the context of those provisions, and certain cross-border tax plans which have or may come into use in response to the present treaty. In addition, the article will briefly consider the OECD commentary on permanent establishment and the extent to which the new Canada-U.S. provisions fall in line with or deviate from the OECD model. Finally, the article will consider alterations that may have to be made to existing tax planned cross-border trade activities if treaty protection is to continue to be enjoyed.

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the Income Tax Act, Can. Rev. Stat. ch. 148 (1952), as amended by Can. Stat. ch. 63 (1970-71-72).

[6] Convention and Protocol Between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, March 4, 1942, 56 Stat. 1399, T.S. 983, as modified by the supplementary conventions of June 12, 1950 (2 U.S.T. 2235, T.I.A.S. 2347), Aug. 8, 1956 (8 U.S.T. 1619, T.I.A.S. 3910), Oct. 23, 1966, (18 U.S.T. 3186, T.I.A.S. 6415) [hereinafter cited as Present Treaty].

[7] Id. ¶ 3(f), 10 of the Protocol as amended by 2 U.S.T. 2235.

[8] Id. art. I, para. 1.

[9] Organization for Economic Cooperation and Development Committee on Fiscal Affairs, Model Double Taxation Convention on Income and Capital 19-44 (1977).

I. Permanent Establishment Under the Present Treaty.

In Canada, subsection 2(3) of the Income Tax Act (the Act) together with Section 115, set out the regime for taxation of nonresidents, essentially asserting Canada's jurisdiction to tax, *inter alia*, nonresidents who carry on business in Canada.[10] In Article I of the present treaty, however, Canada and the United States each agree to exempt from domestic taxation business profits derived in their respective jurisdictions by an enterprise of the other state unless the earning of those profits can be allocated to a permanent establishment of that enterprise in the state seeking to tax. By corollary, if business profits are derived by an enterprise of one state from a permanent establishment maintained by it in the other state, such revenue will be taxed in the state where the permanent establishment is located. Thus, Article I of the present treaty can be seen as an exception of limited scope to Canada's normal claim of jurisdiction to tax nonresidents in one of the circumstances envisaged by subsection 2(3). In effect, Article I, which is a provision normally found in international tax treaties, merely confirms the basic rule that when a business enterprise carries on a business at a site in another country that other country will expect to tax the profits that are derived in that country.

A. Definition

Although the notion of permanent establishment appears quite simple in its concept, its application can often be considerably more difficult. The present treaty itself does not contain a definition of permanent establishment. The Protocol to the present treaty, does, however, afford guidance to the meaning of the term permanent establishment. Article 3(f) of the Protocol provides that:

> The term "permanent establishment" includes branches, mines and oil wells, farms, timberlands, plantations, factories, workshops, warehouses, offices, agencies and other fixed places of business of an enterprise but does not include a subsidiary corporation. The use of substantial equipment or machinery within one of the contracting States at any time in any taxable year by an enterprise of the other contracting State shall constitute a permanent establishment of such enterprise in the former State for such taxable year.
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> When an enterprise of one of the contracting States carries on business in the other contracting State through an employee or agent established there who has general authority to contract for his employer or principal or has a stock of merchandise from which he regularly fills orders which he receives, such enterprise shall be deemed to have a permanent establishment in the latter State.
>
> The fact that an enterprise of one of the contracting States has business dealings in the other contracting State through a commission agent, broker or other independent agent or maintains therein an office used solely for the purchase of merchandise shall not be held to mean that

[10] Income Tax Act, supra note 5.

such enterprise has a permanent establishment in the latter State.[11]

B. Jurisprudence

Unfortunately there is little case authority in Canada to guide tax planners in dealing with Article I of the present treaty. The permanent establishment concept, however, is also found in the Canadian Income Tax Regulations.[12] Under these Regulations corporations pay tax to the various provinces of Canada according to how much of their total taxable income earned in Canada is allocable to a permanent establishment in each province.[13] The decision of the Supreme Court of Canada in *Sunbeam Corporation (Canada) Ltd. v. Minister of National Revenue*,[14] dealing with the meaning of permanent establishment under the Income Tax Regulations of 1952, 1953, and 1954, is, therefore, relevant and helpful to our discussion.[15]

Sunbeam had its head office and manufacturing plant in the province of Ontario. During the three years in question Sunbeam sold its products in the province of Quebec exclusively to wholesale distributors. In addition, during these three years Sunbeam employed two sales repre-

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[11] Present Treaty, supra note 6, ¶ 3(f) of the Protocol as amended by 2 U.S.T. 2235.

[12] Can. Stat. O. & Regs. ch. 133 :400(2) (1953), as amended by Act of Nov. 19, 1953, Can. Stat. O. & Regs. ch. 1033 (1953).

[13] The definition of "permanent establishment" as it read during the years in question was as follows:

411. (1) for the purposes of this Part,
  (a) permanent establishment includes branches, mines, oil wells, farms, timber lands, factories, workshops, warehouses, offices, agencies, and other fixed places of business;
  (b) where a corporation carries on business through an employee or agent who has general authority to contract for his employer or principal or has a stock of merchandise from which he regularly fills orders which he receives, the said agent or employee shall be deemed to operate a permanent establishment of the corporation;
(2) The use of substantial machinery or equipment in a particular place at any time in a taxation year shall constitute a permanent establishment in that place for that year.

The main difference between the definition of "permanent establishment" in section 411 of the Income Tax Regulations and the definition of "permanent establishment" contained in the Protocol to the present treaty is that the former does not contain the 3rd paragraph of the definition set forth in the present treaty which provides that business dealings through a commission agent, broker or other independent agent does not constitute a permanent establishment.

[14] 36 D.L.R.2d 91 (Can. S.C. 1963).

[15] Note, however, the different principles of interpretation that may apply to the interpretation of a domestic taxation statute as opposed to an international treaty. Fiscal legislation, as is well known, is generally to be strictly construed: Partington v. Attorney General, L.R. 4 H.L. 100 (1869), Pryce v. Monmouthshire Canal & Railway Companies, 4 A.C. 197 (1878); Tennant v. Smith, 1892 A.C. 150; The King v. Crabbs 1934 S.C.R. 523 (Can. S.C.); See also E.A. Dreidger, The Construction of Statutes 148 et. seq. (1974). Compare Articles 31 and 32 of the Vienna Convention on the Law of Treaties, U.N. Doc. A/conf 39/27 (1969). See also R. Lenz, Interpretation of Double Taxation Treaties, XLII General Reporter 299 (1960), A.D. McNair, The Law of Treaties 27 et. seq. (1938); both cited in D.A. Ward, General Principles of Treaty Interpretations, International Fiscal Association (Canadian Branch) Special Seminar on Interpreting Tax Treaties 1 (1977).

sentatives in Quebec. The written employment agreements with the two representatives had a term of one year with provisions for automatic extensions on a yearly basis. The agreements were, however, subject to arbitrary termination at any time on two weeks' written notice by either party. Each contract provided for commission sales by the sales representative with respect to certain of Sunbeam's products and guaranteed a minimum amount in commissions. The sales representatives were required to pay their own expenses out of their remuneration from Sunbeam. Each agreement required the sales representative to devote his entire time, best efforts, and full, undivided attention to the sale of Sunbeam's products in his territory. The sales representative did not have authority to make contracts on behalf of Sunbeam and did not keep a supply of goods for delivery. Instead, orders were filled from Sunbeam's Ontario plant.

Each sales representative maintained an office in his own residence but received no rent or added compensation from Sunbeam for so doing. Each sales representative also provided his own office equipment without compensation from Sunbeam. The telephone directory did not list the sales representative's residence as Sunbeam's place of business and the residence did not carry any business signs. Sunbeam provided each of its sales representatives with calling cards, however, showing that he was Sunbeam's representative.

Each of the sales representatives used the office for doing the paper work that resulted from the business and some of the distributor's orders were received there. The office was also used for sales demonstrations and training programs.

Holding that Sunbeam did not have a "permanent establishment" in the province of Quebec during the years in question, the Canadian Supreme Court found that the word "establishment" contemplates "a fixed place of business of the corporation, a local habitation of its own."[16] In the concluding words of the judgment, Mr. Justice Martland stated that:

> From the evidence it is clear that the appellant did not have any fixed place of business of its own. As a result of its contracts with Comtois and with Dyke [who were the two sales representatives in Quebec], it had, and it only had, an employee, who was subject to dismissal on two weeks' notice, to act as its sales representative. I do not agree that the fact that such employee, for the discharge of his duties under his contract, set up an office in his own premises constituted that office a branch, an office or an agency of the appellant. It is the appellant who must have the permanent establishment in the province of Quebec to qualify for the tax deduction and neither the office of Comtois nor that of Dyke was, in my opinion, a permanent establishment of the appellant.
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> The fact that the appellant had an employee or agent in Quebec was not, in itself, sufficient to constitute a permanent establishment of the appellant. This, I think, is made clear by paragraph (b) of section

[16] 36 D.L.R.2d at 95.

> 411(1) of the Regulations. An employee or agent can be deemed to operate a permanent establishment of a corporation under that paragraph, but only if he has authority to contract for his employer or principal, or if he has a stock of merchandise from which he regularly fills orders which he receives. Neither of these requirements was met in the present case.[17]

While it is clear that the definition of permanent establishment pertains to a fixed site, jurisdiction to tax will be established only if a business is carried on[18] at that site.[19] Therefore, mere ownership of a fixed site will not be sufficient to constitute a permanent establishment under Article I of the treaty. The site must also be one at which an enterprise of the other country is actually carrying on business before any significance will attach under Article I of the treaty.

The U.S. Tax Court's decision in *Consolidated Premium Iron Ores Lim-*

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[17] Id. at 96.

[18] Note the extended meaning of carrying on business set out in section 253 of the Act:

> Where in a taxation year, a non resident person
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> (a) produced, grew, mined, erected, manufactured, fabricated, improved, packed, preserved or constituted, in whole or in part, any thing in Canada whether or not he exported that thing without selling it prior to exploration, or
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> (b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada,
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> he shall be deemed for the purpose of this Act, to have been carrying on business in Canada in the year.

See Sudden Valley, Inc. v. The Queen, [1976] C.T.C. 297 (F.C.T.D.).

[19] See Masri v. M.N.R., [1973] C.T.C. 448 (F.C.T.D.). The appellant and certain other nonresidents purchased certain parcels of raw land near Montreal, disposing of the land several years later for substantial profits. One of the nonresidents had a brother in real estate business in Montreal whose advice was relied upon in negotiating the various transactions. The Minister of National Revenue contended that the appellant was carrying on business in Canada and was taxable on his share of the profits from the venture. However, Mr. Justice Heald allowed the appellants appeal holding that although he was carrying on business in Canada, he was exempt from tax under Article I of the present treaty by reason of not having a permanent establishment in Canada since he had no office or place of business in Canada, no telephone listing and no bank account for most of the relevant time periods. But cf. Les Entreprises Blaton-Aubert Societe Anonyme v. M.N.R., [1972] Can. Tax. C. 609 (F.C.T.D.). In that case, the construction of the Belgian Pavilion at Expo '67 was carried out pursuant to a contract awarded to a Canadian contractor and the appellant, which was a resident of Belgium. Under the joint venture agreement the appellant was chiefly responsible for half the financing with the management and conduct of the project being entrusted to the Canadian contractor. The Minister of National Revenue claimed that the 50% share of profits payable to the appellant was derived by it from carrying on business in Canada, and that such amount was subject to Canadian tax. The appellant argued that its sole raison d'etre was to assume responsibility to the government of Belgium for the carrying out of the contract and it was not in fact carrying on business in Canada. Noel A.C.J. held that the appellant was carrying on business in Canada since its obligations extended beyond mere financial considerations and since it could be called upon to complete construction of the project had the Canadian contractor failed to do so. Moreover, since construction was part of the appellant's normal business activities, it clearly fell within the ambit of subsection 2(2) of the Act whereby nonresidents carrying on business in Canada are taxable therein. See also G. Drolet, "Definitions Residence of Individuals and Corporations, Enterprises and Permanent Establishment", International Fiscal Association (Candian Branch) Special Seminar on Interpreting Tax Treaties, supra, note 12.

ited v. Commissioner of Internal Revenue[20] adds further support to this proposition. In that case the Tax Court found that Consolidated Premium, a Canadian company, had "no real office" in the United States; no officers, directors or employees there; no bank account or books of account; no telephone listing; and no employees or agents with general authority to contract for their employer or principal. Therefore, the Tax Court concluded that Consolidated Premium did not have a permanent establishment in the United States, notwithstanding the fact that the company had at one time procured a licence to do business in Ohio and had used a printed letterhead giving an address in the United States.[21] In rejecting the contention of the Internal Revenue that Consolidated Premium had a permanent establishment in the United States, Judge Van Fossan stated that:

> The term "permanent establishment" normally interpreted suggests something more substantial than a license, a letterhead and isolated activities. It implies the existence of an office, staffed and capable of carrying on the day to day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. The descriptive word 'permanent' in the characterization 'permanent establishment' is vital in analyzing the treaty provisions. It is the antithesis of temporary or tentative. It indicates permanence and stability.[22]

l. Substantial Equipment. One other interesting aspect of the definition in the Protocol is that the use of "substantial equipment" within one of the countries at any time in the year by an enterprise of the other country shall constitute a permanent establishment.[23] The curious point regarding this inclusion lies in the fact that the use of such equipment is not inherent in the notion of permanency implicit in the other parts of the definition. The equipment in question need not even be the property of the nonresident enterprise but may be equipment merely rented locally for the purpose of fulfilling services in the country. Thus, for example, a traveling circus or a nonresident contracting company may be regarded as having a permanent establishment in Canada at any time it performs or carries out contracts in Canada merely because it makes use of substantial equipment in Canada in the process of undertaking those activities.[24] To take the example a step further, the specially fitted aircraft of an aerial survey company might constitute a permanent establishment in Canada simply by flying in Canadian air space.[25]

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[20] 28 T.C. 127 (1957), aff'd 265 F.2d 320 (6th Cir. 1959). See also Commissioner of Internal Revenue v. Inez de Amodio, 34 T.C. 894 (1960).

[21] 28 T.C. at 152-53.

[22] Id. at 151. See Thom, Permanent Establishment under the Tax Convention, 5 Can. Tax. J. 344 (1957) for a somewhat critical discussion of the decision.

[23] Present Treaty, supra note 6, § 3 of the Protocol.

[24] Feingold, The Use of Substantial Equipment or Machinery at Any Time During the Year as a Permanent Establishment, 28 Can. Tax. J. 217 (1980).

[25] See No. 630 v. Minister of National Revenue, 22 Can. Tax App. Bd. 91 (1959). See also

2. *Offices and Agencies*. Although the definition of permanent establishment contained in the Protocol and the judicial gloss which has coloured that definition over the years will leave reasonably little doubt in most cases as to when a permanent establishment exists within the meaning of the present treaty, mention in the Protocol of "offices" and "agencies" as constituting a permanent establishment may give rise to some uncertainty.

Some clarification is provided, however, by the closing words of clause 3(f) of the Protocol, which distinguishes between agents who are actually employed by the nonresident enterprise and independent agents who are simply retained by the enterprise.[26]

While the second and third paragraphs of Article 3(f) of the Protocol deal with the circumstances in which an agent of a foreign enterprise will be deemed to constitute a permanent establishment, the two paragraphs view the dilemma from different perspectives. Under the second paragraph, the domestic enterprise must not only have an employee or agent established in the other country, but that employee or agent must have either general authority to contract for his principal or a stock of merchandise from which he regularly fills orders that he receives before a permanent establishment will be imputed. In contrast, the final paragraph emphasizes the independent character of the agent. Therefore, despite paragraph two, if treaty protection is to be enjoyed, the agent must not be an employee of the nonresident enterprise. Furthermore, it seems clear that an independent storage and warehousing firm which receives, holds, and delivers up goods on the orders of a multiplicity of principals will not constitute a permanent establishment of a nonresident, even if a stock of goods is kept on hand and delivered to local

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The Queen in Right of the Province of Manitoba v. Air Canada, [1980] Can. Tax C. 428 (Can. S.C.), where the Supreme Court of Canada held that the Manitoba Retail Sales Tax Act, R.S.M. 1970, c. R150 was ultra vires the province insofar as it purported to tax Air Canada on overflights of its aircraft through the airspace over Manitoba and on flights landing temporarily in Manitoba from outside points before proceeding onward. Id. at 436. Merely going through the airspace over Manitoba did not give the aircraft a *situs* there to support a tax which pursuant to subsection 92(2) of the Constitution Acts, 1867-1982, was to be "within the Province." Id. at 434. There had to be a substantial or more than a nominal presence in the province to provide a basis for imposing a tax in respect of the entry of aircraft into the province. However, the decision is not technically concerned with the concept of permanent establishment. See also Feingold, supra note 24.

[26] Compare O.E.C.D. Model Convention, supra note 9, Article V(4)(b) which provides that "permanent establishment" shall not be deemed to include the maintenance of a stock of goods "solely for the purpose of storage, display or delivery." The Present Treaty does not contain such a provision and instead provides that a permanent establishment exists where a business is carried on through "an employee or agent established there, who has general authority to contract for his employer or principal or has a stock of merchandise from which he regularly fills orders which he receives." See also Rev. Rul. 63-113, 1963-1 C.B. 410; Rev. Rul. 56-594, 1956-2 C.B. 1126. Cf. Commissioner v. Handfield, 23 T.C. 633 (1955) where a permanent establishment was found to exist because the foreign distributor did not obtain title to the merchandise in his own name; Willard, Tax Considerations for Exporters, 1964 Conference Report 192 (Canadian Tax Foundation) (1965).

customers on the specific instructions of the nonresident enterprise.[27]

Thus, for example, the determination of whether an American manufacturer's distribution of products in Canada through a Canadian distributor, will constitute a permanent establishment, thereby subjecting the American manufacturer to Canadian tax, will depend upon whether the distributor is an agent of the American manufacturer in Canada, whether the Canadian distributor is selling in the Canadian market on behalf of the manufacturer, or whether he buys and resells the products on his own account. This distinction may not always be an easy one to make. Indeed the mere fact that the distributor purchases goods from the supplier for resale will not necessarily mean that the relationship between them is not one of principal and agent.[28]

Two Canadian cases illustrate this distinction. In the first, *American Wheelabrator & Equipment Corporation v. Minister of National Revenue,*[29] a U.S. enterprise sold abrasives and dust collecting equipment in Canada. The enterprise hired a sales representative in Canada who interviewed customers, advised them regarding the services of Wheelabrator, and recorded their requirements. The sales representative, however, had no authority to quote prices or to contract with customers on behalf of the company. He was paid on a commission basis and no office or telephone listing was maintained in Canada except through a telephone answering service company. The agent worked at his own home. Since no one in Canada had authority to negotiate or enter into contracts on behalf of the company, the Tax Appeal Board held that the company did not have a permanent establishment in Canada within the meaning of the present treaty.

In contrast is the decision of the Exchequer Court of Canada, in *Minister of National Revenue v. Panther Oil and Grease Manufacturing Co. of Canada Ltd.*[30] In that case the appellant company had plants in Ontario and Saskatchewan and sold products in Quebec through a sales organization consisting of a provincial division manager, district managers, and a large number of salesmen who were paid on a commission basis. The provincial manager and the district managers were full time employees, had offices in their homes, and, although most orders were sold by shipment from outside Quebec, they also warehoused a limited amount of the appellant's products for quick delivery. The entire sales organization was closely supervised by the provincial division manager and each salesman had the power to authorize sales on credit except where he chose to refer credit problems to the principal office in Ontario for advice. Under these circumstances it was held that the company's organization in Quebec was a permanent establishment within the meaning of the Income

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[27] Strikeman, Canada Tax Service 5110.

[28] Short, Permanent Establishment and Agencies, 11 Can. Tax. J. 387, 388 (1963). See also Short, Allocation of Income—Agencies, 12 Can. Tax. J. 135 (1964).

[29] 4 Can. Tax App. Bd. 345 (1951).

[30] [1961] Can. Tax C. 363.

Tax Regulations,[31] and, therefore, the company could claim a tax deduction as to its income earned in Quebec.

The primary distinction between the two cases appears to turn on the maintenance by the distributor of a stock of goods. In the former case the distributor had no authority to contract on behalf of the company nor did he maintain a supply of the company's goods for distribution. In the latter case, although the sales agents had no authority to enter into contracts on behalf of the company,[32] they did maintain a small stock of goods from which to fill orders.[33]

C. Planning Cross Border Trade

What then are the implications of these principles in the planning of cross-border trade and service activities under the present treaty? Consider a hypothetical situation. International Widget ("International"), a company engaged in the manufacture and distribution of widgets in the United States decides to expand its sales to customers in Canada and proposes to engage one or more independent sales representatives who are not employees of International to solicit orders from customers in Canada. All orders will be subject to acceptance by International in the United States and shipments will be made to Canadian customers F.O.B. International's warehouse in the United States. International expects that Canadian sales will be substantial. Therefore, in order to accelerate and streamline the clearance of cheques from its Canadian customers, International proposes to employ a "lock box service" through a Canadian chartered bank ("Canbank") in Toronto. Under this arrangement, Canadian customers would be instructed to mail their invoices together with their payments to a post office box address. Under this proposed "lock box service" agreement, Canbank will have exclusive and unrestricted access to the post office box in order to collect the contents on a daily basis. Canbank will deposit the cheques found in the box in International's account and forward the other items removed from the box, which are not intended for deposit, to International in the United States. Under these circumstances would International incur liability for Canadian income tax under the Act?

Subsection 2(3) of the Act would subject International to Canadian tax with respect to income earned from carrying on business in Canada. If there were any doubt under the common law rules, the statutory ex-

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[31] Income Tax Regulations, supra note 14.

[32] See Treas. Reg § 519.103(a) (1943).

[33] Compare Sunbeam Corporation (Canada) Ltd. v. Minister of National Revenue, 36 D.L.R.2d 91 (Can. S.C. 1963). The factual situations of the two cases are virtually identical and thus, it might be thought that the decision in the Sunbeam case effectively overrules Panther. Although Sunbeam seems to overrule Panther on most points, it is suggested that the cases could be distinguished by a court on the basis of the maintenance of a stock of goods from which orders are regularly filled. Thus, if employees of the foreign enterprise exist in Canada the maintenance of a store of goods should be avoided unless the persons maintaining such goods are independent agents. See also Commissioner v. Handfield, 23 T.C. 633 (1955).

tension of the common law test of carrying on business[34] leaves no doubt that the solicitation of orders from customers in Canada by independent sales representatives engaged by International would result in International being deemed to be carrying on business in Canada. International's income from this activity would thus be subject to tax under the Act. Of course, the provisions of the Act are subject to the terms of the treaty[35] and, consequently, International would be taxable in Canada only to the extent that its industrial and commercial profits are "allocable . . . to its permanent establishment" in Canada. If International were an enterprise within the meaning of paragraph 3(d) of the Protocol to the Present Treaty and income from its Canadian sales constituted industrial and commercial profits, then International's right to rely upon the treaty for exemption from Canadian tax would depend upon whether International were deemed to have a permanent establishment in Canada to which its Canadian sales could be allocated.

Given the definition of permanent establishment under the present treaty, it is clear that the use of independent sales representatives in Canada by International would not of itself mean that International has a permanent establishment in Canada.[36] As an added precaution, however, International would probably wish to enter into written sales agreements with the independent sales representatives under which it is specified that the sales representatives are independent contractors and not employees of International. Furthermore, these sales representatives should probably be remunerated at a fixed commission rate and, ideally, should be free to render their services to others. The agreement, however, could restrict the sales representatives from acting for or contracting with any other third pary to promote products in competition with International products. Even if the sales representatives were not independent contractors, but were employees of International, so long as they had neither authority to contract for International nor maintained a stock of merchandise from which they regularly filled orders, International would not be seen as having a permanent establishment in Canada as a result of the relationship.

The "lock box" aspect of the transaction presents greater difficulty. Here the issue is whether the post office box could be considered as an "other fixed place of business" as contemplated by the permanent establishment definition. While there have been no Canadian cases decided on this point, it is generally believed that for there to be a fixed place of

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[34] Can. Stat. Ch. 63 § 253 (1970-71-72), supra note 18.

[35] Once tax conventions have been signed by the Contracting States, they are enacted in each state by an implementing statute which provides that the agreement in question is to have the force of law. The implementing Act will also provide that in the event of any inconsistency between the tax agreement and the Canadian income tax law, the provisions of the tax agreement will prevail to the extent of the inconsistency. See A.R.A. Scace, The Income Tax Law of Canada 21 (4th ed. 1979).

[36] See 4 Can. Tax App. Bd. 345 (1951). See also 36 D.L.R.2d 91 (Can. S.C. 1963).

business, there must be an office or similar facility through which the business of the U.S. enterprise is carried on. Therefore, the maintenance of a post office box address in Canada for the receipt of payments and other correspondence from Canadian customers would probably not be sufficient to constitute a permanent establishment as contemplated by the present treaty.[37] This conclusion is supported by the third paragraph of the permanent establishment definition which specifically provided that the fact that an enterprise of the United States has business dealings in Canada through an independent agent should not by itself constitute a permanent establishment in Canada.[38] Consequently, as Canbank would clearly be an independent agent for International, the lock box arrangement should not constitute a permanent establishment in Canada for International. Accordingly, it appears that International could carry on its proposed arrangement in Canada without fear of Canadian income tax liability.

As a further example, assume that the city of Calgary, Alberta has recently been granted a National League Baseball franchise. In anticipation of avid fan support from Calagarians the city has decided to construct the Gatewest Stadium, which will be the new home of the Calgary Drillers Baseball Club. The stadium will have food, souvenir and beverage concession, and it will be used in the off season for other attractions, such as concerts. The stadium will be owned by the Drillers Baseball Club. Rather than setting up, managing, and operating the facilities at the stadium by itself, however, the club proposes to enter into a management services agreement with Baseball Services Unlimited ("Services"), an American company which has tendered an offer to provide those services. The Club and Services propose to enter into an agreement that provides that Services will be responsible for the recruiting and training of personnel, the supervision and management of the attractions at the Stadium, and the supervision and coordination of the establishment of the attractions. In effect, Services would operate the attractions, although all personnel would be paid by the Club, and the Club would provide all of the facilities relating to the attractions. Two service managers would be paid in part by Services for services performed by them in Canada for the Club. This arrangment could easily result, however, in those individuals being considered employees of Services rather than of the Club. Services would not use substantial equipment or machinery in Canada in order to fulfill its obligations to the Club, and in consideration of the services it provides, Services would be paid fifteen percent of the gross ticket sales from the Stadium.

Although it seems clear under these circumstances that Services would be carrying on business in Canada and would thus be liable to

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[37] See Consolidated Premium Iron Ores v. Commissioner, 265 F.2d 320, 324 (6th Cir. 1959).

[38] Present Treaty, supra note 6, § 3 of the Protocol.

Canadian tax, we must once again consider the impact of the present treaty and determine whether or not the industrial and commercial profits earned by Services would be allocable to "its permanent establishment" in Canada, which would result in a loss of treaty exemption. While it is clear that Services would be carrying on business in Canada at a fixed place of business, that place of business would not be "its" permanent establishment if the Stadium facilities were owned and controlled exclusively by the Club and if they were not leased to Services. In such event, Services would have a good basis on which to claim exemption from Canadian tax under the present treaty, although such exemption could be jeopardized if Services were deemed to have sufficient control of the Stadium facilities through its service managers to give Services a permanent establishment in Canada. In light of the *Sunbeam* case,[39] however, as long as Services had no control over the Stadium's facilities, those facilities would not constitute a permanent extablishment of Services in Canada. Out of an abundance of caution, however, Services might wish to have the agreement expressly state that exclusive possession of the facilities remained at all times with the Club.

It would be arguable, however, that Services had a permanent establishment in Canada with resultant liability to Canadian taxation with respect to industrial and commercial profits, if it could be said that its two sales managers were employees or agents established in Canada with general authority to contract for their employer within the meaning of the middle paragraph of the definition of permanent establishment. Services could avoid such a conclusion by ensuring that none of its employees or agents, including management, who had general authority to contract on its behalf, became established in Canada.

II. Permanent Establishment Under the New Treaty.

The new treaty follows the general pattern set down by the Organization For Economic Cooperation and Development in the model OECD treaty.[40] The new treaty, however, also contains special provisions designed to deal with problems of U.S. citizens residing in Canada[41] and other provisions that recognize particular aspects of business dealings which exist between the two countries.[42]

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[39] See 36 D.L.R.2d 91 (Can. S.C. 1963).

[40] Supra note 9.

[41] For example, American citizens residing in Canada are taxed on their worldwide income both in the United States, by reason of their citizenship and in Canada by reason of their resident status. However, in the computation of foreign tax credit in Canada under section 126 of the Act, credit is only allowed for U.S. tax up to the rate of 15% on investment income with any excess being allowed only as a deduction in the determination of income under subsection 20(11) of the Act. Double taxation can thus result in Canada. Article XXIV(6) of the new treaty in combination with Article XXX(3)(b) will provide relief from this problem once the new treaty is ratified.

[42] See, e.g., New Treaty, supra note 1, art. V(4).

A. *General Principles*

As is the case in the present treaty, the new treaty follows the general rule that the business profits of a resident of a contracting state will be taxable in the other contracting state only to the extent that they are attributable to a permanent establishment situated in the other state.[43] That no basic change in the meaning of the term permanent establishment is contemplated may be seen in Article V(1), which states that the term means "a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on."[44] Thus, it is clear from this statement that no permanent establishment will exist unless (1) there is a place of business, that is, a facility such as premises or machinery and equipment, (2) the place of business is fixed, that is, established at a place with a sense of permanence, and (3) the business of the enterprise is carried on at that fixed place of business.[45] Although a fixed place of business will constitute a permanent establishment only if it is not of a purely temporary nature, the term "place of business" includes any premises, fixtures, or installations used in the carrying on of the business. These premises or fixtures do not have to be used exclusively by the business nor do they have to be owned, rented, or otherwise at the disposal of the enterprise carrying on the business.[46]

B. *Definition*

Paragraph 2 of the definition provides that the term "permanent establishment" includes especially a place of management, a branch, an office, a factory, a workshop, and a mine.[47] Interestingly enough, while consistent with the OECD Model Treaty, the new provision avoids any reference to "farms, timberlands and plantations" or, more significantly, to "the use of substantial equipment" as is contained in the Protocol to the present treaty.[48] In this respect the new treaty raises the threshold level for source basis taxation of activities that involve the use of substantial equipment but do not otherwise constitute a fixed place of business.[49]

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[43] Article VII of the new treaty closely follows Article VII of the O.E.C.D. Model Treaty, supra note 9. Note that the concept of permanent establishment is also relevant for the purposes of determining the source of interest and royalty payments under articles XI and XII of the new treaty under Article V(9).

[44] Note, however, that Article V of the new treaty avoids the use of the term "enterprise of contracting state" found in subsection 3(f) of the Protocol to the present treaty and in this respect avoids the introductions of an additional term to the new treaty. United States Treasury Department, Canada-U.S. Tax Treaty Technical Explanation, Can. Tax Rep. (CCH) Special Report No. 470, Para. 30 (Jan. 19, 1981).

[45] Commentary on Article V Concerning the Definition of Permanent Establishment, O.E.C.D. Model Treaty, supra note 9, at 59.

[46] Coulombe, Analysis and Examination of Articles Dealing with Personal Scope, Taxes Covered, and Tax Jurisdiction, The Canada-U.S. Income Tax Treaty, 1980 Conference Report 314, 325 (1981).

[47] New Treaty, supra note 1, art. V(2)(a)-(f).

[48] See Protocol to New Treaty supra note 1.

[49] U.S. Treasury Department, supra note 44, para. 30.

The new treaty does, however, expand upon the wording of the OECD Model where it stipulates in Article V(2)(f) that "a mine, an oil or gas well, a quarry or any other place of extraction of natural resources" will constitute a permanent establishment.[50] The new treaty also incorporates Article V(3) of the OECD Model Treaty regarding building sites, constructions, and installations, although varying the language slightly to make it clear that any time such a project exceeds twelve months in duration, it will automatically constitute a permanent establishment, while if less than twelve months, it will not.[51]

I. Employees. Article V(5) of the new treaty which corresponds with the same provision in the OECD Model, continues the treatment of employees outlined in paragraph 3(f) of the Protocol to the present treaty, although in more limited scope. While under the present treaty a permanent establishment will be found to exist where an employee maintains a stock of goods from which he regularly fills orders, an important change has been made in the new treaty. This aspect has been deleted from the new treaty thus further limiting the circumstances in which a permanent establishment will be found to exist. The new treaty provides that a person other than an agent of independent status who is engaged solely in the maintenance of a stock of goods or merchandise belonging to a resident of the other state for the purpose of storage, display, or delivery does not constitute a permanent establishment.[52]

Article V(6) of the new treaty stipulates that "a fixed place of business used solely for, or a person described in paragraph (5) engaged solely in," certain enumerated activities, will not constitute a permanent establishment notwithstanding paragraphs (1), (2), and (5) of Article V.[53] The enumerated activities are the use of facilities for storage, display, or

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50 This stipulation is further expanded by Article V(4) which provides that the use of a drilling ship or rig in a contracting state to explore for or exploit natural resources constitutes a permanent establishment if, but only if, such use is for more than 3 months in any twelve month period. Coulombe suggests that although under the present treaty a permanent establishment would likely have existed in such circumstances owing to the "use of substantial equipment or machinery," the existence of service rigs to maintain drilling rigs could be argued as falling outside the treaty provision. Coulombe, supra note 46, at 327. Responding to this assertion, the session moderator, R. Alan Short, Director of Tax Policy at the Canadian Ministry of Finance commented, "in regard to a drilling rig or ship used to explore or exploit natural resources in the context of fishing, if a drilling ship, in fact fishes and is successful, then it would certainly qualify as a permanent establishment. Otherwise I do not think it falls within the definition. But this is an example of the style of that convention: the wording is obviously drafted by a committee. The draft has a certain amount of elegance and in part, precision. In the expression 'drilling rig or ship' the word 'drilling' is intended to modify both rigs and ships. I suppose some law school might set a doctoral thesis on that question of interpretation. The extent to which the courts will look to intention is an interesting question, but the specific issue will be unlikely to reach the courts because, as a practical matter, it will simply be interpreted by the administration as it was intended." The Canada-U.S. Income Tax Treaty, supra note 46.

51 Article V(3) of the new treaty provides that "a building site or construction or installation project constitutes a permanent establishment if, but only if, it lasts more than 12 months."

52 New Treaty, supra note 1, art. V(5).

53 Id. art. V(6).

delivery; the purchase of goods or merchandise or the collection of information; advertising, the supply of information, scientific research or similar activities that have a preparatory or auxiliary character; and the maintenance of a stock of goods for purposes of storage, display, delivery, or processing.[54] Although Article V(6) of the new treaty corresponds with the provisions of Article V(4) of the OECD Model, the language of the two provisions differ in one important respect. Under the OECD text, any combination of the activities listed in Article V(4) will result in a finding of permanent establishment unless such combination remains of a preparatory or auxiliary character.[55] No similar restriction exists in the corresponding provision in the new treaty. Thus, arguably, the language of the new treaty would allow for a greater degree of activity than its OECD equivalent without a permanent establishment being created.[56] It should also be noted that the reference in Article V(6)(e) to specific activities does not imply that any other particular activities of a preparatory or auxiliary nature, such as the servicing of a patent or the inspection of the implementation of engineering plans, do not fall within the scope of Article V(6)(e).[57]

2. *Agents*. Article V(7) excludes from the definition of "permanent establishment" the carrying on of a business in a contracting state through a broker, general commission agent, or any other agent of independent status acting in the ordinary course of business. If treaty protection is to be enjoyed the agent must be both legally and economically independent of the foreign enterprise and must be acting in the ordinary course of his business when he acts on behalf of that enterprise.[58] Whether an agent will be deemed to be independent of the enterprise represented will depend on the extent of the agent's obligations vis-a-vis the enterprise.[59] Thus, if the agent's commercial activities for the enterprise involve detailed instructions from or control by the foreign enterprise a sufficient degree of independence will not exist to invoke treaty protection.[60]

The requirement that the agent or commission broker act in the ordinary course of his own business will not have been met if, in place of the foreign enterprise such persons perform activities which economically belong to the business sphere of the foreign enterprise rather than to that of their own business operations. Thus, for example, if a commission agent habitually acts as the foreign enterprise's permanent agent with

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54 Id. art. V(6)(a)-(c).
55 O.E.C.D. Model Treaty, supra note 9, art. V(4)(f).
56 Coulombe, supra note 46, at 328.
57 U.S. Treasury Department, supra note 44, para. 30.
58 New Treaty, supra note 1, art. V(7).
59 Id.
60 Commentary on Article V Concerning the Definition of Permanent Establishment, O.E.C.D. Model Treaty, supra note 9, at 67. Note that another important element in the determination of independence will be whether the entrepreneurial risk is to be born by the agent or by the foreign enterprise which the agent represents.

full authority to enter into contracts, he would probably be deemed a permanent establishment of the foreign enterprise with respect to this particular activity even though he sells the goods or merchandise of the foreign enterprise in his own name. Such an agent would be acting outside the ordinary course of his own trade or business (namely that of commission agent) unless his activities were restricted to those set out in Article V(6).[61]

3. Subsidiaries. Article V(8), which is identical to Article V(7) of the OECD Model Treaty, provides that the presence of a subsidiary company in one contracting state does not, of itself, constitute a permanent establishment of its parent located in the other state. A comparison with the wording of the present treaty, however, shows the new wording to be less definitive; section 3(f) of the Protocol simply states that permanent establishment "does not include a subsidiary corporation."[62] Thus, under the new treaty a subsidiary corporation could be a permanent establishment of its parent under the same circumstances as any other person even if the subsidiary could also be regarded as an independent agent if it had and habitually exercised authority to conclude contracts in the name of the parent.[63]

4. Extension of the Tests. Finally, in a departure from the provisions of the present treaty, Article V(9) purports to extend the application of the permanent establishment tests to the Convention as a whole for determining "whether any person has a permanent establishment in any State," rather than simply the contracting States.[64] This provision would be invoked in determining whether a person other than a resident of Canada or the United States had a permanent establishment in Canada or the United States and whether a person residing in Canada or the United States has a permanent establishment in a third State.[65]

5. Management Services. One further change in the new treaty which enterprises engaged in cross border transactions should note pertains to management services. Under the present treaty, if a U.S. enterprise renders management services in Canada it will be taxable in Canada on income earned from such services and no treaty protection will be available. This result occurs because of the omission of management fees from the definition of industrial and commercial profits in Article II of

61 Id. at 68.

62 Present Treaty, supra note 6, § 3(f) of the Protocol.

63 Coulombe, supra note 46, at 328.

64 New Treaty, supra note 1, art. V(9).

65 Regarding the application of this provision in respect of interest and royalties under the New Treaty, see McKie, Recipe for Usury (Article XI: Interest); and Cole, Royalty Transactions and Variations under the New Canada-U.S. Income Tax Treaty; supra note 46 at 414 and 706.

the present treaty.[66] Thus, a U.S. enterprise carrying on business in Canada would sustain Canadian tax on management charges even though the enterprise does not have a permanent establishment in Canada. Under the new treaty this result will not occur.[67]

6. Important Amendment. It is true that in several respects the language of the new treaty may be preferred to the provisions of the present treaty, particularly regarding such items as the maintenance of a stock of goods for delivery in one or the other country, or the omission from the new treaty of provisions which resulted in the use of substantial equipment giving rise to a permanent establishment. It may be, however, that the most significant change in the new treaty in respect of jurisdiction to tax lies in the amended wording of Article VII. Article VII of the new treaty is substantially similar to Article I of the present treaty in that it exempts profits of U.S. residents generated in Canada where the U.S. resident does not carry on business "through a permanent establishment" in Canada. In contrast to Article I of the present treaty, however, a foreign enterprise need carry on business in Canada only through "a" permanent establishment, whereas under the present treaty, it must carry on business in Canada through "its" permanent establishment before treaty protection from Canadian tax is lost.[68]

Consider the example of International Widgets discussed above. While the change in wording might not give International a permanent establishment in Canada, it may be that if the independent sales representatives were employees rather than independent contractors, their use and control of any fixed place of business in Canada in the course of employment might be sufficient to establish that International was carrying on business in Canada through a permanent establishment and thus enable Canada to impose tax levied under the Act. Although this aspect

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[66] Article II provides in part that "For the purposes of this Convention, the term 'industrial and commercial profits' shall not include income in the form of rentals and royalties, interest, dividends, management charges or gains derived from the sale or exchange of capital assets."

[67] Subsection 805(1) of the Canadian Income Tax Regulations (Consolidated Regulations of Canada, Vol X. ch. 945 (1978)) stipulate that where a nonresident person carries on business in Canada amounts such as management charges which can be allocated to the business carried on in Canada by the nonresident, which would otherwise be subject to nonresident witholding tax of 15% under Part XIII of the Act, will not be taxed under Part XIII, but rather Part I. In order to claim exemption from Canada's regular 50% corporate income tax under Part I, however, fees received must constitute industrial and commercial profits within Article I of the present treaty which by definition, excludes management charges. Thus, notwithstanding that a foreign enterprise might not have a permanenet establishment in Canada, where it earns management fees in respect of services rendered in the course of carrying on business in Canada, no treaty protection will be available because management charges are excluded from the protection afforded by Article I. A similar result will occur where rentals, royalties and interest are earned by a nonresident carrying on business in Canada in similar circumstances.

[68] Under the new treaty, management charges are not dealt with separately and are not excluded from "business profits" of the U.S. resident which are exempt from Canadian tax by Article VII so long as the U.S. resident does not carry on business in Canada through a permanent establishment located there. Consequently, the difficulty which can arise under the present treaty with respect to management charges does not arise under the new treaty.

of the proposed transaction would have to be carefully examined by International in light of the new treaty wording, the proposal to use a post office box in Canada would not be affected by the new treaty since, as was the case under the present treaty, such a post office box would not constitute a fixed place of business through which International's business is carried on,[69] and thus would not constitute a permanent establishment.

Similarly, in our second example, the provisions of the new treaty may alter the treaty protected status which Baseball Services Unlimited expected to apply to its service agreement with the Calgary Drillers Baseball Club. Because Article VII of the new treaty provides that the industrial and commercial profits of a foreign enterprise need only be generated through a permanent establishment rather than *its* permanent establishment, it seems possible that the mere use by Baseball Services of the Stadium facility, regardless of ownership or control, would disqualify Services from exemption from Canadian tax when the new treaty comes into force.

It might be possible to amend the agreement between Services and the Club, however, to protect the treaty exempt status of Services. Among the provisions that would have to be contemplated would be clauses providing that only Club employees would make use of the facilities at the Stadium and that Services would not be in charge of the operations but would, in effect, be restricted to providing consulting services to the Club. Moreover, if Services compensated any of the employees this action would risk making these persons employees of Services, in which case their use of the Stadium facilities would give Services a permanent establishment in Canada, which would disentitle [Baseball] Services from protection under the new treaty. However, if the real transaction could be structured so that Baseball Services would be nothing more than an adviser, i.e. if all employees working the Stadium concessions and attractions were employees of the Club only and received no remuneration from Services, and if a Club employee were in control of the Stadium facilities and Services reported to that person, then Baseball Services would have a good chance of being held not to be doing business in Canada through a permanent establishment under the new treaty. While it can be argued that the amended terms of the agreement would, in effect, change the nature of the transaction originally contemplated by the Club and Baseball Services, this result may be unavoidable where the nonresident enterprise is insistent upon ensuring treaty protected status.

III. Conclusion.

It took over ten years to negotiate the new treaty. Even now, it appears that it may be some time before it comes into effect. Many of

[69] See Consolidated Premium Iron Ores v. Commissioner 28 T.C. 127 (1957).

the new treaty provisions, such as the stipulations that the mere use of substantial equipment in one country, or the maintenance of a stock of goods for the filling of orders, do not constitute a permanent establishment will no doubt be welcomed by contractors, manufacturers, and distributors engaged in cross-border transactions. Enterprises engaged in offshore resource drilling activities are likely to have neutral feelings towards the new treaty, since they will still be considered as having a permanent establishment in one or the other state by reason of Article V(4) of the new treaty if not by the use of substantial equipment in Canada or the United States as was previously the case.[70]

Nonetheless, the provisions in the new treaty make it clear that all existing cross-border business plans between Canada and the United States will have to be carefully reviewed upon implementation of the new treaty. Therefore, it is likely that many Canadian and U.S. enterprises will find themselves obliged to reconsider and restructure the organization of their economic involvement in their neighbour's country if they are to continue to enjoy treaty protection.