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Can Canada Levy Tax on the Continental Shelf?

by A. Peter F. Cumyn*

I AM GOING to conclude our proceedings today with a novel subject matter, one which I think has attracted very little attention, and which is of great interest in Canada because of recent developments in the off-shore drilling program on the continental shelf east of Newfoundland. This is an interesting area because it is one in which tax law, constitutional law, and, to some extent, public international law overlap.

The stakes are very big and considerable activity is going on behind the scenes in Ottawa. There are still, however, large gaps in the Canadian fiscal system which, while there have been attempts to close them, are nonetheless still somewhat open.

As I say, this is terra nova, if not terra incognita. Actually, Canadians aren't making jokes about Newfoundland any more. Rather, they are witnessing a political battle between St. John's and Ottawa over the power to tax the revenue which will arise from these resources.

I am going to tackle the subject matter in two sections. First I am going to discuss the legal and constitutional background, and second, the tax issues which are raised.

I. THE CONSTITUTIONAL BACKGROUND

A. *Public International Law*

In international law, Canada as a sovereign state has full sovereignty over its territory. This territory includes the territorial sea. Subject to the right of innocent passage, which remains a public right, Canada can do whatever it wishes within its territorial sea, which extends 12 miles from the low water mark. Because of the fact that the coastline is indented, there are sometimes base lines, in which case the twelve-mile limit extends from the base line. The territorial sea includes the sub-soil, the seabed, the overlying waters and finally the air space above.

Beyond the territorial sea lies the continental shelf. Canada asserts exclusive sovereignty over the continental shelf, but for a limited purpose, namely exploring for and exploiting natural resources.

The continental shelf is not a part of Canada geographically because over it lie the high seas, and the high seas are certainly not part of Canada. However, Canada has exclusive ownership of the oil and gas within and under its continental shelf, and it also has jurisdiction to legislate with respect to the area regarding the exploitation of natural resources.

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In March 1970, Canada ratified the 1958 Geneva Convention on the Continental Shelf. That Convention contains a definition of the continental shelf. This definition is continuously under review and, indeed, is somewhat under dispute.

It appears clear that the continental shelf goes out to a depth of 200 metres. However, it can also go out beyond that depth, if it is feasible to exploit resources. Currently, exploitation is possible at depths in excess of 200 metres.

Canada's position is basically that the continental shelf goes out as far as 350 miles, depending on its configuration, to the point at which the seabed slopes down dramatically. This means that the shelf is about two million square miles — a very considerable area.

There is another basic constitutional principle which should be mentioned here. Canada has no limit on its power to pass fiscal legislation of extraterritorial operation. It can literally tax a Chinese farmer on the sale of his cow.

There are, of course, three main limitations on the exercise of this power. Firstly, the observation of the general principles of public international law. Secondly, Canada's international treaties, and in this I refer not only to tax treaties, but also, for instance, to the Geneva Convention of 1958. Thirdly, Canada cannot enforce its tax legislation extraterritorially. The decision of the British House of Lords in *Government of India v. Taylor* (1955) A.C. 491 clearly established this point.

B. Federal Provincial Law

The above observations deal largely with international questions. However, as between Canada and the provinces, there are also numerous complexities. Although Canada's provinces have exclusive jurisdiction in certain areas, notably property and civil rights, their geographic boundaries stop with certain exceptions at the low water mark. This is the source of one of the larger gaps in Canada's fiscal structure at the present time insofar as taxing offshore resources is concerned; surprisingly, the gap occurs in the present Canada-United States Tax Convention, which defines Canada to mean the Provinces and Territories, thereby excluding most of the territorial sea and all of the continental shelf. I shall talk more of this later.

Why do the provinces generally stop at low water mark? An answer to this question takes one back into Canada's colonial history. When the original provinces came together to form Canada in 1867, they did not have a territorial sea. Thus any jurisdiction beyond low water mark that accrued subsequently to Canada as a result of its achieving Dominion status benefitted Canada but not the provinces. However, Newfoundland is a case by itself. When it entered Canada in 1949, it was already a Dominion. At that time, it arguably had its own continental shelf, and if so, it may still have it.

This, in any event, and quite predictably, is the position which is presently asserted by the Government of Newfoundland. Last winter when he was still Prime Minister, Joe Clark, the Conservative leader, appeared to have been prepared to concede the point. However, Mr. Trudeau seems to want to have it referred to the Supreme Court. It may be that Newfoundland is entitled to a three-mile limit, although as I say, the matter is one of great doubt.

One of the great hiatuses in the Canadian legal system at present is that the federal government does not pass legislation in a great number of areas, such as property and civil rights. Nor can the provinces pass legislation applicable in the territorial sea because they generally stop at the low water mark. Presumably, what Canada should do is pass a law making applicable as a law of Canada in each offshore area the law of the adjacent province, save to the extent that there is specific overriding federal legislation. Presently, there are only a few instances in which Federal legislation extends to the offshore area beyond the 12-mile limit: the Criminal Code, the Fisheries Act and the Oil and Gas Production Conservation Act.

II. THE TAX ISSUES

Let us now turn away from the areas of international and constitutional law to that of taxation. Section 255 of the Income Tax Act contains an extension of the normal meaning of Canada by defining the expression "in Canada" to include and to have always included for the purposes of the Act the seabed and sub-soil of the submarine areas adjacent to the coast of Canada, in respect of which grants are issued by the Government of Canada or of a province of the right, license or privilege to explore for, drill for or take any petroleum, natural gas or minerals.

This extension is expressed as being for greater certainty, but clearly it isn't, because without it, Canada might extend as far as the 12-mile limit, but certainly would not include the seabed and sub-soil of the continental shelf.

Another thing which is interesting about this definition is that it refers to the seabed and sub-soil, but not to the overlying water and air space. This means for instance that a fishing boat or factory ship which operates outside the twelve-mile limit but within, say, the 200-mile limit for fishing is clearly outside of Canada. It could even be arguable that within the twelve-mile limit, such a vessel was not in Canada. This is a matter which is open to some doubt.

The third problem with the definition is that it refers only to areas in respect of which grants are issued to explore for gas, oil and minerals. If a particular area isn't governed by a grant at a particular time, has it suddenly been excluded from Canada for the purposes of the Income Tax Act?

A fourth observation about the present definition of Section 255 of

the Act is that it doesn't define Canada, but rather the expression "in Canada." In most cases, it so happens that the Act uses the word "Canada" preceded by the word "in," but there is at least one case where this is not so and that is in the definition of international traffic in subsection 248(1) of the Act. Paragraph 81(1)(c) of the Act exempts from tax the income of a non-resident from the operation of a ship in "international traffic" if certain other conditions are met. Subsection 248(1) defines "international traffic" to mean,

in respect of a non-resident person carrying on the business of transporting passengers or goods, any voyage made in the course of that business where the principal purpose of the voyage is to transport passengers or goods

- (a) from Canada to a place outside Canada,
- (b) from a place outside Canada to Canada, or
- (c) from a place outside Canada to another place outside Canada.

This definition is an exception to the general rule in the Act, in that nowhere does it use the expression "in Canada." The importance of this exception may be illustrated by the following case.

An offshore service vessel taking supplies from Halifax to a drilling rig outside of the 12-mile limit is going from a place within Canada to a place which, in the normal sense, is outside Canada. Unless the Act extends the limits of Canada in a material way, a non-resident's income from operating the vessel may be exempt from tax under paragraph 81(1)(c).

Turning to the specifics of the problems to which I have alluded, I'll deal first with the taxation of extraction activities and second with offshore services.

A. *Extraction Activities*

Under the present Act, and I'll refer in a moment to the proposed amendment to Section 255, it seems to me that it is relatively clear that any non-resident extracting oil or gas from the continental shelf is carrying on business in Canada. It may not be carrying on business in a province, but it is carrying one on in Canada.

However, will all of its income be derived from carrying on a business in Canada, or may Canada only tax the income from that part of its activities which takes place within the continental shelf? Since the shelf only includes the sub-soil and the seabed, the drilling platform itself is arguably outside Canada. The situation is more or less like that of a factory that straddles the border, part of it inside Canada and part of it outside Canada. There may be an argument that only a portion of the profits are allocable to a source in Canada because the platform is one part of the profit-earning process and the well down below is another part.

Another difficulty is that non-residents are not allowed under income tax regulation 1102(3) to depreciate property situated outside of Canada.

The drilling platform is a depreciable asset, but is it in Canada?

These are presumably some of the reasons why there is now before Parliament a Notice of Ways and Means Motion proposing, among other things, an amendment to Section 255 of the Act. This amendment was first proposed in the ill-fated budget of Mr. Clark of December 11, 1979. It was resuscitated by the Trudeau Government in its Notice of Ways and Means Motion of April 21, 1980. It reads as follows:

That after Royal Assent to any measure giving effect to this paragraph, Canada shall with respect to specified resource exploration, exploitation and related activities be declared to include and to have always included the seas and air-space over the submarine areas referred to in section 255 of the Act.

In other words, this amendment would bring into Canada for income tax purposes the water and the air lying above the seabed and sub-soil of the continental shelf.

An important thing to note is that this is a declaratory amendment. Canada is to be declared to include and to have always included the areas in question. In our constitutional law, there is nothing illegal about retroactive legislation. However, such legislation is considered to be repugnant, and therefore the retroactivity must be clearly expressed. In the present context, retroactivity will clearly change the rules as they exist at the present time. For example, it will clearly put the platform of the extraction operation discussed earlier within Canada.

Some of Canada's international tax treaties may well override this provision. A case in point is the United States-Canada Tax Convention which happens to define both Canada and the United States in its Protocol. According to Article 5 of the Protocol, "Canada when used in a geographical sense means the Provinces, the Territories and Sable Island." This definition uses the word "means," not "includes," and accordingly one must infer that for purposes of the Convention, Canada does not include any areas other than the Provinces, the Territories and Sable Island. Since the Provinces generally stop at low water mark, with the possible exception of Newfoundland, this virtually leaves out the entire offshore area.

This could mean that any extraction operations conducted by a U.S. enterprise on the Canadian continental shelf will be carried on outside of Canada, and the drilling platforms used will not constitute permanent establishments within Canada.

B. Offshore Services

I turn now to the taxation of offshore services, things like submarines that hover near the bottom of the sea, and offshore services vessels that carry out men and supplies.

The position which Canada takes in this area has evolved quite a bit

recently. In the summer of 1977, it conceded that a two-man submersible operated by a non-resident above the continental shelf was not performing services in Canada because it wasn't on the seabed, it was about 15 metres up. Accordingly, its income was not subject to withholding tax under Regulation 105. With the impending retroactive amendment to the Income Tax Act definition of "Canada," the Department could not make that concession at the present time, unless the situation were affected by an income tax treaty. It is noteworthy that many of Canada's tax treaties contain a definition of Canada which is akin to the present definition in Section 255, rather than the proposed new definition. They contain no reference to the sea and air space over the sub-soil and the seabed of the continental shelf. Accordingly, any ships operated by non-residents in those areas could be operating outside of Canada for the purposes of the treaty, quite apart from the additional fact that under Canadian law a ship is generally not considered to constitute a permanent establishment.

III. CONCLUSION

Canada obviously has it in its interest to bring within its tax net these new and potentially very profitable activities on its east coast. The amendment to Section 255 is one step in the right direction. It is far from sufficient, but one must ask oneself, just how far can and should Canada go?

First, there are two principles in conflict. One is the freedom of the high seas, and the usually concomitant protection from double taxation of international shipping. The other is Canada's right to control and profit from the exploration of the resources within its continental shelf.

In addition, Canada must abide by its international tax treaties. Perhaps it is on the verge of solving the peculiar problems raised by the Canada-United States Convention, but there are still a number of other treaties which also raise problems in this area.

Finally, there was a rather interesting bit of speculation in *Oil Week*, a magazine published in Canada, in its March 31, 1980 edition, on whether Canada could really assert sole ownership of the resources beyond a certain point, such as a depth of 200 metres or a distance of 200 miles, on its continental shelf. Canada is arguing in favour of a shelf that extends as far as 350 miles, and there is a considerable difficulty as to whether or not it really can be quite so ambitious. The article discussed the suggestion that resources taken out of the shelf beyond a certain line such as the 200 mile limit should bear an overriding royalty in favour of "the international community." The question remains, however, could international tax law one day have to deal with an international tax?