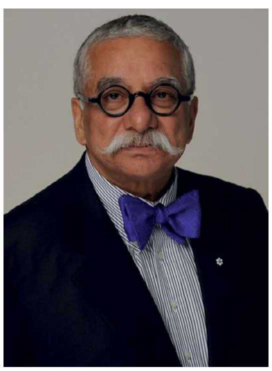
Canadian Current Tax

VOLUME 28, NUMBER 7 | Cited as 28 Can. Current Tax | APRIL 2018

# • INTERNATIONAL TAXATION OF BUSINESS PROFITS •

Professor Vern Krishna, CM, QC, FRSC, University of Ottawa Law School, and Counsel:
Tax Chambers LLP (Toronto)

**Vern Krishna CM**

## A. GENERAL COMMENT

**International** tax treaties generally tax income from business on a net basis. This contrasts with the taxation of investment income, which is taxed on a gross basis.

In determining liability for tax on business profits, we start with the domestic rule. Most countries have domestic "place of business" or "carrying on business" rules that tax non-residents on their business income within the source country.

As a starting point, and subject to international tax treaty provisions, Canada taxes non-residents on their taxable income that they earn from a business that they carry on *in* Canada.[1] Under Canada's tax treaties, however, the tax bar is raised so that non-residents are taxable on business income only if they conduct the business through a permanent establishment in Canada.

The question of allocating tax jurisdiction between residence and source country is not significant where capital outflows and inflows between the countries are approximately equal. In a world of perfectly equal capital flows, it makes little difference whether the residence or the source country taxes the business profits of MNEs.

Taxable jurisdiction is important when capital flows between countries are uneven. Residence country taxation works to the advantage of developed countries because MNEs generally go from developed to developing countries to do business and earn profits from the latter's resources. Developing countries prefer source-based taxation as MNEs exploit their resources for profit. Of course, as economies develop and economic power shifts — for example, India and China — the focus of tax

**• In This Issue •**



LexisNexis®

*Canadian Current Tax is published by LexisNexis Canada Inc. in collaboration with the CGA Tax Research Centre. The CGA Tax Research Centre at the University of Ottawa promotes research in Canadian domestic and international tax law through publications, conferences and as a conduit to governmental agencies.*

## CANADIAN CURRENT TAX

**Canadian Current Tax** is published monthly by LexisNexis Canada Inc., 111 Gordon Baker Road, Suite 900, Toronto ON M2H 3R1 by subscription only.



**ISBN 0-409-91091-0 (print)** **ISSN 0317-6495**
**ISBN 0-433-44637-4 (PDF)**
**ISBN 0-433-44375-8 (print & PDF)**

Subscription rates: $595.00 per year (print or PDF)
$685.00 per year (print & PDF)

**General Editor**
Professor Vern Krishna, CM, QC
Firm: Of Counsel: Tax Chambers LLP
University of Ottawa Law School
E-mail: vern.krishna@taxchambers.ca

Please address all editorial inquiries to:

**LexisNexis Canada Inc.**
Tel. (905) 479-2665
Fax (905) 479-2826
E-mail: cct@lexisnexis.ca
Web site: www.lexisnexis.ca



LexisNexis®

**Publications Mail**
Reg. No. 186031

negotiations shifts as MNEs of developing countries become more internationally acquisitive.

### B. TAX TREATIES

Countries are prone to claim taxing jurisdiction over foreign corporations that operate within their borders.[2] Indeed, multinational enterprises (MNEs) are attractive targets for taxation because they do not generate the political emotion that domestic persons can readily muster.

The League of Nations recognized the propensity of governments to tax foreign corporations: "A survey of the whole field of recent taxation shows how completely governments are dominated by the desire to tax the foreigner". Hence, the League conceived the notion of the "permanent establishment" to inhibit taxation of foreign corporations. T. S. Adams (the US representative on the team of Technical Experts of the League of Nations) played a significant, even predominant, role in developing the notion to protect the business interests of US multinational corporations. His assistant, Mitchell Caroll, said:[3]

> After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States firm on profits from advertising its wares and receiving mail orders from customers in its territory. In the early 1920's, the British Board of Inland Revenue sought to impose liability … [on] sales through a local commission agent… even if the non-resident and his British intermediary took pains to conclude the contract abroad.

The fundamental theory underlying international double tax treaties is to tax the business income of MNEs trading *in*, as opposed to trading, *with* a country. The theory is implemented in the "permanent establishment" (PE) concept, which is intended to provide a measure of the depth of an enterprise's presence in a country. The concept prevents governments from overreaching their power by taxing persons based on an insignificant presence in the source country.

## C. FUNCTION OF THE PE CONCEPT IN TAX TREATIES

The PE concept pervades tax treaties, and no other single concept is as determinative of income allocation between the taxpayer's State of residence and State of source of income. The primary function of the PE is to set the threshold for taxation of cross-border business profits between treaty partners and establish a threshold for source country taxation of a non-resident's business profits. A resident of a state is taxable by another state only if the resident carries on business through a PE in the other state, and then only to the extent of the profits attributable to the PE.

Hence, the definition of a PE can determine the allocation of tax between the source and residence countries. The lower the threshold of PE, the more the tax that the source country can collect. The higher the threshold, the lower the tax for the source country.

OECD Article 7(1) states the general rule for the allocation of tax on business profits:

> Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxes in that other State.

OECD Article 5(1) is the starting point in determining the allocation process:

> For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The underlying principle is that a PE is a distinct and separate enterprise engaged in business activities. To be taxable in the source country, the MNE's profits must be attributable to a notional "distinct and separate enterprise" engaged in business in the country. This avoids tax obligations where an enterprise generates only minimal profits without a sufficient presence in the country. However, the basic concept of PE was developed for a "bricks and mortar" economy, which has evolved over time. The concept does not fit easily into a digital economy where goods and services are delivered electronically across national boundaries. The sale of digital goods and services in electronic commerce across national boundaries may require an economic substance and dollar threshold test in the future.

In addition to the allocation of business profits to a State, the PE concept may also affect other throwback rules pertaining to other types of income.

### Investment Income

For example, Articles 10(4) (dividends), 11(4) (interest), and 12(3) (royalties) all anchor payments in the State where the beneficial owner earns the income that is effectively connected with a PE in the State.

### Other Income

OECD Article 21 provides that income not dealt with in any other Article of a Treaty is taxable only by the country in which the taxpayer is resident, subject to a "throwback" to Article 7 (Business Profits) if the taxpayer carries on business through PE in the State.

### Capital Gains

OECD Article 13(2) provides that gains form the alienation of movable property forming part of the permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from alienation of such permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

### Employment Income

OECD Article 15(2) provides that remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

Non-Discrimination

OECD Article 24(3) provides that the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other state than the taxation levied on enterprises of that other State carrying on the same activities. The provision shall be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

## D. THE MODEL TREATIES

Most tax treaties are premised on the OECD Model Tax Convention for the Elimination of Double Taxation on Income and on Capital and the Prevention of Tax Evasion and Avoidance (herein the OECD Model), the latest version of which appeared on November 21, 2017, or the UN Model Treaty. The United States models its treaties on its own US Model. All three models start with the premise that a taxpayer's business income should be taxable primarily by its state of residence, unless the taxpayer has a "significant presence" in the country where it derives its income — the source State.[4] We determine significant presence by looking to see if the taxpayer has a permanent presence in the source state.

Hence, paragraph 7(1) of the *OECD Model* (2017) states the general premise of the residence rule:

> "Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State."

Similarly, paragraph 7(1) of the UN Model:

> "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment."

And, paragraph 7(1), the US Model (2016):

> "Profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 of this paragraph may be taxed in that other Contracting State."

Under all three Models, a MNE's business profits are taxable by the country of its residence, *unless* the enterprise carries on its business in the source State through a permanent establishment in that State. If it does, the MNEs business profits are taxable by the source State to the extent that they derive from, and are attributable to, a permanent establishment (PE) in the source State.

Thus, there are three essential questions that determine jurisdiction to tax profits:

1. Do the profits derive from a business?
2. Does the taxpayer have a PE in the source State?
3. How much profit is attributable to the PE?

## E. MEANING OF "BUSINESS" UNDER DOMESTIC LAW

Business income derives from using property, a process that generally combines labour and capital.

In contrast, income from an investment derives from holding property through a passive process. Thus, the distinction between business and investment income depends primarily upon activity. Business income derives from activity. Investment income is the yield on the property.

There is a refutable presumption that corporate income is business income.[5] One refutes the presumption through contrary facts since most businesses engage in both business and investment activities — for example, generating business income and cash management. Rebutting the presumption is a question of fact.

The *Income Tax Act* (Canada) deems a "business" to include "a profession, calling, trade, manufacture or undertaking of any kind whatever and … an adventure or concern in the nature of trade".[6] By its very nature, an adventure or concern in the nature of trade is an isolated transaction that has elements of risk and speculation.

### 1. Carrying on a Business

The domestic law threshold for "carrying on business" is low. Section 253 of the *Income Tax Act* (Canada) deems a non-resident person to be carrying on business in Canada if he produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs anything in Canada.

In addition, the Act also deems a person to be carrying on business in Canada if he solicits, orders or offers anything for sale in Canada through an agent or servant, regardless where the parties conclude the transaction or contract. The rule applies to any form of solicitation of business or orders — whether tangible or electronic — *in* Canada.

The term "business" implies continuing activity. Expressions such as "engaged in business", "carrying on business" and "doing business" essentially mean the same thing. All three expressions — either separately or connectedly — suggest progression, continuity, or sustained activity.

"Engaged in business" means occupied in business or employed in business. "Carrying on" means conducting, prosecuting and continuing business by performing progressively all the acts normally incident thereto." Similarly, the expression "doing business", conveys the idea of business being done, not from time to time, but all the time. Hence, we cannot say that a non-resident person who engages in an isolated transaction is *carrying on* a business.[7] Under the *Income Tax Act*, however, a "business" includes an "adventure or concern in the nature of trade". Thus, an isolated transaction can be a "business".[8]

The phrase "carrying on business in Canada" also includes any activity where a non-resident solicits orders or offers anything for sale *in Canada* through an agent or servant, no matter where the transaction is completed.[9]

"Soliciting orders", means seeking orders. The word "offer" has its ordinary meaning in contract law.[10] Thus, *absent treaty protection*, a non-resident is liable for Canadian income tax simply by soliciting orders or by offering goods for sale in Canada. However, advertising a product for sale in Canada is not an "offer" and is not, *by itself*, sufficient to characterize a business as carried on in Canada.[11]

### 2. Incidents of Trade

There is no single criterion to determine whether a person is carrying on a business. In *Erichsen v. Last*, for example:[12]

> … There is not, I think, any principle of law which lays down what carrying on trade is. There are a multitude of things which together make up the carrying on of trade, but I know no one distinguishing incident, for it is a compound fact made up of a variety of things.

The essential feature is to determine whether a person is conducting a business in, or with, a country. The following are some of the traditional factors to consider about the enterprise:

- Where does it make its contracts?
- Where are goods delivered and payments made?
- Where are its assets?
- Does it use an agent or independent contractor?
- Where in substance do its profits arise?

- What is the nature of its activities/transactions?
- Where are its bank accounts, listed telephone numbers and addresses?
- Does it intend to do business in the country?
- Where does the business purchase its assets?
- What is the degree of supervisory or other activity in the country?
- What is the substance of the transactions?
- Does the business have a representative or resident expert in the country?
- Are the activities in the country merely ancillary to its main business?
- Are there individuals in the country who help the business in its endeavours?

However, as the nature of some economies has developed globally and, in technological industries, moved from bricks and mortar to electronic commerce, the conduct of "business" needs to be evaluated in a more sophisticated context of its activities.

### 3. Solicitation of Business

The phrase "offered anything for sale in Canada" is limited to an offer that, if accepted, will create a binding contract between the buyer and the seller.[13] Thus, non-residents who merely canvass Canadian business are not liable to tax in Canada.[14]

The place where one concludes contracts can be important in determining where a person is carrying on business.[15] In *Sudden Valley Inc.*,[16] for example, a US company lured Canadians living on the west coast of Canada to the Seattle area, where its representative would then attempt to sell them land in the United States. The company took all of the offers to purchase and financial deposits in the United States. The US company's presence in Canada was a Vancouver office from which they invited Canadian residents to visit the United States. The company's only activity in Canada was to entice Canadians to visit Sudden Valley in the hope that they might buy some property.

The company also conducted a sales campaign of advertisements in Canadian publications and television broadcasts from US border stations. The advertising material, however, did not mention the offering of land for sale but merely referred to a "gracious invitation to Sudden Valley for a visit. Held: they made no offer, and they offered nothing for sale, in Canada.

In *Piedras Negras*,[17] a radio station that had previously broadcast from Texas moved across the Rio Grande to Mexico. All of its production facilities were in Mexico, but it broadcast in English to a Texas audience, and derived all of its revenues from advertisers in the United States. Other than the collection of payments from advertisers, the company did not employ any labour in the US.

The foreign corporation was not subject to US income tax on its income from the advertising contracts because it earned its income outside the United States. The mere solicitation of business was not sufficient to constitute "doing business" for the purposes of establishing a taxable nexus in the US.

However, having an office in a country can make a difference to taxable nexus. For example, in *North Western States Portland Cement Co*.[18] the court held that solicitation *plus* an office in the US was sufficient contact to subject the seller to state tax.

Similarly, in Revenue Ruling 56–165 (1956–1 CB849), the Internal Revenue Service ruled that regular and active solicitation in the United States was sufficient to cause a taxpayer to be engaged in a US trade of business under the US–Swiss Treaty. In this situation, however, the company brought logging equipment into the United States to display its products and generate orders that it filled in the country. The company had a physical presence in the United States beyond the mere solicitation of orders.

## F. PERMANENT ESTABLISHMENT

The second step in determining whether a country has taxable jurisdiction over the business profits of a non-resident enterprise is to ascertain whether the enterprise has a "permanent establishment" (PE) in the country. The OECD Commentary to paragraph 5 states the purpose of the PE concept:

> The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise

> of the other Contracting State. Under paragraph 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

Where an enterprise has a PE in a country, there is sufficient taxable nexus between the enterprise and the source of its income. Thus, the PE test marks the minimum threshold above which a country may tax the business profits of a non-resident within its territory.

A PE is essentially a separate enterprise taxable on its share of profits calculated on an arm's length basis. Traditionally, the PE concept has relied on a physical presence test, and not an economic presence standard. The physical presence requirement benefits multinational enterprises (MNEs) that engage in global trade. The test provides a degree of uniformity, predictability and administrative convenience. The test is intended to mitigate double taxation and reduce the potential for jurisdictional tax disputes. The test also reduces the administrative burden on MNEs as they do not have to file net basis income tax returns in every country in which they have customers or other sources of income.

A corporation that wants to do business in another jurisdiction will prefer to operate where it can easily and definitively estimate its income tax exposure. The physical presence test provides greater certainty than an economic presence test. The test, however, applies only to federal taxes and may not apply to provincial or state taxes in a federal system.

The physical presence test, which relies on a substantial nexus between the corporation and the place where it conducts its business, is becoming increasingly problematic. Because of technological advancements, it has become increasingly easier for companies to do business globally, but without physical presence in a country by using technology.

The general rule is that only business profits attributable to a PE are taxable in the jurisdiction where the establishment is located. An allied principle is that profits should be measured in terms of arm's length transactions. The arm's length rule allows the source country where the permanent establishment is located to rectify the enterprise's book profits to properly reflect any income that the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length.

## G. CONCLUSION

The liability for tax on international income depends upon the nature of the income. The first step is to characterize the source of income according to domestic rules and then apply the relevant treaty rules in respect of the particular source. The treaty rules will generally rely on the concept of "permanent establishment".

[***Vern Krishna***, *CM, QC, FRSC is Professor of Common Law at the University of Ottawa, and Tax Counsel, Tax Chambers, LLP (Toronto). He is a member of the Order of Canada, Queen's Counsel, a Fellow of the Royal Society of Canada, and a Fellow of the Chartered Professional Accountants of Canada. His practice encompasses tax litigation and dispute resolution, international tax, wealth management and tax planning. He acts as counsel in income tax matters, representing corporate and individual clients in disputes with Canada Revenue Agency, and appears in all courts as tax counsel.*]