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*by Peter Cumyn**

I WOULD LIKE TO briefly describe the treaty-making process in Canada and then narrow my discussion to problems under the current Canada-United States Tax Treaty.

In Canada, the negotiation of treaties is entrusted to the Department of Finance which is also responsible for tax legislation. This differs from the duties of Revenue Canada, which administers both the Income Tax Act and the treaties once they become law. In Canada treaties do become law, that is to say, once the Department of Finance has negotiated them they travel the same routes as any other legislation; through the House of Commons, followed by the Senate, and they have to receive the same sanctions as other bills. Once treaties become law they all will "speak" in the sense that they override the Income Tax Act even as the Act is subsequently amended. Generally speaking, this override feature of treaties is accomplished through a specific provision contained in the implementing legislation.

When Canada reformed its tax system in 1972 it immediately embarked on a hectic round of new treaty negotiations. However, the Canadian government did not achieve results as rapidly as it had hoped, and this explains to a large extent why certain provisions in the Canada-United States Tax Treaty were delayed in implementation until 1976. At the present time Canada has about twenty treaties. It entered into negotations first with its lesser trading partners, before confronting the United Kingdom and the United States. While the United Kingdom tax treaty has not posed any problems for Canada, the same cannot be said of the new Canada-United States Tax Treaty, although it now appears that the tax credit is the stumbling block, everything else being virtually resolved.

I now shall discuss several specific provisions of the Canada-United States Income Tax Agreement. Each of these provisions is of current public interest and some have generated Canadian case law.

The first is the industrial and commercial profits provision. Article I of the Convention says that an enterprise of one of the contracting States is not subject to taxation by the other contracting State with respect to that enterprise's industrial and commercial profits, except to the extent that they are allocable to a permanent establishment. There is a line of Canadian court decisions dealing with this provision, the first being that of *Tara Exploration & Development Co., Ltd. v. M.N.R.* (1972) C.T.C. 328. In this case, a Canadian corporation was basically carrying on a mining operation in Ireland. It traded once or twice in Canada in speculative securities and the

* Of Stikeman, Elliott, Tamaki, Mercier & Robb, Montreal. These remarks were made at the Canada-United States Law Institute's Transnational Taxation Conference, held April 21, 1978, at the Case Western Reserve University School of Law, Cleveland.

decision of the court was that this in itself did not constitute carrying on business in Canada, because the element of continuity which should be present in the conduct of a business was absent. Although *Tara* did not really raise treaty provision issues because under domestic law Tara was not taxable, it did provide the basis for the *Masri* decision. In *G. R. Masri v. M.N.R.* (1973) C.T.C. 448, an individual resident of New York owned several pieces of real estate in Canada and in due course he placed them on the market and sold them. It was held that because the real estate was offered through Canadian brokers, Mr. Masri has been carrying on a business in Canada. But, it was held that he had no permanent establishment in Canada. Interestingly this means that the raw land itself did not constitute a permanent establishment. It was the object of the trade, but not the place where it was conducted. Accordingly, Mr. Masri could not be taxed by Canada by virtue of the provisions of the Canada-United States Income Tax Agreement. There were two more cases decided in 1978. The first case involved a Mr. Abed, and the facts are almost identical to those in *Masri*. However, the interesting point in *H. S. Abed v. M.N.R.* (1978) C.T.C. 5, is that the court held that Mr. Abed had no enterprise in the United States. He was just a personal investor. He owned various lots of real estate in Canada, and although it could be said, as in *Masri*, that he was not carrying on a business through a permanent establishment in Canada, he was not a United States enterprise and therefore, he was not entitled to treaty protection. The next case, *J. Rutenberg v. M.N.R.* (1978) C.T.C. 38, involves an individual who likewise lived in New York and owned real estate in Canada. Rutenberg was held to be carrying on a business like Masri and Abed, he was held not to have a business enterprise and therefore not entitled to treaty protection. However, it was considered that he had a permanent establishment in Canada. Thus, these three cases split a hair one way and then another and show, if anything, an evolution away from treaty protection, particularly with regard to speculative real estate, and they throw light on the significance of an expression such as "a United States enterprise."

Another interesting item is the intepretative bulletin dealing with the Canada-United States Income Tax Convention. Bulletin IT-173R of July 7, 1975, comments on the meaning of permanent establishment as seen through the eyes of the Canadian authorities, in the context of the United States Treaty. For instance, it gives the example of a person prospecting in a particular geographical location of Canada, but who is basically a nomad. He has no fixed place of business. This is cited as an example of a person having no permanent establishment in Canada. It is further indicated that the length of time that a fixed place of business exists is not really an indicator of a permanent establishment. What is more relevant is the continuity of the fixed place of business during the time frame involved. The bulletin also mentions that a field office erected in Canada by a contractor from the United States to carry on building or other operations would be a fixed place of business. It also adds that the use by a resident of the United States of substantial equipment or machinery in carrying on his business in Canada constitutes a permanent establishment; the resident need not own the equipment or machinery, use is sufficient. It should be noted that these bulletin examples are stated in the context of the capital gains provisions of article VIII, but they are equally applicable to the industrial and commercial profits sections.

Next to be discussed is the treatment of directors' fees. There have been many problems recently involving directors of Canadian corporations living in the United States. Article XIII B of the Treaty states that if the directors' meetings are held in the United States, then Canada will not levy any tax on fees paid for those meetings. The problem arises, however, where the directors meet in Canada. It is necessary to establish whether the fees are being paid on a per meeting basis or on an annual fee basis. If the former, then it can be said that on the days upon which the directors meet, each director, albeit a non-resident, is being employed in Canada. Then one must look to article VII of the Treaty to determine whether or not he comes within the exemption made available. If the director is being paid on an annual basis the considerations are somewhat different, because there it is presumed that each day he is a director he carries certain responsibilities, thus the entire fee should be considered to have been earned on a per diem basis. Article VII grants such an individual an exemption if he is present in Canada for a period of less than 183 days, and if his compensation does not exceed $5,000. The actual provisions of article VII become a little more complicated, however, when applied in specific circumstances. For example, if a Canadian resident moves to the United States in August, under the American system section 114 of the Internal Revenue Code will tax him on his worldwide income up to the end of August, if that is when he left Canada, and will consider him to be an American resident thereafter. This is subject to the exception that if he is employed in Canada on any day or during any period after August and for the rest of the year, he is taxable on his worldwide income. Revenue Canada takes the position that if he is a director during the balance of the year, then he can be exposed to taxation on his worldwide income, absent the Treaty, on those days on which he is employed in Canada as a director, probably the days on which he is actually physically present in Canada. The protection that article VII of the Treaty provides in this complicated situation is imperfect, because it refers to one who is not present in Canada for period(s) totalling 183 days. Of course, if he remains in Canada until the end of August, he will exceed the 183 day limit. Thus, there are problems when a person moves from Canada to the United States after 183 days in a year, which can be avoided by having him resign his Canadian directorship and assuming it again at the beginning of the following year.

Another area of interest involving executive transfers is that of pensions. Under the Treaty, a Canadian source pension paid to a United States resident is free of Canadian withholding tax. A pension is defined in the protocol as being an annual or periodic sum. In *C. A. Specht v. The Queen* (1975) C.T.C. 127, a man who was asked to resign or suffer the consequences of being fired from a Canadian job moved to the United States and received an indemnity which was in effect a pension, payable over a five year period.

Revenue Canada sought to assess withholding tax, arguing that this was not truly a pension. The court held that it was a pension and as such exempt from withholding tax. The question, however, is whether the words in the protocol which require periodicity are merely explanatory or whether they are restrictive.

In *R. v. J. M. Cruickshank* (1977) C.T.C. 344, a lump sum payment was held to constitute a pension under the Canada-France Treaty, and thus to benefit from the exemption from Canadian withholding tax afforded under that Treaty. However in the Treaty there is no specific definition involving periodicity. The meaning of the word "pension" was merely left to the lexicon and the court held that it should be given the widest possible meaning. In particular it should be given an interpretation which would dovetail with the meaning given to it in the Income Tax Act, where in fact it would include a lump sum.

The problem is of some interest because in Canada there are "income averaging annuity contracts" which permit people to defer certain sudden increases in their income. For instance, if a man makes a capital gain in Canada which will greatly increase his rate of tax, he can buy an income averaging annuity and effectively only pay tax on his gain at the time that the annuity is paid back to him. If he moves to reside in the United States in the interim, he can, of course, hope to receive the full amount of that annuity free of Canadian withholding tax. What happens however if he wishes to collapse his annuity immediately after he has moved to the United States? If he receives that single payment, will it constitute an annuity for the purposes of the Treaty? Can one rely on *Cruickshank* or does the requirement of periodicity in the protocol mean that one cannot avoid withholding tax in such a circumstance? There lies a problem.

Another problem in the area of annuities is where a man is transferred to the United States and he is a member of a Canadian company's pension plan. It is decided that he should cease to be a member in the Canadian pension plan and become a member of the American plan. Since the American plan is prepared to assume all of the Canadian plan's liabilities *vis-à-vis* this man, the Canadian plan pays an amount to the American plan representing the assets required to fund the liability that the American plan is assuming. Should there be withholding tax on such a payment? Revenue Canada has in fact assessed withholding tax on a payment of the capital sum of this nature by a Canadian pension plan to a United States pension plan, notwithstanding the fact that since the United States plan was assuming a concomitant liability, there was no income but an offsetting liability being transferred with the assets. One could argue that if Revenue Canada views this as being an income type payment and subject to withholding tax, then surely it should accept that it constitutes a pension or annuity and thus free of withholding tax under the Treaty. The matter is currently under litigation.

A final point of interest concerns the exchange of information paragraphs or articles to be found in all of our treaties. It is relatively rare that one is actually given a problem under one of these paragraphs. However, the following is an example which I find rather disquieting. An American company with a Canadian subsidiary has a transfer pricing problem. The Canadian subsidiary and American parent eventually settle the problem by negotiation with Revenue Canada on the basis that a reasonable transfer price would be *X* dollars. Some months later the American company is dealing with a New Zealand subsidiary (New Zealand is being used for illustrative purposes only) and the New Zealand tax authorities raise the issue of whether or not the transfer pricing between the United States and New Zealand is fair. The issue goes to court and the American executive testifying in the case is suddenly confronted with various facts and figures which he realises have been taken from the confidential settlement between the United States and Canada. He finds himself attempting to justify his price in New Zealand, only to be cross-examined on the settlement figure in Canada. In those circumstances, given the exchange of information provisions in the treaty, is Canada in fact entitled to breach its normal obligations of confidentiality *vis-à-vis* the Canadian taypayer, and to give the information to the New Zealand authorities. The general wording varies slightly from treaty to treaty, but generally it says that the information which can be exchanged is information of use in levying taxes in the countries to which the treaty relates. But, as in our hypothetical example of Canada and New Zealand, is it really appropriate for Canada to make information available to the New Zealand authorities which will help them resolve a transfer pricing problem between a United States parent and a New Zealand subsidiary? This is certainly a point to be borne in mind when reading the provisions towards the end of a treaty.