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United States - Canadian Income Tax Covention and Protocol

THE UNITED STATES-CANADA INCOME TAX CONVENTION AND PROTOCOL — METHOD AND CRITERIA USED TO DEFINE THE MEANING OF "PERMANENT ESTABLISHMENT," Rev. Rul. 77-45, 1943 C.B. 526

The United States, in the interest of free trade and in cooperation with various foreign nations, has entered into twenty-two income tax conventions to date.[1] Generally, these Conventions permit a foreign corporation or individual to engage in income-producing activity within the borders of the host state without being subjected to taxation by the host state.

In Revenue Ruling 77-45 a Canadian corporation claimed that its business activities in the United States were exempt from United States income taxation under Article I of the United States-Canada Income Tax Convention and Protocol.[2] Article I states, in part, that "an enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable . . . to its permanent establishment in the latter State." Section 3(f) of the Protocol to the Convention defines "permanent establishment" as used in Article I by identifying such factors as fixed places of business and the presence of a contracting agent in the taxing State as definite indicia of a permanent establishment belonging to a foreign corporation.

The subject Canadian corporation [hereinafter referred to as M] was an engineering consulting firm which had contracted to design a manufacturing plan to be built in the United States. While the actual physical construction was to be performed by an independent contractor, M maintained employees at the site to inspect the contractor's work, make minor adjustments in design plans, and maintain general record books. M's employees were under the direct supervision of the Canadian home office and were

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1. These conventions, although uncodified, have been incorporated into United States tax law in 26 U.S.C. § 894. For a general discussion of tax conventions, their purposes, and how they function, *see* Surrey, *International Tax Conventions: How They Operate and What They Accomplish,* 23 *J. Taxation* 364 (1965); and PRACTICING LAW INSTITUTE, TAX TREATIES IN INTERNATIONAL PLANNING, TAX LAW AND PRACTICE HANDBOOK SERIES No. 83 (1975).

2. Convention and Protocol (1942), 56 Stat. 1399, T.S. No. 983. Supplementary Convention (1951), 2 U.S.T. 2235, T.I.A.S. 2347. Supplementary Convention (1957), 8 U.S.T. 1619, T.I.A.S. 3916.

not authorized to make major adjustments to the design plans drawn at the home office. Nor were they invested with any power to enter contracts within the U.S. The facilities used by the employees were neither owned nor leased by M. This undertaking constituted M's sole United States activity and it was anticipated that the project would be completed within a one year period.

No issue was raised as to the nature of M's activities on the construction site. The Internal Revenue Service, however, contended that in determining the "permanence" of M's activities, such activities should be viewed in conjunction with those of the situs as a whole; that is, if the total construction site possessed the necessary attributes of an Article I "permanent establishment," M's activities must also be so construed and taxed accordingly. The ruling dismissed the Service's claim by stating simply that the planning and supervision of a construction site do not transform that construction site into "a construction site of the enterprise that plans and supervises construction." Accordingly, M's activities alone had to meet the requirements of a "permanent establishment" if they were to be taxed.

Several factors were cited in support of the determination that M did not have a "permanent establishment" as defined by Section 3(f): M's employees had no contracting or major decision-making powers, M neither owned nor leased any equipment at the site, and the duration of M's presence was not to exceed one year.

The ruling provides further guidelines as to what activities of a foreign corporation will or will not be found to constitute a taxable "permanent establishment." In *Consolidated Premium Iron Ores Limited v. Commissioner of Internal Revenue*,[3] the tax court summarized the criteria which would give rise to a conclusion that a corporation maintained a permanent establishment.

> Premium had no real office in the United States; no officers, directors, or employees here; no bank account or books of account; no telephone listing; its name did not appear on any door or office; it had no employee or agent established here who had "general authority to contract for his employer or principal," such authorized agent being one of the definitive tests of a "permanent establishment" under the treaty.[4]

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3. 28 T.C. 127 (1957), *aff'd* 59-1 USTC 9387 (1959).
4. *Id.* at 151.

The court concluded that Premium had no permanent establishment in the United States on the theory that to be considered permanent an establishment must be "engaged in trade or business," a test which would require a continual or sustained activity in the United States.[5]

In *Consolidated Premium,* the tax court summarized the statutory meaning to be given to the word permanent in stating: "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."[6] Revenue Ruling 77-45 reflects this theme, and adds the qualification that in evaluating the permanence of a foreign corporation's activities the court will consider only those activities; the nature of the domestic work (or work of other foreign corporations) to which the corporation's activities are conjoined is irrelevant. Obviously of paramount importance in determining permanence is the presence of any of the qualifying criteria listed in Section 3(f), such as an employee with independent contracting powers, a circumstance notably absent in both *Consolidated Premium* and the instant case.[7] The court would then examine any evidence which suggests permanence in the plain meaning of that word. Such factors as the

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5. *Id.* Although the court only relied upon the phrase "engaged in trade or business" as an aid in defining "permanent establishment," many tax treaties directly incorporate the concept into their controlling article. For example, Article III of the United States — Denmark Income Tax Convention and Protocol provides that business profits shall not be taxed by the host state unless the foreign taxpayer is "engaged in trade or business in such other state through a permanent establishment." 62 Stat. 1730 (1948). A foreign corporation's activities must then meet two explicit definitional requirements in order to be taxable. Of course, as suggested by the *Premium* court, the two may be so inextricably intertwined as to make proof of one proof of the other.

6. 28 T.C. at 152.

7. For example, in *Consolidated Premium,* the court made a special effort to point out that at the one time an employee did contract in the United States, he first phoned the home office in Toronto for authorization. *Id.*

It is clear that the "employee" with contracting powers need not be an employee of the foreign interest. He need only have an express or implied power to legally obligate that interest. In Donroy, Ltd. v. U.S., 301 F.2d 200 (1962), a Canadian corporation which had a limited partnership agreement with a California limited partnership was deemed to have an Article I "permanent establishment" in the United States because the legal obligations made by one partner necessarily obligated all the partners. *See also* Handfield v. Comm., 23 T.C. 633 (1955).

ownership or rental of an office and equipment, telephone listings, advertising, the presence of employees empowered to make major decisions, and anything else which might logically suggest that the corporation's interest in the situs is more than transitory will be taken by the court as indicating a "permanent establishment." Curiously, the ruling stresses one year time limitation on M's activities as one determinative factor; the figure is mentioned in neither the Convention nor Protocol. Its consideration by the court does, however, suggest that activities of a greater duration will dispose the court to view such activities as indicating a permanent establishment within the purview of Section 3(f) and thus taxable.

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