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# Policy Forum: A Subsidiary as a Permanent Establishment of Its Parent

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**ABSTRACT**

This article considers the implications of the current international debate on when a subsidiary, or its activities, may be a permanent establishment of its parent. The issue has become a pressing one, particularly in Europe, because of the extent to which multinationals locate significant personnel and functions in countries other than the parent's country of incorporation. The authors analyze this issue in the context of both a Canadian subsidiary and a US subsidiary with reference to relevant domestic law and jurisprudence as well as treaty considerations. They then discuss how profits might be attributed to such an establishment. They conclude by asking whether the "subsidiary as permanent establishment" analysis may, in future, displace more classic transfer-pricing challenges, a question presently being considered in the broader international debate.

**KEYWORDS:** TRANSFER PRICING ■ PERMANENT ESTABLISHMENTS ■ SUBSIDIARIES ■ TREATIES ■ CORPORATE VEIL ■ UNITED STATES

**CONTENTS**



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## INTRODUCTION

There is a multi-nation debate on when a local subsidiary, or its activities, may be a permanent establishment of its foreign parent,[1] and no international consensus at all on the consequences of finding that it is—that is, the determination of the profits to be attributed to the permanent establishment.[2] In this article, we will look at these two questions in the context of a Canadian corporation with a US subsidiary and a US corporation with a Canadian subsidiary.

## US SUBSIDIARY

With the exception of banks and some insurance companies, Canadian and other non-US corporations with US operations ordinarily conduct those operations through US subsidiaries, as opposed to branches, offices, or other fixed places of business. If they do conduct US operations directly, they do so knowing what the tax consequences will be. The assumption in using a US subsidiary is that any US federal income tax will be limited to the taxable income of the subsidiary and that, leaving aside withholding tax on dividends, royalties, and like income, there will be no tax on the foreign parent corporation. There may, of course, be transfer-pricing adjustments, but ordinarily those would only affect the taxable income of the US subsidiary.

Is the US tax assumption correct? Or are there circumstances in which the activities of a US subsidiary might cause the Canadian or other foreign parent to have a permanent establishment in the United States? US tax would then be imposed on the profits attributable to the permanent establishment, which would be in addition to the tax paid by the US subsidiary on its taxable income. If that happened, how serious would the consequences be?

### When Is a US Subsidiary a Permanent Establishment of a Canadian Parent Corporation?

There is not much authority in the United States on when the activities of a US subsidiary may cause a foreign parent to have a permanent establishment in the United States,[3] but the issue of when a subsidiary is a permanent establishment of its parent is a hot topic in Europe. Apart from troubling cases in the European Union, the issue is arguably more pressing today because of the extent to which multinational enterprises locate significant personnel and functions in countries other than the parent's country of incorporation.

1 Because, for example, of the *Philip Morris* case in Italy: *Ministry of Finance v. Philip Morris* (2002), 4 ITLR 903 (Supreme Court of Cassation).

2 See International Fiscal Association, *The Attribution of Profits to Permanent Establishments*, Cahiers de droit fiscal international, vol. 91b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2006).

3 The two most relevant cases, *The Taisei Fire & Marine Ins. Co.*, infra note 15, and *Inverworld, Inc.*, infra note 16, are discussed below.

Under article VII(1) of the US-Canada tax treaty,[4] business profits of a Canadian enterprise may be subject to US tax only if attributable to a permanent establishment of the Canadian corporation in the United States.[5] Article V, which defines a permanent establishment, provides in paragraph 8 that a Canadian corporation will not have a permanent establishment in the United States only on account of the fact that it "controls" a US corporation.[6] Some have thought that the language of this provision, at least in the form included in the OECD model treaty[7] (a subsidiary is not "of itself" a permanent establishment of its parent), may imply that there is a presumption or at least an inference that a subsidiary is a permanent establishment of its foreign parent.

Today, however, it is plain that the United States does not take the view that the ownership of a US subsidiary, by itself, in any way implies that the foreign owner has a US permanent establishment. The Treasury department's technical explanations of US tax treaties typically so state,[8] and the 2006 US model tax treaty goes further in this direction when it states that control of a subsidiary "shall not be taken into account in determining" whether the shareholder has a permanent establishment.[9]

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4 The Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the US-Canada treaty").

5 Article VII(1) provides, "The business profits of a resident of a Contracting State shall be taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated therein. If the resident carries on, or has carried on, business as aforesaid, the business profits of the resident may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

6 Article V(8) provides, "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not constitute either company a permanent establishment of the other."

7 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2005) and the accompanying commentary (herein referred to as "the OECD model treaty" and "the commentary," respectively), article 5(7).

8 However, the Treasury's explanation of article V(8) of the US-Canada treaty (control of a subsidiary "does not automatically render" the subsidiary a permanent establishment of the parent) suggests that there may be a concern. See United States, Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, April 26, 1984. On the other hand, the Senate Foreign Relations Committee report says that the permanent establishment determination under the US-Canada treaty "is to be made without regard to the fact that the company may be related to a resident of the other country. . . . The relationship is thus not relevant; only the activities of the company being tested are relevant." See United States, *Report of the Senate Foreign Relations Committee Accompanying the 1980 U.S.-Canada Income Tax Treaty and 1983 and 1984 Protocols*, Exec. Rep. no. 98-22, 98th Cong., 2d sess. (1984).

9 United States, Treasury Department, United States Model Income Tax Convention of November 15, 2006, article V(8).

Focusing on the language of article V(8) may, however, miss the point, which is to determine when the activities of a US subsidiary are in fact such that it has become an agent of its foreign parent and, on that basis, is a permanent establishment of the parent. The cases in which this is relevant are ordinarily those where there is an integrated business with functions performed by both the foreign parent and its US subsidiary. In the real world, where subsidiaries do not in fact operate with complete independence from their corporate parents, the risk of finding that a subsidiary is an agent of its parent in such a case is not to be dismissed.

Under article V, if a subsidiary is an agent of the parent, the parent will have a permanent establishment in the United States unless the subsidiary is an "independent" agent.[10] Neither the Treasury department nor the Senate Foreign Relations Committee explanation provides any meaningful elaboration on what constitutes an "independent" agent for the purposes of the US-Canada treaty.[11] The Treasury department's commentary on the 2006 US model treaty, however, says that "independence" requires both legal *and* economic independence and that the subsidiary's activities be in the ordinary course of its business; that legal independence means not being subject to "detailed instructions" from the principal regarding the conduct of the agent's operations or to "comprehensive control"; that, in determining economic independence, what is relevant is the extent to which the agent bears business risk, "primarily" the risk of loss; and that independence may not be present if the agent acts "exclusively or nearly exclusively" for the principal.[12] The language is consistent with the commentary on the OECD model treaty[13] and the Treasury's commentary on the 1996 US model treaty,[14] and no doubt reflects the view of the Treasury and the Internal Revenue Service generally.

## The Taisei Fire and Inverworld Cases

Of the recent cases that have considered whether activities of a US corporation caused a foreign corporation to have a permanent establishment or its equivalent in the United States, one, *Taisei Fire*,[15] held for the taxpayer and the other, *Inverworld*,[16] held against the taxpayer.

10 Article V(7) states, "A resident of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in that other State through . . . [an] agent of an independent status, provided that such persons are acting in the ordinary course of their business."

11 See supra note 8.

12 United States, Treasury Department, United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, article V(8).

13 Paragraphs 36 to 38.6 of the commentary on article 5 of the OECD model treaty.

14 United States, Treasury Department, Technical Explanation of the United States Model Income Tax Convention, September 20, 1996.

15 *The Taisei Fire and Marine Ins. Co., Ltd.*, 104 TC 535 (1995).

16 *Inverworld, Inc.*, 71 TCM (CCH) 3231 (1996); supplemented 73 TCM (CCH) 2777 (1997).

In *Taisei Fire*, the Internal Revenue Service asserted that three Japanese insurance companies had permanent establishments in the United States on account of the activities of Fortress, an unaffiliated US corporation that managed reinsurance in the United States for each of the companies. Up to "net acceptance limits," Fortress could reinsure and cede reinsurance under contracts that bound the Japanese insurance companies. The Tax Court held that Fortress was, within the meaning of the treaty, an "agent of independent status" because (using the commentary on the 1963 OECD model treaty)[17] it was legally and economically independent[18] of the Japanese companies. The court found legal independence because Fortress's relationship with the insurance companies was defined by management agreements; there were no overlapping employees, directors, or officers; and Fortress had discretion in the conduct of its business. The court found economic independence because Fortress had no guarantee of revenues and no protection from loss (since there was a risk that one or more of the insurance companies would terminate its agreement with Fortress).

In *Inverworld*, a Cayman Islands parent corporation, Inverworld, Ltd., was held to be engaged in business in the United States through a fixed place of business because of the activities undertaken by its US subsidiary and the parent's use of the subsidiary's office to conduct its own business with Mexican clients. *Inverworld* was not a tax treaty case, but it concerned a part of the Internal Revenue Code that, in language similar to the permanent establishment article of most treaties, imposes US tax only if there is an office or other fixed place of business to which income is attributable and specifies that an independent agent is not such a fixed place of business. The Tax Court opinion found that the subsidiary was not an independent agent because, among other things, it dealt almost exclusively with its parent. The subsidiary's office was attributed to the parent because the parent used the office to conduct its activities, used it as a return address, and had no other office.

Neither *Taisei Fire* nor *Inverworld* took into account the ownership of the US corporation in determining whether there was or was not a permanent establishment; each decision turned on the actual day-to-day operations of the US corporation. But would the facts in *Inverworld* have been as bad as they were if the US corporation had not been owned by its Cayman Islands parent? With independent ownership, would the US corporation have operated more independently? And suppose that in *Taisei* the US corporation, Fortress, had been owned by one or all of the Japanese insurance companies: would it then have operated with the same degree of independence? In other words, would the facts have been as good as they were? As a practical matter, the fact that a US corporation is owned and controlled by a foreign corporation is unquestionably important.

17 Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963).

18 The court did not address the issue of whether both legal and economic independence were required or whether only one was enough.

## If There Is a Permanent Establishment, What Are Its Profits?

The substantive issue in permanent establishment disputes is the step that follows the determination that there is a permanent establishment, namely: what is the income "attributable" to the permanent establishment?[19] If there is a permanent establishment, the income attributable to the permanent establishment will be taxed to the foreign parent and the tax will be additional to any tax payable by the US subsidiary. Under article VII(2) of the US-Canada treaty, the profits attributable to the permanent establishment are "the business profits which it might be expected to make if it were a distinct and separate person enterprise engaged in the same or similar activities under the same or similar conditions."

The "separate entity" language of the treaty notwithstanding, it is not clear whether, or to what extent, the US-Canada treaty overrules US domestic-law provisions that would (1) not recognize revenue or expense resulting from interbranch transactions, (2) adopt an all-or-nothing approach to some kinds of income, and (3) in some circumstances apply "source" rules that would result in far more income being subject to US tax than would be the case if the permanent establishment were allocated income on the basis that it was a separate entity entitled to be compensated for the functions performed, risks assumed, and assets used in the business.

Consider an example in the OECD *Report on the Attribution of Profits to Permanent Establishments*,[20] which (adapting the example to the United States) involved a foreign corporation that passed title to inventory sold to customers in the United States and, because personnel of its US subsidiary managed inventory risks, was held to have a US permanent establishment. Under the Internal Revenue Code, 50 percent of the gross income from the sales would have been US-source income, assuming that no "independent factory price" could be established for the inventory and that the inventory had been produced by the foreign parent.[21] Under a transfer-pricing approach, the additional income would presumably be related to the arm's-length value of managing the inventory. The results of the two approaches may be radically different.

There are other examples. Consider the facts in *Taisei Fire*, and assume that the US corporation in that case was a permanent establishment of one of the Japanese insurance companies. The Japanese insurance company would have been taxed under the US rules that apply to non-life insurance companies, which impose tax on (1) premium income from the insurance of US risks and (2) income from investments held as reserves against those risks. Or suppose that a foreign hedge fund with a US adviser was—on account of the way in which it purchased debt securities of US issuers—viewed as being engaged in the active conduct of a lending or financing

19 See supra note 2 for the discussion of this issue at the 2006 IFA congress in Amsterdam.

20 Organisation for Economic Co-operation and Development, *Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading)* (Paris: OECD, December 2006), part I.D-5(ii)(a), 69.

21 Treas. reg. section 1.861-7 under the Internal Revenue Code of 1986, as amended.

business in the United States through a US office (and not as a "trader" or "investor" in debt securities). All of the income from the US securities would be included in the US tax base (without apportionment and notwithstanding that offshore personnel participated in the transactions), subject to deductions for expenses, including imputed interest expense.

Whatever the situation under article VII of the existing US-Canada treaty, the United States has clearly begun to move much closer to the evolving OECD approach. The OECD is currently working on a revision to article 7 to address this issue, and the present "authorized OECD approach" is that a permanent establishment should be treated as a "functionally" separate entity—a "legally distinct and separate enterprise"—and its profits determined by arm's-length pricing with other parts of the same legal enterprise, based on the assets used, risks assumed, and activities of the permanent establishment.[22]

The 2006 US model treaty goes much further toward the authorized OECD approach than prior model treaties and provides a number of new rules. First, only profits derived from the assets used, risks assumed, and activities performed by the permanent establishment may be attributed to the permanent establishment, and the attribution must be made under the OECD transfer-pricing guidelines.[23] This is a major alteration of the US rules that would apply in the absence of a treaty since it regards the permanent establishment as a "functional" and "legal" separate entity and adopts a transfer-pricing model for determining the profits attributable to the permanent establishment. Second, under the technical explanation, "internal dealings"—for example, interbranch notional principal contracts—may be used to allocate income within an enterprise.[24] Third, the 2006 model treaty seemingly affirms and makes generally applicable the decision in *The North West Life Assurance Co. of Canada*,[25] which held that the business profits article of the US-Canada treaty trumped the formulary determination of investment income, by providing that US tax on the investment income of the permanent establishment of an insurance company is on "the portion of [an] insurance company's overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment."[26]

Following the OECD's lead, therefore, the United States seems to be moving toward an approach under which the profits attributable to a permanent establishment under article 7 of the 2006 US model treaty may not be materially different from the income that would be allocated to the subsidiary under a transfer-pricing adjustment.

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22 See *Report on the Attribution of Profits to Permanent Establishments*, supra note 20, part I.B, at 12.

23 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf).

24 Supra note 12, article VII. In addition, in the case of a financial institution other than an insurance company, interest expense attributable to a permanent establishment may, at the taxpayer's election, be determined by risk-weighting assets. This is consistent with a number of recent treaties or pending protocols, but has not so far been a standard feature of US tax treaties.

25 107 TC 363 (1996).

26 Supra note 9, footnote to article 7(3).

The non-treaty US rules, under which transfer-pricing adjustments to the subsidiary's income would not be a substitute for finding that the foreign parent has a permanent establishment, would yield to this new approach. This, of course, raises the question of whether the tax authorities should ever bother to assert a permanent establishment, as opposed to simply adjusting the subsidiary's income—an approach that would be far more consistent with good treaty relationships than treating the parent as having a permanent establishment.

### Are There Other Consequences If a Subsidiary Is a Permanent Establishment of Its Canadian Parent?

While imposition of US tax on the profits attributed to a permanent establishment is the main consequence of a determination that a Canadian (or other foreign) parent corporation has a permanent establishment in the United States on account of the activities of a subsidiary, there are other points to consider. First, it is possible that no US tax returns would have been filed by the Canadian parent and, as a consequence, there could be penalties that would not be imposed if instead a simple transfer-pricing adjustment were made to the income of the subsidiary. Second, under the Internal Revenue Code, no deductions or credits are allowed to a foreign corporation in the absence of a return filed in the manner prescribed in regulations. There would likely be a 5 percent branch profits tax liability on the after-tax profits of the Canadian parent's permanent establishment.

## CANADIAN SUBSIDIARY

What conclusions can be drawn in the reverse fact pattern, where a US corporation conducts its business in Canada through a Canadian subsidiary? Again, the threshold assumptions would be that any Canadian federal income tax would be limited to the taxable income of the subsidiary and, apart from Canadian non-resident withholding tax, there would be no tax on the foreign US parent corporation. Are there circumstances in which the activities of the Canadian subsidiary might cause the US parent to be viewed as carrying on business in Canada through a permanent establishment?

### When Is a Canadian Subsidiary a Permanent Establishment of a US Parent Corporation?

Canada does not have a model tax treaty but is generally guided by the OECD model. While the OECD commentary on article 5(7) dealing with subsidiaries is sparse, it does state:[27]

1. that it is generally accepted that the existence of a subsidiary does not, of itself, constitute the subsidiary a permanent establishment of the parent company

27 Paragraphs 40 and 41 of the commentary on article 5 of the OECD model treaty.

and, as a corollary, that for purposes of taxation, subsidiaries are generally regarded as independent legal entities;
2. that the fact that the trade or business carried on by the subsidiary is managed by the parent company does not constitute the subsidiary a permanent establishment of the parent company; and
3. that a subsidiary will constitute a permanent establishment under the same conditions stipulated in paragraph 5 (agency) as are valid for any other unrelated company—that is,
    a. if it cannot be regarded as an independent agent, and
    b. if it has, and habitually exercises, an authority to conclude contracts in the name of the parent company.

As in the United States, there is limited (perhaps even more limited) judicial authority[28] in Canada on when the activities of a wholly owned subsidiary of a foreign parent will result in the parent corporation being deemed to have a permanent establishment on the basis of agency.[29]

Taxpayers in Canada are generally entitled to arrange their affairs so as to minimize tax; and, in the absence of a sham, obtaining a tax benefit by means of choosing a particular structure is not a basis for piercing the corporate veil. Canadian courts have long endorsed the common-law principle of autonomous legal personality of a corporation[30] and have been prepared to disregard it for Canadian income tax purposes only in the following very limited circumstances:

28 The most relevant case, *United Geophysical Co. of Canada v. MNR*, 61 DTC 1099 (Ex. Ct.), and a case dealing not with agency but rather sham, *Dominion Bridge Co. Ltd. v. The Queen*, 75 DTC 5150 (FCTD); aff'd. 77 DTC 5367 (FCA), are highlighted in the discussion below; however, neither of these decisions resolves the precise issues raised in this analysis.

29 In Canada, the issue of permanent establishment also arises in interprovincial businesses within Canada. While interesting, particularly having regard to the fact that the corporate taxing statutes of many provinces define permanent establishment in a manner similar to tax treaty definitions, the jurisprudence is necessarily restricted because the issue is one of domestic (interprovincial) law and not one of treaty interpretation. These cases offer potentially relevant guidance on allocation of profits but, again, are necessarily limited for the same reason. See *MNR v. Panther Oil & Grease Manufacturing Co. of Canada Ltd.*, 61 DTC 1222 (Ex. Ct.); and *Sunbeam Corporation (Canada) Ltd. v. MNR*, 62 DTC 1390 (SCC).

30 In *Houle v. Canadian National Bank*, [1990] 3 SCR 122, at 178, the Supreme Court of Canada said, "Almost a century ago, the case of *Salomon* . . . established the concept of an independent legal personality of a corporation, and it is often this very fact that attracts individuals to incorporate. The limitation of liability to the interest one possesses as a shareholder, with the resulting exclusion of certain personal liability for debts of the corporation is a key feature of the corporate format, which carries other advantages, including fiscal ones." For civil-law purposes in Quebec, the Civil Code of Québec (SQ 1991, c. 64) specifically recognizes separate legal personality, with exceptions. Article 309 provides, "Legal persons are distinct from their members. Their acts bind none but themselves, except as provided by law." Article 317 provides, "In no case may a legal person set up jurisdictional personality against a person in good faith if it is set up to dissemble fraud, abuse of right or contravention of a rule of public order." Courts

- fraud or improper conduct;[31]
- agency, where the income of the agent corporation may be deemed to be that of the principal;[32] and
- sham.[33]

With respect to agency, the mere fact that a parent controls all of the shares of a subsidiary does not result in an implied agency. Like the United States, Canada takes the view that the ownership of a Canadian subsidiary does not, by itself, in any way imply that the US "owner" has a Canadian permanent establishment.[34] In determining whether an agency exists, Canadian courts have considered who is in fact carrying on the business and how it is being carried on. So the issue in Canada is essentially the same as in the United States: when will a Canadian subsidiary be a permanent establishment of its US parent, not because it is a subsidiary but because of how it conducts its business as an agent of the parent company?

In *United Geophysical Co. of Canada v. MNR*,[35] agency was debated in a US parent-Canadian subsidiary fact pattern, but in unusual circumstances: it was the Canadian taxpayer and not the Crown that argued agency, and the issue arose in connection with source taxation rather than permanent establishment.[36] The taxpayer, a Canadian subsidiary of a US parent corporation, paid rent on equipment owned by the

applying these Civil Code articles have been prepared to lift the corporate veil to find shareholders personally liable where, for example, a corporation became insolvent after the payment of discretionary dividends or the misappropriation of funds for the benefit of shareholders.

31 For the basic principle, see *Pioneer Laundry & Dry Cleaners Limited v. Minister of National Revenue* (1939), 1 DTC 499-69 (PC). In *The Queen v. Crestbrook Forest Industries Limited*, 93 DTC 5186 (FCA), the court said that the corporate veil must not prejudice the administration of justice. We ignore fraud for purposes of this discussion.

32 See, for example, *Piggott Investments Ltd. v. The Queen*, 73 DTC 5507 (FCTD); and *Aluminum Company of Canada Ltd. v. City of Toronto*, [1944] SCR 267.

33 See *Lagacé v. MNR*, 68 DTC 5143 (Ex. Ct.).

34 In *Colbert et al. v. The Queen*, 94 DTC 6620, at 6622 (FCTD), the Federal Court stated, "Since *Salomon* . . . it has been a well settled principle of company law that the mere holding of all of the shares of a corporation does not lead to the conclusion that the business carried on by the company is the business of the shareholder." See also *Fortino et al. v. The Queen*, 97 DTC 55 (TCC).

35 Supra note 28.

36 A more recent lower-court decision in Canada, *Avotus Corporation v. The Queen*, 2007 DTC 215 (TCC), offers another example of a case where a taxpayer argued that its subsidiary was an agent; however, here the fact that there was an agency agreement in place between the parties was ultimately the determining factor in the court's analysis and decision. In *Avotus Corporation*, a Canadian parent corporation asserted that its (Puerto Rican) subsidiary was an agent. The Canadian parent corporation sought to deduct its subsidiary's losses and asserted agency on the basis of a validly executed agency agreement. Absent a sham, the court said, the agency agreement between the parties governed irrespective of the parties' (to some extent) inconsistent conduct, including the fact that the subsidiary had both issued financial statements and filed tax returns in Puerto Rico.

parent but used by the subsidiary in Canada. The Canadian subsidiary was assessed for Canadian non-resident withholding tax on the rental payments. The taxpayer argued, inter alia, that the business it carried on in Canada was the business of its parent and it was carrying on that business as an agent. The court rejected the argument, reinforcing the principle that neither the mere ownership of all of the shares of another company nor the complete domination by one company of the other makes the company's business that of its owner:

> In my opinion, the contention that the appellant was merely an agent for the Corporation and that the business carried on in Canada by the appellant was in reality the Corporation's business is not borne out by the evidence. While it is clear that a business can be carried on by a company as agent for a disclosed or an undisclosed principal, *unless the company which carried on the business is nothing but a sham the mere fact of ownership by a person of all the shares of that company will not make the company's business that of the owner of the shares, nor will complete and detailed domination by that owner of every move the company makes be sufficient to make the company his agent or the business his own, for the company, if legally incorporated, has a legal existence and personality of its own, distinct from that of the owner or owners of its shares*. The same applies where the owner of the shares is itself an incorporated company.[37]

The court specifically relied on the following facts to reach its conclusion:

1. No resolutions were passed by either corporation appointing, or accepting the appointment of, the subsidiary as the agent of the parent, nor was any agency agreement ever entered into.
2. The subsidiary's accounts showed its profits as its own, with no liability to account therefor to its parent.
3. The subsidiary paid Canadian income tax on its profits.

The other decision often discussed in the context of a subsidiary's business being considered that of the parent company is *Dominion Bridge Co. Ltd. v. The Queen*.[38] This case did not involve the application of an income tax convention, nor did it depend on any permanent establishment findings; rather, it was decided on the basis of an early anti-avoidance doctrine and a finding that the foreign subsidiary of a Canadian parent corporation was a sham. However, the decision is instructive in that it identifies the factors that will be taken into account in determining when the corporate veil may be pierced and the subsidiary entirely disregarded.

In *Dominion Bridge*, the Canadian taxpayer carried on the business of manufacturing steel. It purchased 85 percent of its steel requirements domestically (in Canada and the United States) and the balance from offshore mills or commission agents.

37 *United Geophysical*, supra note 28, at 1102 (emphasis added).

38 Supra note 28.

The taxpayer formed a wholly owned subsidiary in the Bahamas to become its direct offshore steel supplier and paid the subsidiary 85 percent of the price it paid for domestic steel, which was higher than the market value of offshore steel. The Canadian taxpayer was the subsidiary's only customer. The minister alleged that the subsidiary was a sham and that the taxpayer was in fact carrying on its own business. The subsidiary had no employees with any technical knowledge of the purchase and sale of steel, and every minute detail of every step of every purchase through the subsidiary was worked out by the taxpayer. Every aspect of the subsidiary's operations was controlled and approved by the taxpayer's vice-president. The taxpayer also controlled the price at which the subsidiary bought and sold steel.

In very strong terms, the court concluded that the subsidiary was a puppet of the parent; that the parent was the directing mind and will of the subsidiary; and thus that the business of the subsidiary was in fact the business of the parent.[39] Six specific tests were applied in *Dominion Bridge* to reach the conclusion that the subsidiary's business was that of the Canadian parent:[40]

1. Were the profits of the business the profits of the parent or the profits of the subsidiary? In a legalistic and formalistic view, they were the profits of the subsidiary; in a legalistic and substantive view, they were the profits of the Canadian parent.
2. Who appointed the persons conducting the subsidiary's business? Here, they were all appointed directly by the Canadian parent.
3. Who was the head and brains of the subsidiary? Here, it was the vice-president of the parent.

39 In the court's words, ibid., at 5154-55 (FCTD),

> the Appellant has camouflaged, disguised the operations of Span [the subsidiary] to make them appear as independent of the Appellant's whereas, in fact, the evidence, documentary and oral, is pervaded with the control, management and presence of the Appellant, its sole client. . . .
>
> The fact that the Appellant always controlled every step of the operations of Span from the purchase price to the selling price of off-shore steel, that the Appellant paid Span the price of domestic steel for off-shore steel, the latter steel having a lower fair market value, and the power the Appellant had to control the Board by virtue of Article 74 of the Articles of Association of Span show that the purpose of the incorporation of Span was a sham and that its operations were also a sham because, in point of fact, these operations were those of the Appellant and consequently the expenses and disbursements of the Appellant pertaining to the creation and the operations of Span and the income of Span from interest and dividends are as feigned as the creation and operations of Span. . . .
>
> The conditions in the present instance permit to say that Span was a puppet of the Appellant; that the Appellant was "the directing mind and will" of Span. The business of Span was in fact the business of the Appellant.

40 These tests were originally laid down in *Smith, Stone & Knight v. Birmingham Corpn.*, [1939] 4 All ER 116 (KB).

4. Which entity governed the adventure, decided what should be done, and decided what capital should be embarked in the venture? Here, the Canadian parent did all of these things.
5. Through whose skill and direction were the profits made? Here, they were made only through the parent's skill and direction.
6. Was the parent in effectual and constant control of the subsidiary? Here, it was.

The court concluded that the transactions were not bona fide but feigned as part of a sham. The facts of the case and the court's reliance on the findings that (1) the subsidiary was "a puppet"[41] of the parent, and (2) the parent was "the directing mind and will" of the subsidiary, are limitations that must be assessed in considering the extent to which the *Dominion Bridge* decision contributes to the permanent establishment issue.

## CONCLUSION

Irrespective of whether the issue arises in the United States or Canada, a final question is whether taxpayers should be concerned about the extent to which a "subsidiary as permanent establishment" challenge is simply a new twist on a transfer-pricing challenge. Whether revenue authorities choose to challenge the perceived "shifting" of income (and functions and risks) in the form of a permanent establishment argument or through a more classic transfer-pricing challenge may be significant. While the ultimate allocation of profit (and thus, the income adjustment) may now be the same under either approach (with the release of the OECD's December 2006 final report on allocating profit to a permanent establishment), the *basis* for the adjustments is probably still different. A permanent establishment challenge, particularly one involving a subsidiary, is likely to be the more difficult, and would involve fundamental changes to both the parent's *and* the subsidiary's income.

41 In an earlier decision of the Supreme Court, a distinction was made between an agent and a puppet (or sham) or, more specifically, between a business *being carried on* by an agent and a business of one company that in fact *becomes* the business of another. See *Aluminum Company of Canada*, supra note 32. The court observed, ibid., at 271, that "the business of one company can embrace the apparent or nominal business of another company where the conditions are such that it can be said that the second company is in fact the puppet of the first; when the directing mind and will of the former reaches into and through the corporate façade of the latter and becomes, itself, the manifesting agency. In such a case it is not accurate to describe the business as being carried on by the puppet for the benefit of the dominant company. *The business is in fact that of the latter* [emphasis added]." See also *Piggott Investments Ltd.*, supra note 32.