Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 1

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PRÉCIS

Les règles servant à déterminer la provenance géographique du revenu imposable sont importantes dans le régime fiscal international du Canada. Il est essentiel, aux fins de l'application de plusieurs dispositions de la Loi de l'impôt sur le revenu, d'établir la provenance géographique du revenu. Cependant, en matière de commerce électronique, la notion d'emplacement géographique est pratiquement dénuée de sens puisque les transactions peuvent être effectuées sans tenir compte des frontières entre les pays. Comment les règles habituelles sur la provenance du revenu peuvent-elles s'appliquer aux transactions électroniques lorsque ces transactions semblent être réalisées dans le lieu imaginaire que constitue le cyberespace, plutôt que dans un lieu réel donné. Quelles sont les conséquences, pour l'administration du régime fiscal international du Canada et l'élaboration de la politique fiscale canadienne, des problèmes que soulève cette question? Les règles sur la provenance du revenu survivront-elles à ces difficultés? En outre, quelles sont les options dont le gouvernement dispose quant à l'élaboration de sa politique? L'auteur de cet article comportant deux parties se penche sur ces questions et tente de formuler des réponses pertinentes.

La première partie de l'article offre un aperçu des règles canadiennes sur la provenance du revenu. Comme le Canada ne s'est pas doté, dans sa législation, de règles détaillées régissant la provenance du revenu, le texte porte surtout sur les dispositions législatives qui, dans les faits, tiennent lieu de ces règles, ainsi que sur le droit jurisprudentiel et sur les prises de position de Revenu Canada. La deuxième partie de l'article, devant figurer dans la prochaine parution de la présente revue, comportera une description du commerce électronique, tel qu'il est pratiqué à l'heure actuelle, ainsi qu'une analyse des difficultés qu'il pose pour l'application des règles en vigueur sur la provenance du revenu. Enfin, il y sera question

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des solutions proposées par le gouvernement. L'auteur de l'article tentera de démontrer qu'il est nécessaire de conserver des règles sur la provenance du revenu et que le Canada devrait modifier les règles en vigueur compte tenu des caractéristiques particulières du commerce électronique et des principes généraux qui sous-tendent sa politique fiscale. En outre, l'auteur proposera des règles sur la provenance du revenu s'appliquant à la fois aux transactions habituelles et aux transactions électroniques et il offrira une analyse de ces propositions à la lumière de la politique fiscale.

ABSTRACT

The rules for determining the geographical source of taxable income are important to the Canadian international tax system. Determination of the geographical source of income is essential for the application of many provisions of the Income Tax Act. In the world of electronic commerce ("e-commerce"), however, geographic location is virtually meaningless since transactions may be conducted without regard to national boundaries. How can traditional source rules apply to e-commerce transactions that seem to take place in the nebulous world of cyberspace rather than in any physical location? What are the implications of these challenges for the Canadian international tax system and Canadian tax policy? Can source rules survive these challenges? And what are the policy options available? The author of this two-part article addresses these questions and attempts to arrive at some persuasive answers.

Part 1 of the article provides an overview of Canada's source rules. Because Canada does not have comprehensive statutory source rules, the discussion focuses on statutory provisions that effectively function as source rules, the jurisprudence, and Revenue Canada's administrative pronouncements. Part 2 of the article, which will appear in the next issue of this journal, will describe e-commerce in its current form, explain how it challenges existing source rules, and discuss the government's response to these challenges. The author will argue that there is a continuing need for source rules and that Canada should rethink its existing rules, taking into account the special features of e-commerce as well as general tax policy principles. The author will propose statutory source rules that would apply to both traditional and e-commerce transactions, and will provide a tax policy analysis of these proposals.

INTRODUCTION

Source rules are of fundamental importance to the Canadian international tax system. In general, non-residents of Canada need to know the source of their income in order to determine whether they must pay Canadian tax. Under the Income Tax Act,[1] non-residents are subject to Canadian tax

[1] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

only if they have Canadian source income. For Canadian residents, the primary function of the source rules is to determine whether the taxpayer is entitled to relief for foreign taxes. Under the Act, Canadian residents are subject to Canadian tax on their worldwide income but are allowed a credit or deduction for foreign taxes paid with respect to their foreign source income. The extent of relief for foreign taxes depends on the source rules.

Source rules refer to rules that establish the geographic location where income-creating activities occur. Geographic location is generally determined by reference to the particular type of income. The usefulness and legitimacy of source rules are being seriously challenged by electronic commerce ("e-commerce"), which obscures the characterization of income and makes geographic location virtually meaningless. These challenges may threaten the delicate balance between residence-based taxation and source-based taxation, and may call for a complete overhaul of the existing international tax system. Proposals of ways to address these challenges range from maintaining the status quo to adopting revolutionary measures, such as replacing source-based taxation with residence-based taxation or introducing a "bit tax."

This two-part article discusses the relevance and effectiveness of Canada's source rules in the age of e-commerce. Part 1 provides a comprehensive overview of the existing source rules and their importance to the Canadian income tax system. Part 2, which will appear in the next issue of this journal, will begin with a discussion of the concept of e-commerce, examining its special features compared to traditional commerce, its implications for international trade and investment, and its impact on the existing international tax system. The discussion will then focus on the challenges of e-commerce for source-based taxation and Revenue Canada's responses to these challenges. I will argue that there is a continuing need for source taxation in the age of e-commerce and that Canada should rethink its existing rules to ensure that they are consistent with Canada's international tax policy. I will also propose new statutory source rules for traditional and electronic transactions and discuss their policy implications.

CANADA'S SOURCE RULES

Under the Canadian tax system, source rules are necessary to determine the tax liability of both Canadian residents and non-residents. Canada generally asserts tax jurisdiction over the Canadian source income of non-residents ("source taxation") and the worldwide income of Canadian residents ("residence taxation"). Compared with countries like the United States, Canada has a strong commitment to source taxation because of its history as a capital importer.[2] However, the Act does not contain any detailed source rules. In these circumstances, taxpayers and their advisers

[2] Brian J. Arnold, "The Canadian International Tax System: Review and Reform" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1792-1818, at 1807.

must turn to the common law and to Revenue Canada's administrative practice for guidance. Unfortunately, there are few Canadian cases dealing with the territorial source of income, and the case law is not well developed. Moreover, while Revenue Canada has adopted certain administrative positions with respect to the determination of source, its pronouncements are broad and general, leaving many issues unresolved.

For Canadian international tax purposes, the source of both gross income and net income is important. For example, part XIII tax is imposed on Canadian source gross income from dividends, interest, and royalties, and part I tax is imposed on Canadian source net income from business, employment, and the disposition of taxable Canadian property. In order to establish the source of net income, it is necessary to allocate deductions to different sources of gross income. In Canada, however, little attention has been paid to the allocation of deductions. The rest of part 1 of this article first discusses the importance of source and the allocation of deductions, and then examines in detail source rules for each major type of income.

The Importance of Source

Meaning of "Source"

The concept of "source" for Canadian tax purposes may be understood to have two meanings: "character of income" and "geographic origin or location." The character aspect of the concept refers to the nature of the activity that generates income.[3] Main character sources of income are identified in section 3 of the Act and include income from employment, income from business, and income from property. For non-resident withholding tax purposes, income is further categorized to include interest, dividends, royalties, and management fees. The source of income in a territorial sense means the geographical place in which an item of income is derived.

Territorial source rules are inherently connected to character source rules. Each type of income has its own territorial source rule or rules. For example, the source of employment income is the place where services are performed, the source of dividend income is the country of residence of the paying corporation, and the source of royalty income is the country of residence of the payer or the place of use of the property generating the royalty.

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[3] Other commentaries have referred to the meaning of "source" as used in the Act as the "generic" source or the "efficient cause" of the income. See, for example, Robert Couzin, "Business and Property Income," in *Current Developments in Measuring Business Income for Tax Purposes*, 1981 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1982), 41-71; W.A. Macdonald, "Territorial Source of Income," in *Income Taxation in Canada* (Toronto: Prentice-Hall) (looseleaf) (service discontinued), paragraph 16,254; *Ward's Tax Law and Planning* (Scarborough, Ont.: Carswell) (looseleaf), section 12.1[a]; Bruce M. McLean, "Sourcing of Business Income," in *Current Developments in Measuring Business Income for Tax Purposes*, 1987 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1987), 9:1-37; and David A. Ward, "Allocation of Income and Expense Items," in *Corporate Management Tax Conference 1975* (Toronto: Canadian Tax Foundation, 1975), 102-18, at 103.

Significance of Source Rules

Source rules are important to the Canadian tax system for a variety of reasons. At a fundamental level, source rules aid in determining whether an item is taxable under section 3, how income is computed under section 4, and whether a taxpayer is entitled to tax benefits granted under various provisions of the Act.[4] With respect to the international aspects of the Canadian tax system, source rules are equally necessary for source taxation and residence taxation.

General

Section 3 defines "income" to be income from a source inside or outside Canada, including income from an office, employment, business, and property.[5] Although the wording of this provision is very broad, Canadian courts have been reluctant to expand the major sources of income beyond the traditional ones.[6] The concept of "source" in this context has been held to mean that income must be a yield from a productive source, such as services rendered to an employer (where the employment is the source) or business activity (where the business is the source) or the use of property (where the property is the source).[7] Any accretions to a taxpayer's wealth in other forms, such as gifts, inheritances, or windfalls, are not from a "source" and therefore are not income. Capital gains were at one time not considered to be income from a source, but rather proceeds from the disposition of a source of income.[8] Capital gains are currently taxable because of specific statutory requirements.[9]

Section 4 requires that, in computing a taxpayer's income, the income or loss from each type of income and each territorial source be computed as though each were the taxpayer's only source of income or loss. Thus, an expense incurred to earn income from property may not be deducted in

[4] Some of these rules are also relevant to the determination of provincial tax jurisdiction over income earned by out-of-province corporations.

[5] Miscellaneous statutory inclusions not based on the four traditional sources are contained in sections 56 to 59.1.

[6] For example, in *Fries v. The Queen*, 90 DTC 6662; [1990] 2 CTC 439 (SCC), the strike pay that a union paid its members while they were on strike as a replacement of their employment income was considered not taxable. The Supreme Court of Canada said that it was not satisfied that strike pay was "income . . . from a source" within the meaning of section 3, and that "the benefit of the doubt" should go to the taxpayers.

[7] It has been suggested that the source theory of income arose in the United Kingdom at a time when the economy was primarily agricultural and it was natural to think of income in those terms. See Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1966), 64-65.

[8] Capital gains were not considered income until 1972 when the Act was amended to specifically include capital gains as a source of income. At present, only three-quarters of capital gains are taxable. Therefore, for purposes of determining section 3 income, a taxpayer must determine whether income is from the listed traditional sources, from capital gains, or from other sources.

[9] Paragraph 3(b).

computing income from a business. Similarly, income must be computed on a place-by-place basis. Where a taxpayer carries on a business both inside and outside Canada, as explained further below, business expenses must be reasonably allocated to each source.

The Act contains numerous tax credits and other deductions and allowances, many of which apply to income from specific sources. For example, the "small business deduction" under section 125 applies to active business income earned in Canada by Canadian-controlled private corporations, and the "manufacturing and processing credit" under section 125.1 applies to manufacturing and processing profits arising in Canada. A dividend refund of a private corporation under section 129 is computed by reference to "Canadian investment income" and "foreign investment income," both of which are concepts that involve a determination of sources of income.[10] The source rules therefore affect a taxpayer's entitlement to tax benefits.

International Tax

For international tax purposes, source rules are necessary for both residence taxation and source taxation.[11] In the case of source taxation, as noted earlier, non-residents of Canada are subject to Canadian tax only on Canadian source income. Canadian source income from employment, income from business, capital gains, and certain rental income are taxed on a net basis in accordance with part I of the Act.[12] Canadian source income from property and income from other sources are subject to withholding tax on the gross amount of the income in accordance with part XIII of the Act. In addition, non-resident corporations carrying on business in Canada through a branch are subject to a "branch tax," which is a proxy for dividend withholding tax.[13] Canadian source income derived by non-residents which is not covered by part I or part XIII is not taxed in Canada. In addition, Canadian source income from international transportation is exempt from Canadian tax, provided that the non-resident's home country grants substantially similar relief to a Canadian resident.[14] Whether an item of income is from a Canadian source is determined by the source rules.

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[10] For a list of statutory provisions where territorial source rules are relevant, see Macdonald, supra footnote 3, at paragraph 44,257.

[11] For an overview of the Canadian international tax system, see Arnold, supra footnote 2; B.J. Arnold, "The Taxation of Foreign-Source Income: Dividends from Foreign Corporations and Anti-Tax Haven Measures," in W. Neil Brooks, ed., *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Scarborough, Ont.: Carswell, 1988), 277-98; Donald J.S. Brean, *International Issues in Taxation: The Canadian Perspective*, Canadian Tax Paper no. 75 (Toronto: Canadian Tax Foundation, 1984); David B. Horsley, "Canada," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 70a, *The Assessment and Collection of Tax from Non-Residents* (Deventer, the Netherlands: Kluwer Law and Taxation, 1985), 315-31; and Vern Krishna et al., *Canadian International Taxation* (Scarborough, Ont.: Carswell) (looseleaf).

[12] Subsection 2(3) and section 115.

[13] Section 219.

[14] Paragraph 81(1)(c).

With respect to the taxation of residents, the Act contains two types of provisions for which source rules are relevant: (1) rules to provide relief from international double taxation, and (2) anti-avoidance rules. When a Canadian resident is taxable on income earned from a foreign country, double taxation occurs when that income is also taxed by the source country. To provide relief from international double taxation, the Act either allows the taxpayer to claim a credit or deduction for foreign taxes paid or simply excludes foreign source income from Canadian taxation.[15] Source rules determine whether foreign taxes are creditable against Canadian tax and the type of relief available for foreign taxes. Relief is available only if taxes are paid on income derived in a foreign country. If under Canadian rules an item of income is considered to have its source in Canada, no foreign tax relief is available. The type of relief also depends on the nature of foreign source income:

- Dividends received from foreign affiliates of Canadian corporations are treated differently from other types of foreign source income. Under section 113, dividends paid out of an affiliate's "exempt surplus" are effectively exempt from Canadian tax, whereas dividends paid out of an affiliate's "taxable surplus" are taxable with a credit for both foreign direct and indirect taxes paid in respect of the dividends. The distinction between "exempt surplus" and "taxable surplus" is, in turn, based on the source of income earned by the foreign affiliate. In general, exempt surplus includes after-tax active business income earned in a treaty country, provided that the affiliate is also resident in a treaty country.[16] Taxable surplus includes active business income earned by an affiliate in a non-treaty country and passive income (foreign accrual property income—FAPI).

- Foreign taxes paid on foreign source income other than dividends from foreign affiliates are either creditable under section 126 or deductible under subsection 20(11) or (12). For purposes of these provisions,

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[15] See sections 126 and 113 and subsections 20(11) and (12).

[16] For further discussion, see Firoz Ahmed, "Selected Issues Relating to the 1995 Foreign Affiliate Amendments," International Tax Planning feature (1995), vol. 43, no. 6 *Canadian Tax Journal* 2142-67; Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986), 149-86; Brian J. Arnold, "The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens" (1985), vol. 33, no. 3 *Canadian Tax Journal* 445-89; Larry F. Chapman, "Foreign Affiliate Amendments: Three Strikes and You're Done," International Tax Planning feature (1995), vol. 43, no. 2 *Canadian Tax Journal* 433-46; Wallace G. Conway, "The New Foreign Affiliate Provisions: The Department of Finance's Perspective," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 40:1-7; K.J. Dancey, R.A. Friesen, and D.Y. Timbrell, *Canadian Taxation of Foreign Affiliates*, 4th ed. (Don Mills, Ont.: CCH Canadian, 1986); Sandra E. Jack, "The Foreign Affiliate Rules: The 1995 Amendments" (1995), vol. 43, no. 2 *Canadian Tax Journal* 347-400; Allan R. Lanthier, "The Taxation of Foreign Affiliates" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1603-28; and Eric Lockwood and Michael Maikawa, "Foreign Affiliates and FAPI: Problems and Tax-Planning Opportunities Resulting from the 1995 Changes" (1998), vol. 46, no. 2 *Canadian Tax Journal* 377-414.

foreign source income is further categorized as foreign business income or foreign non-business income. Foreign business-income taxes are fully creditable against Canadian tax, subject to the limitation that the amount of credit cannot exceed the Canadian tax otherwise payable on the foreign source income.[17] Unused credit can be carried over to other years. Foreign non-business-income taxes are also creditable, but any unused credit cannot be carried over to other years. Foreign taxes on income from property are creditable up to 15 percent of the income; any excess foreign taxes may be deducted under subsection 20(11).

Source rules also affect Canadian residents through the application of certain anti-avoidance rules, such as the FAPI provisions.[18] These rules were designed to prevent the deferral or avoidance of Canadian tax on certain foreign source passive income earned by residents through controlled foreign corporations, offshore investment funds, or offshore trusts.

- The FAPI rules apply where a controlled foreign affiliate (CFA) of a Canadian resident earns income from property, income from a business other than an active business, and certain types of capital gains. Section 91 requires that a pro rata share of the FAPI of the CFA be taxed in the hands of the Canadian shareholder of the CFA, whether or not the income is received.

- The offshore investment fund rules in section 94.1 apply where Canadian residents own an interest in an "offshore investment fund property." Residents must include in income a notional amount equal to the prescribed rate of interest applied to the designated cost of the interest. Section 94.1 applies where the offshore investment fund property derives its value, directly or indirectly, primarily from portfolio investments in certain types of property.[19]

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[17] Subsection 126(1).

[18] Sections 90 to 95.

[19] The 1999 federal budget (tabled on February 16, 1999) proposed changes to section 94.1. The budget statement indicated that current section 94.1 is deficient for two reasons. First, it applies only where one of the main reasons for the taxpayer's acquiring or holding the investment in the offshore fund was to derive a benefit from certain portfolio investments in such a manner that the taxes, if any, on the income, profits, and gains from such assets for any particular year would be significantly less than the tax that would have been applicable if the income, profits, and gains had been earned directly by the taxpayer. Revenue Canada has had difficulty enforcing the provision. Second, the imputed income bears no relation to the actual income of the fund. These deficiencies are addressed by the proposed "foreign-based investment fund" (FIF) rules. A "foreign-based investment fund" is defined as any non-resident entity more than 50 percent of the cost of the assets of which are investment properties. The motivation test is removed. Instead of determining income under the imputed income formula, Canadian resident investors with sufficient information with respect to the income of the FIF would be subject to tax on an annual basis on the undistributed FIF's income in a manner similar to FAPI rules applicable to controlled foreign affiliates. In the absence of sufficient information, income would be computed on a "mark-to-market" basis. The proposed rules would not apply to FIFs that annually distribute or allocate to Canadian investors their share of the fund's income, FIFs

(The footnote is continued on the next page.)

• The offshore trust rules in section 94 apply to a non-resident trust where it acquires property directly or indirectly from an individual resident in Canada who is or is related to a Canadian resident person who is "beneficially interested" in the trust.[20] A non-resident discretionary trust is deemed to be resident in Canada and subject to tax on passive investment income from non-Canadian sources and income earned from Canadian sources. Non-discretionary non-resident trusts are treated as non-resident corporations with the result that Canadian resident beneficiaries of the trust are required to include in income their share of the passive foreign investment income and Canadian source income earned by the trust.

Finally, source rules are important in the treaty context. Canada's tax treaties allocate tax jurisdiction between the residence country and the source country and require the residence country to provide relief from double taxation. As in the domestic context, source rules are relevant to the determination of the scope of source taxation and the entitlement to relief from double taxation.

As suggested above, in general, source rules are equally necessary for source taxation and residence taxation. However, because of Canada's strong commitment to source taxation,[21] domestic source rules for the purposes of source taxation are more specific. As well, as discussed below, they sometimes differ from the source rules for residence taxation. Under Canada's tax treaties, on the other hand, source rules are generally the same for both purposes. Canada's treaties generally include a provision that deems income to arise in the contracting state that has the jurisdiction to tax the income under the treaty.[22] Whether a contracting state has the jurisdiction to tax an item of income depends on whether the income is sourced in that country. Therefore, the same source rule determines not only whether

[19] Continued . . .
situated in the United States, or FIFs that are clearly not used to avoid or defer Canadian tax. In addition, an exemption would be available for temporary residents and new immigrants for their first five years of Canadian residency.

[20] The term "beneficially interested" is broadly defined in subsection 248(25). Despite the broad definition, there are concerns that existing section 94 is not fully effective because the laws of certain foreign jurisdictions make it particularly difficult to determine whether a trust has a Canadian resident beneficiary. The 1999 federal budget proposed changes to section 94. Under the proposed rules, a non-resident trust that acquires property or receives loans from a Canadian resident would be deemed to be resident in Canada and would be taxed on all of its undistributed income.

[21] Over the years, Canadian tax policy has been focused more on the taxation of non-residents than on the taxation of foreign source income. Canada has been at the forefront of tax policy with respect to the taxation of non-residents, both substantively (for example, in introducing branch tax and thin capitalization rules) and in the development of enforcement procedures (such as section 116 certificate procedures). See Arnold, supra footnote 2, at 1807.

[22] See, for example, article XXIV(3) of the Convention Between Canada and the United States of America 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 Canada-US treaty").

income is subject to tax in the source country, but also whether relief is available in the residence country for source-country taxes.

Allocation of Deductions

While source rules are necessary for the allocation of income items to specific economic activities and geographic locations, the rules for allocating expenses are necessary to determine a taxpayer's taxable income from each source.[23] For purposes of residence taxation, the expense allocation rules play a central role in the determination of the foreign source income to be included in the taxpayer's income, as well as the limitation on the amount of the credit available for foreign taxes paid on foreign income. Foreign income is foreign gross income reduced by the expenses and other deductions that are reasonably allocated to it. Therefore, the greater the allocation of deductions to foreign gross income, the lower the amount of foreign net income. The lower the amount of foreign taxable income, the less tax credit available.[24]

For purposes of source taxation, the allocation rules are very important where the Act imposes taxes on Canadian source income of non-residents on a net basis. Net basis taxation applies to Canadian source income from employment, business, property, and capital gains. In addition, non-resident taxpayers can elect to be taxed on a net basis in respect of certain Canadian source rental income.[25] Therefore, expenses, losses, and other deductions that are allocated to each source in Canada affect the amount of Canadian tax payable.

The allocation rules for deductions are very undeveloped. The only clear rule is found in section 4, which requires a reasonable allocation of expenses. Little guidance is available to determine what is reasonable. While in some cases the determination will not be onerous, in others it may be extremely difficult. Consider a taxpayer that operates a single business in both Canada and the United States, which uses depreciable property. How is capital cost allowance to be apportioned—by the relative value, the relative cost of equipment, or the standard of use? In practice, Revenue Canada seems not to be unduly restrictive in approving reasonably justifiable methods of allocating expenses and other deductions among the various territorial sources of income. Consequently,

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[23] The allocation of deductions for purposes of determining a taxpayer's taxable income from a particular source, activity, or category of gross income is distinct from the issue of the proper allocation of income and deductions between related parties, which is the subject of transfer-pricing rules in section 247.

[24] Under section 126, the amount of foreign tax credit is limited by the lesser of the amount of foreign taxes and the amount of Canadian tax otherwise payable. The amount of Canadian tax otherwise payable is computed by multiplying the pre-credit Canadian tax on the taxpayer's worldwide taxable income by the ratio of taxable income from a particular foreign country to worldwide taxable income. Thus, the lower the amount of foreign taxable income in the numerator in the fraction, the lower the amount of foreign income taxes that may be used as a credit against Canadian tax liability in the tax year.

[25] Subsection 2(3) and sections 115 and 216.

taxpayers have broad grounds to argue for any plausible allocation of specific and general expense items to a particular source. For example, head office expenses might be apportioned by the number of transactions, in proportion to revenue, or on any other logical basis. If a taxpayer adopts a reasonable allocation based on sales, payroll, plant floor space, units of production, amount of capital employed, or other such logically consistent test, generally Revenue Canada will not object.[26]

Interest expense is one of the most significant deductible items in computing income. The allocation of interest expenses is especially important in light of the exemption for dividends received out of the exempt surplus of foreign affiliates. According to Revenue Canada, expenses must be allocated on a factual tracing basis, and only if tracing is impossible is allocation on some other basis acceptable. Under the tracing approach, interest is deductible if the borrowed funds can be shown to have been used for the purpose of earning income from a particular source.[27] This tracing approach involves a factual inquiry into the financing of the activities in question. In some cases, tracing will be clear—for example, where an asset is acquired by a taxpayer for its foreign branch for use in the branch's business and the acquisition is financed with debt that is clearly associated with the asset. In other cases, however, where the taxpayer borrows for the purposes of financing its business activities generally, and where the foreign branch benefits from the financing in some way, tracing may be much more difficult. Taxpayers generally have great latitude in arguing for tracing of expenses to earn foreign source income. When foreign source income is exempt from Canadian tax, as in the case of exempt dividends, a liberal allocation of expenses to that source is problematic from a policy perspective. Multinational corporations can plan their affairs so that all of their interest expense is deductible in Canada.[28]

Canada's tax treaties do not contain specific allocation rules, except the provision based on article 7(2) of the OECD model.[29] According to this

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[26] Ward, supra footnote 3, at 106.

[27] Paragraph 20(1)(c). For further discussion, see Brian J. Arnold and Tim Edgar, "Deductibility of Interest Expense" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1216-44.

[28] Brian Arnold (supra footnote 2, at 1813) suggested that "[a]ny serious response to the problem requires interest apportionment rules under which interest expense would be allocated to foreign source income on the basis of the proportion of either foreign assets to total assets or foreign source income to total income." However, he noted that the apportionment method is not a real alternative. The deduction of interest and other expenses to earn exempt foreign source income constitutes a serious erosion of the Canadian tax base, is indefensible on any tax policy grounds, and should be stopped. See also Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), submitted to the minister of finance by a committee chaired by Jack Mintz (herein referred to as "the Mintz report"), 6.11-6.19; and Brian J. Arnold, "The Deductibility of Interest To Earn Foreign Source Income," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 45:1-23.

[29] Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model").

provision, the profits of a permanent establishment shall be determined as if the permanent establishment were dealing wholly independently with its head office and with all other persons. Furthermore, the deduction of expenses incurred for the purposes of the permanent establishment, including executive and general administrative expenses whether incurred in the state of the permanent establishment or elsewhere, is restricted to those expenses that are deductible under the laws of the contracting state in which the permanent establishment is situated.[30]

The notion that a permanent establishment is treated as a separate entity may be difficult to apply in some cases. One area of difficulty is the treatment of "notional expenses" between the permanent establishment and its head office.[31] Canadian courts have interpreted the treaty provision based on article 7(2) of the OECD model as not authorizing a deduction for notional expenses.[32] For example, in *Cudd Pressure Control Inc. v. The Queen*,[33] the Federal Court of Appeal held that a notional payment of rent for equipment by the Canadian permanent establishment was not deductible.[34]

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[30] Article 7(4) of the OECD model allows the use of a formulary apportionment of total profits of a business to its various parts for the purposes of determining the profits of a permanent establishment. Canadian treaties do not include this provision. For further discussion of the differences between Canada's treaties and article 7 of the OECD model, see David A. Ward, "Canada's Tax Treaties" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1719-58, at 1733-34. For further discussion of treaty interpretations, see Jean-Marc Déry and David A. Ward, "Canada," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 78a, *Interpretation of Double Taxation Conventions* (Deventer, the Netherlands: Kluwer, 1993), 259-89, at 281; Stephen R. Richardson and James W. Welkoff, "The Interpretation of Tax Conventions in Canada" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1759-91; François Vincent, "Crown Forest Industries: The OECD Model Tax Convention as an Interpretive Tool for Canada's Tax Conventions" (1996), vol. 44, no. 1 *Canadian Tax Journal* 38-58; and David A. Ward et al., "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries" (1996), vol. 44, no. 2 *Canadian Tax Journal* 408-24.

[31] The UN model (infra footnote 85) provides more clarity in article 7(3) by stipulating that, in computing the income of a permanent establishment, deductions (other than by reimbursement of actual expenses) are not permitted for certain notional transactions between the permanent establishment and the head office for such things as royalties for use of patents, commissions for specific services or for management, and, except in the case of a banking enterprise, by way of interest on money lent to the permanent establishment. Canada's treaties do not generally include this clarifying provision, except the treaties with some developing countries. It is arguable that the very fact that the UN model has referred to these notional payments lends support to the proposition that, in the absence of such prohibitions, such notional payments would have to be recognized and is consistent with the fiction that the permanent establishment is a separate and distinct enterprise dealing wholly independently with the head office under article 7(2). See Ward, supra footnote 29, at 1734.

[32] In *Twentieth Century Fox Film Corp. v. The Queen*, 85 DTC 5513; [1985] 2 CTC 328 (FCA), Addy J, in obiter, said that the 1942 Canada-US treaty did not authorize a deduction of a notional payment of film royalties by the permanent establishment in Canada to the head office in the United States.

[33] 98 DTC 6630 (FCA).

[34] It is interesting to note, however, that the dissenting decision in *Cudd Pressure* held that, as a matter of treaty interpretation, a notional payment may be deductible under the

(The footnote is continued on the next page.)

It is beyond the scope of this article to discuss the allocation rules in any further detail. The rest of the article will be devoted to a discussion of the source-of-income rules.

Source of Income from Office or Employment

Meaning of "Income from Office or Employment"

Income from an office[35] or employment[36] includes "salary, wages and other remuneration, including gratuities," as well as certain taxable benefits.[37] Typical taxable benefits are fringe benefits, interest-free or low-interest loans, use of the employer's car, reimbursement of personal expenses by the employer, and employee stock options.[38]

In determining what constitutes income from office or employment, it is important to distinguish between employment (or dependent) services and independent personal services. Income from independent personal services is generally treated as business income or, in some cases, as interest or "royalties."[39] The distinction is based on case law tests.[40] In

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[34] Continued . . .
treaty but denied the deduction on the unique facts of the case. Mr. Justice McDonald, who wrote the dissenting decision, denied the deduction to the taxpayer in this case on two grounds. First, it was not reasonable to believe that an independent party would have contemplated entering into this type of contract because of the unique nature of the business conducted by the taxpayer, and particularly the fact that it owned the only equipment in the world suitable for this business transaction, the fact that it would have been unlikely that the head office would have agreed to rent the unit to an unrelated party, and the fact that the exorbitant rental cost would have led to a loss rather than a profit. Second, the head office did not include the notional rent in its income, and thus allowing the deduction would result in double non-taxation of the rent. Tax treaties were intended to prevent international fiscal evasion. Both of these grounds of reasoning are questionable. For a good review of the case, see François Vincent, "Canadian Federal Court of Appeal Rules on Notional Expenses and Permanent Establishments in Canada" (November 2, 1998), 17 *Tax Notes International* 1312-16.

[35] The term "office" is defined in subsection 248(1) to mean "the position of an individual entitling the individual to a fixed or ascertainable stipend or remuneration" and includes the offices of judges, ministers of the Crown, members of legislative bodies, and directors of corporations.

[36] The term "employment" is defined in subsection 248(1) to mean "the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign)." According to this definition, only individuals can render employment services; corporations cannot.

[37] Sections 5, 6, and 7.

[38] For further discussion, see Brian J. Arnold and Jinyan Li, "The Appropriate Tax Treatment of the Reimbursement of Moving Expenses" (1996), vol. 44, no. 1 *Canadian Tax Journal* 1-37.

[39] For example, subparagraph 212(1)(d)(iii).

[40] These tests include the "control" test, which looks at the degree of control possessed by the recipient over the work that is to be performed by the service provider; the "integration" test, which looks at whether the service provider is an integral part of the recipient's business; the "economic reality" test, which asks whether the service provider has the chance of profit and the risk of loss; and the "specified result" test, which looks at whether the service provider has placed his/her services at the disposal of the recipient for a period

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general, personal services are more likely to be considered employment services where (1) the recipient possesses a high degree of control over how the service provider does the work, (2) the services are an integral part of the recipient's business, (3) the service provider bears minimal or no economic risk, and (4) the services are rendered for a period without reference to a specified result.

Territorial Source Rules

The Act contains no general territorial source rules for income from an office or employment. For purposes of source taxation, however, subsection 2(3) and paragraph 115(1)(a) provide that non-residents are taxable in Canada if they are "employed in Canada" and their taxable income is attributable to the duties of the office or employment performed by them in Canada. These provisions implicitly define the territorial source to be the place where services are performed. This "place-of-performance" rule has been accepted by Revenue Canada for purposes of foreign tax relief provisions of the Act.[41] This rule is also consistent with Canada's tax treaties.

The place-of-performance test applies not only to wages and salaries, but also to employment benefits.[42] For example, the territorial source of income from stock option benefits[43] is the place of performance of the duties for which the stock option was granted. If the stock option benefits arose in respect of the individual's employment in Canada, the income arising on the exercise of the option is deemed to be sourced in Canada,

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40 Continued . . .
of time without reference to a specified result. For a discussion of the case law applying these tests, see Brian J. Arnold, Tim Edgar, Jinyan Li, and Daniel Sandler, eds., *Materials on Canadian Income Tax*, 11th ed. (Scarborough, Ont.: Carswell, 1996), 214-227; and Peter W. Hogg, Joanne E. McGee, and Ted Cook, *Principles of Canadian Income Tax Law*, 3d ed. (Scarborough, Ont.: Carswell, 1999), 168-70.

41 *Interpretation Bulletin* IT-270R2, "Foreign Tax Credit," February 11, 1991, paragraph 28, states that for purposes of section 126, the territorial source of income from an office or employment is considered to be the place where the related duties are normally performed, the source of directors' fees is generally the place where directors' meetings are held, and the source of commission income is the place where the effort was expended for the purpose of gaining such income.

42 In *Jarlan v. The Queen*, 84 DTC 6452; [1984] CTC 375 (FCTD), the taxpayer was a scientist. While employed by the National Research Council of Canada, he made an invention the rights to which were vested in the government of Canada. The taxpayer then became a non-resident of Canada. While a non-resident, he received awards from the Canadian government in relation to the invention. The awards were assessed by Revenue Canada as income from employment and subject to tax under subsection 2(3) and paragraph 115(1)(a). The court upheld Revenue Canada's assessment. Without clearly stating the rationale, the decision implied that the source of the awards was the employment services performed by the taxpayer. See also *Interpretation Bulletin* IT-420R3, "Non-Residents—Income Earned in Canada," March 30, 1992, paragraph 6.

43 Subsection 7(1).

whether or not, at the time of realization of the benefit, the individual is a Canadian resident.[44]

In determining whether an individual performs services in Canada, it is necessary to look at whether the individual is physically present in Canada and performs the duties in the course of his/her office or employment.[45] Where an individual performs employment services for an employer partly in Canada and partly in a foreign country, the income is sourced in both Canada and the foreign country. A reasonable allocation must be made in determining the amount of income from each territorial source.[46] The allocation is generally made on the basis of the number of working days spent in Canada and in the foreign country.[47] For an individual who is employed in cross-border transportation between Canada and a foreign country, the income apportionment may be calculated on the basis of either time or kilometres travelled.[48]

The residence of an employer is generally not relevant to the determination of the source of employment income. However, under subsection 115(2), which is an anti-avoidance rule, the employer's residence may determine the source of employment income. This provision applies where an individual, after becoming a non-resident of Canada, continues to be an employee of a Canadian resident corporation and performs all the duties of employment outside Canada, and the income is not subject to tax in a foreign country or the income is not paid in connection with the selling of property, the negotiating of contracts, or the rendering of services for the employer in the ordinary course of a business carried on by the employer.[49] The effect of the rule is to deem the source of the employment

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[44] Subsection 7(4) provides that, where an employee to whom a provision of subsection 7(1) would otherwise apply has ceased to be an employee before the occurrence of the events that would make that provision applicable, subsection 7(1) continues to apply as though the person were still an employee and as though the employment were still in existence. In *Hurd v. The Queen*, 81 DTC 5140; [1981] CTC 209 (FCA), the taxpayer received a stock option while he was employed in Canada and then became a non-resident. He exercised the option while he was a non-resident and realized a benefit in respect of it. The benefit was held to be sourced in Canada. A similar decision is found in *Hale v. The Queen*, 92 DTC 6370; [1992] 2 CTC 379 (FCA). The converse situation, however, produces a different result. A taxpayer who is a non-resident when he/she receives a stock option is considered to have received a taxable benefit if he/she exercises the option after becoming a Canadian resident. See *Tedmon v. MNR*, 91 DTC 962 (TCC).

[45] Factors such as whether the employer is a Canadian resident, the place where the employment contract is concluded, and the place where remuneration is paid are generally irrelevant for such purposes.

[46] Paragraph 115(1)(a).

[47] IT-270R2, supra footnote 41, at paragraph 28. See also IT-420R3, supra footnote 42, at paragraph 7.

[48] IT-420R3, supra footnote 42.

[49] Paragraphs 115(2)(c) and (e). The exception for services related to the selling of property, the negotiating of contracts, or the rendering of services also applies where such

(The footnote is continued on the next page.)

income to be Canada.[50] Subsection 115(2) also applies where a non-resident receives consideration for entering into a contract of service to be performed in Canada or for undertaking not to enter into such a contract with another party, or receives remuneration for services to be performed in Canada and the amount is deductible in computing the employer's income under part I of the Act.[51]

Canada's tax treaties typically follow article 15 of the OECD model and do not include any specific rules determining the source of employment income as such.[52] However, article 15 contains a provision limiting the scope of source taxation, which functions as a source rule. By virtue of this provision, employment income derived by a resident of a treaty country is taxable in Canada only if the employment is exercised in Canada. In other words, the territorial source is the place where the employment is exercised. However, the treaty source rule is much narrower than that for domestic law purposes.[53] Under Canada's tax treaties, even when services are performed in Canada by a non-resident taxpayer, income from the services is not taxable in Canada if the taxpayer is present in Canada for a period or periods not exceeding in the aggregate 183 days in a calendar year (or any 12-month period); if the remuneration is paid by, or on behalf of, an employer who is a Canadian non-resident; or if the remuneration is not borne by a permanent establishment or a fixed base that the employer has in Canada.[54]

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[49] Continued . . .
services are provided to a foreign affiliate of the employer or to any other person with whom the employer does not deal at arm's length.

[50] Paragraph 115(2)(d).

[51] Paragraph 115(2)(c.1).

[52] The place-of-performance test does not apply to employment exercised aboard a ship or aircraft operated in international traffic. Such income is taxed only in the country of residence of the operator of the ship or aircraft (article 8 of the OECD model). Similarly, directors' fees may be taxable in the country in which the company is a resident (article 16 of the OECD model).

[53] The treaty source rule applies not only for source taxation purposes, but also for residence taxation in respect of foreign tax relief. For example, a Canadian resident can claim a credit for US taxes paid on employment income earned in the United States if the income is taxable in the United States under the treaty. If the income is not taxable in the United States under the treaty source rule, the income is not considered to be from US sources. In *Erwin v. The Queen*, 98 DTC 1330; [1998] 2 CTC 2112 (TCC), the taxpayer was a resident of Canada and worked 26 of 150 working days in the United States in 1993. The taxpayer claimed that the employment income earned for the 26 days was income from a source in the United States and eligible for a foreign tax credit under section 126 of the Act. Under article XV of the Canada-US treaty, however, US source income is exempt from US tax. Therefore, the court found that the income attributable to the 26 days in the United States was taxable only in Canada and was not eligible for the section 126 credit.

[54] Some treaties, such as the Canada-US treaty, also provide an exemption where the amount of remuneration does not exceed a stipulated amount ($10,000).

Source of Business Income

Meaning of "Business" and "Carrying On Business"

The terms "business" and "carrying on business" are not conclusively defined in the Act. In practice, for tax purposes, the meaning of these terms includes both their ordinary meaning and the extended statutory meaning contained in subsection 248(1)[55] and section 253, respectively.[56] The ordinary meaning of "business" has been interpreted by the courts as an organized activity that is carried on with a reasonable expectation of profit.[57]

The meaning of "business" and "carrying on business" is not always the same. The courts have interpreted the phrase "carrying on" to import a notion of continuity and regularity; accordingly, an adventure in the nature of trade, which is by nature an isolated transaction (although within the meaning of "business" under subsection 248(1)), cannot be "carried on."[58] Income from a business that is an adventure in the nature of trade may not be income from carrying on business. To overcome the judicial interpretation of "carrying on," statutory clarifications have been introduced in some cases to treat income from an adventure in the nature of trade as income from carrying on a business.[59] For example, the extended meaning

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[55] Subsection 248(1) defines "business" to include "a profession, calling, trade, manufacture or undertaking of any kind whatever and . . . an adventure or concern in the nature of trade but does not include an office or employment."

[56] Section 253 is a deeming rule that brings within the scope of the Act certain activities carried on in Canada by non-residents. For general discussion of the source of business income, see McLean, supra footnote 3; John Durnford, "The Distinction Between Income from Business and Income from Property, and the Concept of Carrying On Business" (1991), vol. 39, no. 5 *Canadian Tax Journal* 1131-1205; and Constantine A. Kyres, "Carrying On Business in Canada" (1995), vol. 45, no. 5 *Canadian Tax Journal* 1629-71.

[57] See *Granite Apartment Ltd. v. MNR*, 75 DTC 140, at 142; [1975] CTC 2175, at 2177 (TRB). The courts have also accepted the presumption that when a corporation, as opposed to an individual, receives income, that income is income from business. See Durnford, supra footnote 56, at 1139-46.

[58] In *Tara Exploration and Development Co. Ltd. v. MNR*, 70 DTC 6370; [1970] CTC 557 (Ex. Ct.), a non-resident corporation whose sole business was exploring for minerals in southern Ireland raised capital in the Canadian market. Part of the capital was used in Canada to purchase and sell shares in a Canadian mining company at a profit. The court found that the purchase and sale of the shares was an adventure in the nature of trade and the adventure took place in Canada. However, the taxpayer was not carrying on business in Canada. The court stated that "the words 'carried on' are not words that can aptly be used with the word 'adventure.' To carry on something involves continuity of time or operations such as is involved in the ordinary sense of a 'business.' An adventure is an isolated happening. One *has* an adventure as opposed to *carrying on* a business." (Ibid., at 6376; 567.) The court seems to have ignored the statutory deeming rule in paragraph 253(b) under which the offer of anything for sale in Canada is deemed to constitute carrying on business in Canada. See also *Direnfeld v. MNR*, 85 DTC 172; [1985] 1 CTC 2200 (TCC); and *Fergusson et al. v. MNR*, 84 DTC 1107; [1984] CTC 2084 (TCC). For discussion, see Durnford, supra footnote 56, at 1180-86.

[59] For purposes of the small business deduction under section 125, the definition of "active business carried on by a corporation" in subsection 125(7) includes an adventure or concern in the nature of trade.

of "carrying on business" in section 253 now includes a disposition of Canadian real property, as well as resource property and timber resource property. Because dealing in real property is often the object of an adventure in the nature of trade, section 253 ensures that profits from the sale of real property derived by a non-resident are taxed as income from carrying on business in Canada.[60]

Territorial Source Rules

The territorial source of income from a business is generally the place where the business is carried on. Other than the deeming rule in section 253,[61] which applies only for purposes of source taxation, the Act contains no rules for determining whether a person carries on business in Canada or outside Canada. Unless section 253 applies, whether a person carries on business in a place is a question of fact to be determined by reference to the principles of case law. Canada's tax treaties contain some provisions that are relevant to the determination of the source of business income. The following is a brief discussion of the meaning of "carrying on business in Canada" and "carrying on business outside Canada" under the case law, section 253, and Canada's tax treaties.

Carrying On Business in Canada

Non-residents of Canada are subject to Canadian tax on income derived from carrying on business in Canada. The meaning of "carrying on business" is generally determined by the common law rules, although in certain circumstances section 253 deems an economic activity to constitute "carrying on business in Canada."

At common law, the place at which a business is carried on is a question of fact that must be determined on the basis of all the facts and circumstances of each case.[62] The courts have devised various tests to determine whether a non-resident person is carrying on business in a particular country. The two most important tests are the place where the sales contracts are made and the place of operations from which profits arise. Other tests

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[60] Paragraph 253(c) ensures Canadian source taxation of such gains. If the property is held by a non-resident as inventory, the profits from the sale of the property are taxable under paragraph 2(3)(b). If the property is held as capital property, gains from the disposition of such property are taxable under paragraph 2(3)(c).

[61] The Act also has rules relating to income earned by corporations in different provinces in Canada. For purposes of allocating corporate income to a province, the source of income is the "permanent establishment" through which business is carried on. The amount of income attributable is determined by a formula under regulation 400.

[62] In *Erichsen v. Last* (1881), 4 TC 422, at 425 (CA), Brett LJ stated that "it would be first of all nearly impossible and secondly wholly unwise to attempt to give an exhaustive definition of when a trade can be said to be exercised in this country. The only thing that we have to decide is whether upon the facts of this case it can be said that this Company is carrying on a profit earning trade in this country." This view was confirmed by the English House of Lords in *Firestone Tyre & Rubber Co., Ltd. v. Lewellin (HM Inspector of Taxes)* (1957), 37 TC 111.

may be relevant, but the importance attributed to each of these tests varies with the circumstances of each case.[63]

The first test, the place where a contract is made, is often considered an important factor in determining the situs of a business, especially the trading of goods.[64] English cases have held that "if the contracts are concluded in this country, that fact alone will be sufficient to constitute an exercise of trade here."[65] The same rationale has been accepted by Canadian courts.[66] However, the place where sales contracts are made is not always conclusive because it is easily manipulated and there are many factors that contribute to the profit-making process.[67] Accordingly, the courts have frequently turned to the second test, which looks at a combination of factors (such as the purchase of materials, the manufacture or production of goods, the location of inventory, the solicitation of orders, delivery, and payment) to determine the place of operations from which the profits arise and hence the situs of business.[68]

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[63] These tests or factors include the place of delivery, the place of payment, the place where purchases are made, the place of manufacture or production, the place from which transactions are solicited, the location of an inventory of goods, the location of a bank account, the place where the non-resident's name and business are listed in a directory, the location of a branch office, and the place where agents or employees of the non-resident are located. See Kyres, supra footnote 56.

[64] See, for example, *Erichsen*, supra footnote 62; *Werle v. Colquhoun* (1888), 2 TC 402 (CA); *Grainger*, infra footnote 70; *Crookston Bros. v. Furtado* (1910), 5 TC 602 (Scot. Ex. Ct.); *Wilcock v. Pinto & Co.* (1924), 9 TC 111 (CA); *Maclaine & Co. v. Eccott* (1926), 10 TC 481 (HL); *Belfour v. Mace* (1928), 13 TC 539 (CA); and *Geigy (Can.) v. Comm'r, Soc. Serv. Tax*, [1969] CTC 79 (BC SC). See also McLean, supra footnote 3, at 9:18-19; and Kyres, supra footnote 56, at 1634-38.

[65] *Crookston Bros.*, supra footnote 64, at 615.

[66] For example, in *Geigy*, supra footnote 64, the taxpayer was a Montreal-based company and manufactured drugs in Montreal. The company sold a substantial quantity of drugs to British Columbia. Its employed representatives in British Columbia promoted sales but did not conduct direct sales. All orders from British Columbia were accepted in Montreal. The issue in this case was whether Geigy was carrying on business in British Columbia. The court held that Geigy was not carrying on business in British Columbia on the ground that the contracts were made in Montreal and that there was no other convincing evidence that Geigy was carrying on business in British Columbia.

[67] In *F.L. Smidth & Co. v. F. Greenwood* (1922), 8 TC 193, at 203-4 (HL), the House of Lords commented that the place where the sales contracts are made is a very important element, but it is not decisive. "I can imagine cases where the contract of re-sale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise." In *Firestone*, supra footnote 62, at 142, the House of Lords stated that "the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can."

[68] For example, in *The Queen v. Gurd's Products Company Limited*, 85 DTC 5314 (FCA), rev'g. 81 DTC 5153 (FCTD), the Federal Court of Appeal applied this test and held that the taxpayer corporation carried on business in Canada. In this case, the taxpayer corporation was incorporated in Canada in 1932 and was completely inactive from 1946 to

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Section 253 supersedes and overrules the above common law principles where they differ. Paragraph 253(a) deems a non-resident person to have been carrying on business in Canada if the person "produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada whether or not the person exports that thing without selling it before exportation." The word "anything" is very broad and includes both tangible and intangible property, as well as services. The enumerated activities have in common the expenditure of labour in relation to property.[69] Therefore, some physical presence (personnel and/or assets) is necessary for a non-resident to fall within paragraph 253(a).

Paragraph 253(b) provides that a non-resident person is deemed to have been carrying on business in Canada if the person "solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada or partly in and partly outside Canada." This provision overrides a case law principle that says that mere solicitation of orders or making of offers for sale in a country does not constitute carrying on business in that country.[70] The scope of paragraph 253(b) is very broad, and sometimes

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[68] Continued . . .
1969. In 1969, because of strained political relations between Iraq and the United States, the taxpayer corporation was reactivated by its US parent corporation so as to serve as a Canadian "address of convenience" and conceal US involvement in dealings with the Iraqis. The taxpayer's business consisted of purchasing Canadian-produced concentrate from a Canadian supplier for resale to Iraq. An employee of a related Canadian manufacturing company redirected mail between the taxpayer and the Iraqis and performed other minor functions necessary to fool the Iraqis into believing that they were dealing only with the taxpayer. The taxpayer did nothing to the packages of concentrate. The agreement was negotiated, executed, and administered in most significant respects outside Canada. The taxpayer was found to carry on business in Canada on the basis of the following factors: the very nature of the activities envisaged to foster the scheme of necessity required the carrying on of a business in Canada; the taxpayer established a bank account in Canada; substantial profits earned from the sale for goods purchased in Canada were at least momentarily in Canada; although the employee of the related Canadian manufacturing company had limited authority, he was the agent of the taxpayer; and the corporations associated with the taxpayer that were involved in the operation were not dealing at arm's length. The main factor guiding the court seems to have been the first one: a taxpayer that attempts to hold out a Canadian presence for purposes of its commercial dealings may be subject to Canadian tax on the basis of the apparent commercial nature of the transaction rather than the legal nature. In other words, the taxpayer was condemned to the tax consequences that, in the view of the court, flowed from its having pretended to have carried on business in Canada. In what was a borderline situation, the court was decisively influenced by the taxpayer's behaviour. Application for leave to appeal this decision to the Supreme Court of Canada was denied. For comments on the case, see M.M. Yaksich, "Carrying On Business in Canada," Current Cases feature (1985), vol. 33, no. 4 *Canadian Tax Journal* 805-10; and Durnford, supra footnote 56, at 1198-1202.

[69] See Macdonald, supra footnote 3, at paragraph 44,033; and Kyres, supra footnote 56, at 1657.

[70] See *Grainger and Son v. Gough (Surveyor of Taxes)* (1896), 3 TC 462 (HL).

ambiguous.[71] For example, does it require the agent or servant to be physically present in Canada to make offers of sale, or can offers be made from abroad by telephone, television, fax, mail, or over the Internet? Technically, this provision may apply to mail order businesses, Internet commerce, and other remote sales businesses that offer to sell products in Canada, even though the offers are accepted outside Canada. However, if paragraph 253(b) is interpreted narrowly to require the servant or agent to be physically in Canada, it will not apply to such remote sales.[72]

Canadian courts have provided limited guidance on the application of section 253. In *Sudden Valley Inc. v. The Queen*,[73] the court held that paragraph 253(b) does not apply to a mere invitation to treat. The word "offer" was held to have its ordinary meaning in contract law—a binding offer, which, if accepted, creates a contract between the offeror and the offeree.[74] It was suggested that the *Sudden Valley* decision is of exceptional

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[71] For example, does "anything" include real property? If it does, does it include real property situated outside Canada? The established case law is that the territorial situs of a business in real property is where the property is situated, no matter where the contract is completed. If "anything" includes foreign real property, paragraph 253(b) represents a significant departure from the common law and more clarification is necessary. It seems more reasonable to interpret paragraph 253(b) to exclude the sale of real property located outside Canada. This was the result, although not the rationale, in *Sudden Valley Inc. v. The Queen*, 76 DTC 6448; [1976] CTC 775 (FCA), discussed in footnote 73, infra.

[72] The narrower interpretation is favoured because paragraph 253(b) was enacted to overrule the case law whereby the solicitation of orders in a country from abroad does not amount to carrying on business in that country. Macdonald, supra footnote 3, at paragraph 44, 342, commented that "while the wording of paragraph 253(b) leaves many doubts as to its precise scope, it would appear that it deems the non-resident to be carrying on business in Canada only where his agent is physically present in Canada, and solicits orders in Canada or offers anything for sale in Canada, regardless of where the contract is completed." In *Grainger*, supra footnote 70, and the cases that followed it, the agent or servant was resident in the United Kingdom. However, because paragraph 253(b) does not impose a residence requirement, it would be unreasonable to insert one in attempting to interpret the meaning of the provision.

[73] Supra footnote 71, at 6449; 776. In this case, a US company was engaged in the business of selling land situated in the United States. The only activity carried on in Canada was that of attempting to induce Canadians to visit Sudden Valley in the hope that some might eventually become interested in buying property there. The company leased office space in Canada, hired telephone operators, contacted various people, and set up meetings to persuade Canadians to visit Sudden Valley and become interested in purchasing property there. Canadians visiting Sudden Valley were approached by the taxpayer company's sales representatives and attempts were made to sell them property. Sales offers were made and accepted only in the United States. The taxpayer had no agent or servant in Canada who had any authority to accept offers. The taxpayer was assessed part XIII withholding tax on the interest portion of the payments made by the Canadian residents in regard to mortgages and agreements for sale. The taxpayer argued that it was carrying on business in Canada and it therefore should not be subject to part XIII tax pursuant to regulation 805. The court held that the company was not carrying on business in Canada because, in the words of the trial judge, "no offer was obtained and no attempt was made to obtain any in Canada and it is equally clear that nothing was offered for sale in Canada either though an agent or otherwise": 76 DTC 6178, at 6180; [1976] CTC 297, at 300 (FCTD).

[74] Ibid., per Addy J, in the Federal Court—Trial Division.

application (because of the nature of the property and the peculiar method by which the property in the United States was offered for sale in Canada) and may not apply to the sale of normal consumer goods.[75] However, there have been no cases to this effect. It is arguable that the decision has a broader application.[76]

Paragraph 253(c) deems the disposition of Canadian resource property and real property to be carrying on business in Canada, no matter where the sale takes place.[77] In the absence of this rule, a sale of Canadian real property may be considered an adventure in the nature of trade, which, under the common law, does not constitute carrying on business in Canada. Hence, although the economic source of the gains from a sale of Canadian real property is Canada, the gains would escape Canadian taxation because neither part I nor part III would apply to tax the gains. Paragraph 253(b) preserves Canadian tax jurisdiction by deeming the sale to constitute carrying on business in Canada.

For the purposes of section 253 and the common law, the business activities of non-residents may be conducted in Canada directly by the non-residents or through an agent.[78] An agency relationship may be constituted in a number of ways and has been held to include a partnership arrangement.[79] A real estate broker or securities broker, who generally acts

[75] Richard G. Tremblay, "Permanent Establishments in Canada," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 38:1-69, at 38:3, footnote 5.

[76] If so, it is possible that a non-resident who solicits orders in Canada by mail or advertising on the Internet and accepts orders outside Canada is not carrying on business in Canada.

[77] The provision was added to the Act after the courts held in *Tara Exploration*, supra footnote 58, and *Fergusson*, supra footnote 58, that an adventure in the nature of trade cannot be carried on. Paragraph 253(c) was intended to ensure that a non-resident who disposes of property (other than capital property) that is Canadian resource property or real estate (including any interest or option with respect to such property) will be considered to carry on business in Canada.

[78] The courts have held that where a person employs a representative to carry on business in a place on his behalf, he is carrying on business there in his own right. See, for example, *Pommery and Greno v. Apthorpe* (1886), 2 TC 182 (QB); *Erichsen*, supra footnote 62; *Werle*, supra footnote 64; *Thomas Turner (Leicester) Limited v. Rickman (Surveyor of Taxes)* (1898), 4 TC 25 (QB); *Smidth*, supra footnote 67; *In re Procter and Gamble Co.*, [1935-37] CTC 334 (Sask. KB); *United Geophysical Co. of Canada v. MNR*, 61 DTC 1099; [1961] CTC 134 (Ex. Ct.); *Pullman v. The Queen*, 83 DTC 5080 (FCTD); *Gurd's Products*, supra footnote 68; and *Twentieth Century Fox*, supra footnote 32.

[79] *Entreprises Blaton-Aubert Société Anonyme v. MNR*, 69 DTC 121; [1969] Tax ABC 68; *Sandhu et al. v. The Queen*, 80 DTC 6097; [1980] CTC 158 (FCTD); and *Randall v. The Queen*, 85 DTC 5208; [1985] 1 CTC 268 (FCTD). Whether a person is an agent of the non-resident as opposed to an independent contractor is a question of fact that usually depends on the arrangements between the parties and the degree of control exercised by the non-resident over the activities of the person. See Kyres, supra footnote 56, at 1646; and William J. Bies, "Agency in Canadian Income Tax Law," in *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 927-39.

in the ordinary course of his/her business, has been found to constitute an agent for a non-resident with respect to the sale of real property or securities in Canada.[80] On the other hand, the mere fact that a non-resident has an agent in Canada does not necessarily mean that the non-resident is carrying on business in Canada. For the activity to constitute carrying on business in Canada, the agent must have the general power to bind the non-resident principal.[81]

Carrying On Business Outside Canada

The concept "carrying on business outside Canada" is relevant to the application of foreign tax relief provisions and subparagraph 212(1)(b)(iii) of the Act. The meaning of this concept is not defined in the Act. Hence, the common law principles discussed above apply.

The courts generally look to the place of profit-generating activities. For example, in *Cutlers Guild Ltd. v. The Queen*,[82] the court held that the taxpayer was not carrying on business outside Canada (that is, in the United States) but was carrying on business in Canada. The reason was that the activities in the United States (general planning, bookkeeping, importation, and marketing) were preliminary and ancillary, while the raison d'être for the taxpayer was to carry on business in Canada—purchasing silverware in the Orient for resale in Canada to retailers. The taxpayer maintained an office and a warehouse in Canada, staffed by several employees engaged in preparing the goods for delivery to customers. Most of the sales were made in Canada.

For the purposes of determining the location where a particular type of business is carried on, Revenue Canada has set out the following guidelines:

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[80] *Thea Corporation v. MNR*, 67 DTC 175; [1967] Tax ABC 206; and *Ross & Company Ltd. v. MNR*, 67 DTC 421 (TAB).

[81] In *Pullman*, supra footnote 78, the taxpayer was a resident of Switzerland. Pullman made 52 mortgage loans, less than half of which were placed in Canada. An "understanding" was reached between Pullman and a Canadian broker, Mr. Burnett, whereby Burnett offered Pullman participation in loans in Canada and elsewhere. Pullman was free to accept or reject any such participation. Burnett handled all the funds and had a power of attorney on a bank account in Pullman's name in Canada. The court held that Pullman was not carrying on business in Canada through an agent. The court stated (ibid., at 5082), "The term 'agent' is very wide and nebulous. 'No word is more commonly and constantly abused than agent' (Per Lord Herschell in Kennedy v. De Trafford 1897 A.C. 180). An agent is one who acts for somebody else. In that very broad sense, Mr. Burnett on many occasions acted on behalf of the plaintiff, such as for the withdrawing or the depositing of sums in the bank account under the power of attorney. It appears, however, from the evidence that Mr. Burnett held no overall exclusive agency and no general power to bind the plaintiff. Whatever agency existed was very limited and specific in its nature."

[82] 81 DTC 5093; [1981] CTC 115 (FCTD). The issue in this case was whether certain interest paid by the taxpayer to a US lender was exempt from Canadian withholding tax by virtue of subparagraph 212(1)(b)(iii). The exemption applied if the interest payment was in respect of a business carried on outside Canada.

(a) Development and sale of real property—the place where the property is situated;

(b) Merchandise trading—the place where the sales are habitually completed, but other factors such as the location of the stock, the place of payment or manufacture may be considered relevant in particular situations;

(c) Trading in intangible property (e.g., stocks and bonds)—the place where the purchase or sale decisions are normally made;

(d) Money lending—the place where the loan arrangement is in substance completed;

(e) Personal property rentals—the place where the property available for rental is normally located;

(f) Real property rentals—the place where the property is situated;

(g) Service—the place where the services are performed.[83]

The territorial source of income from international transportation and communications operations is determined by the same test as for merchandise trading. The source is generally determined by the place of completion of the contract for transmission or carriage and by other factors such as the place of payment, the place of transmission or embarkation, and the place of receipt or disembarkation.[84]

The above source rules are modified by Canada's tax treaties. As discussed below, the treaty rules are much narrower.

Tax Treaties and the Concept of Permanent Establishment

Canada's tax treaties follow article 7 of the OECD model and provide that business profits are taxable in the country of residence of the taxpayer. The other country can tax business income of a resident of another country only if the income is reasonably attributable to a "permanent establishment" in that country. Thus, the source of business income is the place where a permanent establishment is located. The concept of permanent establishment in Canada's tax treaties is generally based on article 5 of the OECD model. In treaties with developing countries, the concept is expanded to incorporate some elements of article 5 of the UN model.[85] Canadian courts have interpreted "permanent establishment" on several occasions.[86]

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[83] IT-270R2, supra footnote 41, at paragraph 26.

[84] See *Erichsen*, supra footnote 62. In that case, a Danish company was held to carry on business in England on the basis that contracts for transmission were habitually concluded in England, messages were sent from and received in England, and payments were made there.

[85] United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN Publication no. ST/ESA/102 (herein referred to as "the UN model").

[86] The concept of "permanent establishment" is relevant not only to the application of Canada's tax treaties, but also to the allocation of corporation income among provinces in Canada. Some of the cases deal with interprovincial allocation of corporation income. For a general discussion, see Tremblay, supra footnote 75; and Ingrid Sapona, "Taxation of Permanent Establishments, Canada," in *Permanent Establishment* (Amsterdam: IBFD Publications) (looseleaf).

The basic definition of "permanent establishment" is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." Canadian courts have held that the word "permanent" means that "the establishment is a stable one, and not of a temporary or tentative character."[87] In one case,[88] the use of another person's office space was held not to give rise to a permanent establishment if the use was so sporadic as to fail to have the degree of continuity and permanence required to constitute a permanent establishment. In another case,[89] the degree of permanence was satisfied where a non-resident trader visited Canada once a year for several years and spent two to three weeks in Canada per visit in order to sell products from a trailer and a collapsible booth, which he set up at an exhibition place in Canada.

A permanent establishment is deemed to include a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.[90] Additional activities may be included in this list in certain treaties, especially those with developing countries. Common additions are "a stock of goods or merchandise belonging to the enterprise maintained for the purpose of storage, display or delivery";[91] a "farm or plantation";[92] a "sales outlet";[93] a "store";[94] or a "warehouse."[95] In addition, a building site, construction,[96]

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[87] *Sunbeam Corporation (Canada) Ltd. v. MNR*, 62 DTC 1390, at 1393 (SCC), aff'g. 61 DTC 1053 (Ex. Ct.). The issue in this case was whether a "permanent establishment" had to be a fixed place of business for the purpose of regulation 411(1)(a), as it formerly read. Regulation 411(1)(a) was virtually identical to the words used in article 3(f) of the protocol to the 1942 Canada-US treaty.

[88] *Shahmoon v. MNR*, 75 DTC 275; [1975] CTC 2361 (TRB). The taxpayer, a US resident, had space available to him in the offices of a corporation of which he was president for the purposes of carrying on his personal business over a period of at least six years. It was held that the use of the office did not constitute a permanent establishment for the taxpayer's personal trading business because of his infrequent use of the space.

[89] *Fowler v. MNR*, 90 DTC 1834; [1990] 2 CTC 251 (TCC). In this case, it seems that the regularity of the taxpayer's visits, rather than the length of the stays, was decisive in the court's reaching the conclusion that the taxpayer was carrying on business through a permanent establishment in Canada.

[90] Several of Canada's treaties (for example, the treaties with the Netherlands, Papua New Guinea, the United Kingdom, and the United States) also deem not only a place of extraction of natural resources, but also a place of exploration for natural resources to be a permanent establishment.

[91] For example, article 5(2) of the Convention Between Canada and the United Republic of Cameroon for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on May 26, 1982.

[92] For example, Canada's treaties with Cyprus, Egypt, India, Indonesia, Kenya, and Zambia.

[93] For example, Canada's treaties with Barbados, Egypt, India, Morocco, and the Philippines.

[94] For example, Canada's treaties with Cyprus, Korea, and Trinidad and Tobago.

[95] For example, Canada's treaties with Bangladesh, Barbados, India, and Thailand.

[96] In *Entreprises Blaton-Aubert Société Anonyme*, supra footnote 79, the taxpayer was a resident of Belgium that entered into a joint venture with a Canadian company for the

(The footnote is continued on the next page.)

or installation project that lasts more than a specified period of time[97] is deemed to be a permanent establishment. In some treaties with developing countries,[98] a permanent establishment also includes the furnishing of services in respect of the project. Activities that are generally preparatory or ancillary in nature are deemed not to give rise to a permanent establishment.[99]

A dependent agent who habitually exercises an authority to conclude contracts constitutes a permanent establishment of the principal.[100] The activities of an independent agent who acts in his/her ordinary course of business do not constitute a permanent establishment.[101] A subsidiary generally

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[96] Continued . . .
construction of the Belgian pavilion at Montreal's Expo 67. The Belgian company did not participate in any active way in the construction of the pavilion, nor did it have employees in Canada. The Belgian company carried out certain functions in Belgium in advancement of the pavilion project. The erection of the pavilion took more than 12 months. The court held that the Belgian company carried on business in Canada through the joint venture and the construction project constituted a permanent establishment.

[97] The period is generally 12 months, but may be shorter in treaties with some developing countries. For example, the period is 6 months in treaties with Argentina, Bangladesh, Barbados, Brazil, China, Indonesia, Israel, Korea, Malaysia, Mexico, Sri Lanka, Thailand, and Zimbabwe. The period is 3 months in treaties with India, Jamaica, Nigeria, Papua New Guinea, and Zambia.

[98] For example, Canada's treaties with Barbados, Cameroon, China, Indonesia, Pakistan, Thailand, and Zimbabwe.

[99] Examples are places of business used solely for the purpose of storing, displaying, or delivering goods; for purchasing goods; for collecting information for the enterprise; for advertising; for the supply of information; for scientific research; or for the servicing of a patent or a knowhow contract. The intention is to exempt a place of business where the services performed are so remote from the actual realization of profits that it is difficult to allocate any profit to that place of business. See paragraph 23 of the commentary on article 5 of the OECD model.

[100] This is consistent with both the OECD model and the UN model. Some of Canada's treaties (for example, the treaties with Barbados, Indonesia, New Zealand, Singapore, and Thailand) also provide that an agent who has no authority but who habitually maintains a stock of goods or merchandise from which he/she delivers goods on behalf of the enterprise will be a permanent establishment.

[101] In *Placrefid Ltd. v. The Queen*, 92 DTC 6480; [1992] 2 CTC 198 (FCTD), aff'g. 86 DTC 1327; [1986] 1 CTC 2449 (TCC), a Panamanian company resident in Switzerland entered into negotiations in Canada through a Canadian agent, a lawyer. It was held that the agent's activities were insufficient to give rise to a permanent establishment of the Panamanian company in Canada. The court found that the agent, apart from his invaluable professional assistance, had no executive mandate to act or bind the defendant except under the express authority and control of its directors. The court implicitly endorsed the view that a lawyer carrying out negotiations and concluding contracts on the instructions of his/her client is an independent agent acting in the ordinary course of his/her business. However, other than establishing the rule that an independent agent does not constitute a permanent establishment of the non-resident that he/she represents, the cases have provided very little guidance to assist in determining the independence of an agent. In this respect, the OECD commentary should be of some assistance. See, for example, paragraph 38 of the commentary on article 5 of the OECD model.

does not constitute a permanent establishment of its parent,[102] unless it acts as an agent of its parent.[103]

Source of Interest Income

Meaning of "Interest"

The Act does not define "interest."[104] The courts have interpreted the term to mean "the return or compensation for the use or retention by one person of a sum of money belonging to or owed to another."[105] Interest is considered to have three characteristics: (1) it is a return or consideration received by one party for allowing another party to use his/her money; (2) it accrues daily; and (3) it is computed by reference to a principal amount.[106]

Many of the cases dealing with the meaning of "interest" for income tax purposes have been decided in the context of the deduction for interest under paragraph 20(1)(c).[107] These cases tend to take a narrow view of the meaning of interest.[108] For example, a discount has been considered not to

[102] Article 5 of both the OECD model and the UN model. This principle was applied by Canadian courts in *United Geophysical*, supra footnote 78. In this case, the Canadian subsidiary of a US company rented equipment from its parent and claimed that the parent was carrying on business in Canada through its agency so that the rental payments were part of business income and not subject to withholding tax. The court rejected this argument and held that the parent did not carry on business in Canada through the agency of its subsidiary. Thurlow J of the Exchequer Court stated (ibid., at 1102; 140), "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."

[103] See *American Wheelabrator & Equipment Corporation v. Minister of National Revenue*, 51 DTC 285 (TAB).

[104] For further discussion, see Brian J. Arnold, "Is Interest a Capital Expense?" (1992), vol. 40, no. 3 *Canadian Tax Journal* 533-53; Arnold, Edgar, Li, and Sandler, supra footnote 40, at 313-19; Robert Raizenne, "Accrual of Interest Income," in *Report of Proceedings of the Fortieth Tax Conference,* 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 23:1-11; Arthur R.A. Scace and Michael G. Quigley, "New Developments in Debt Financing," in the 1982 Conference Report, supra footnote 79, 579-615; and Arthur R.A. Scace and Michael G. Quigley, "Zero Coupon Obligations, Stripped Bonds, and Defeasance—An Update" (1984), vol. 32, no. 4 *Canadian Tax Journal* 689-705, at 689-94.

[105] *Halsbury's Laws of England*, 4th ed. reissue, vol. 32 (London: Butterworths, 1999), paragraph 106.

[106] See *Reference as to the Validity of Section 6 of the Farm Security Act, 1944, of the Province of Saskatchewan*, [1947] SCR 394; *The Queen v. Melford Developments Inc.*, 82 DTC 6281; [1982] CTC 330 (SCC); *Atty-Gen. for Ontario v. Barfried Enterprises Ltd.*, [1963] SCR 570; *Imm. Fournier v. Const. St-Hilaire*, [1975] 2 SCR 2; and *Tomell Inv. Ltd. v. East Marstock Lands Ltd.*, [1978] 1 SCR 974.

[107] For further discussion, see Scace and Quigley, supra footnote 104; and Raizenne, supra footnote 104.

[108] Ibid.

be interest. For the purpose of taxing interest income under paragraph 12(1)(c) or part XIII of the Act, interest has a broader meaning. It includes any amount that is paid on account or in lieu of payment of, or in satisfaction of, interest.[109] For example, for purposes of part XIII, interest includes the following: standby charges and guarantee fees;[110] a portion of a combined income and capital payment where it is reasonable to regard part of the combined payment as being in the nature of interest;[111] gains realized by a non-resident from the transfer of certain debt obligations to a resident of Canada;[112] substitute payments under securities lending arrangements made by a borrower to the lender of an amount equivalent to the interest payments that the lender would have received on the security during the term of the loan;[113] and fees paid by a borrower to the lender for the use of a security under a securities lending arrangement.[114]

Territorial Source Rules

In the absence of any specific statutory source rules for interest income, the residence-of-payer rule can be viewed as a general source rule. For purposes of part XIII taxes, the residence-of-payer rule is implied by subsection 212(1), which imposes withholding taxes on interest paid or credited by a Canadian resident to a non-resident.[115] Although this provision is not a source rule per se, it has the effect of a source rule because Canada asserts jurisdiction to tax non-residents only on their Canadian source income. For other purposes of the Act, such as section 126, the

[109] For example, a late-payment "surcharge" made by a taxpayer for the importation of goods was held to be in the nature of interest paid to the non-resident vendor for purposes of withholding tax. See *Lebern Jewellery Co. Ltd. v. MNR*, 76 DTC 1313; [1976] CTC 2422 (TRB); *The Queen v. Thyssen Canada Limited*, 87 DTC 5038; [1987] 1 CTC 1 (FCA); and *Wenger's Ltd. et al. v. MNR*, 92 DTC 2132; [1992] 2 CTC 2479 (TCC).

[110] Subsection 214(15).

[111] Paragraph 16(1)(b) and subsection 214(2). A combined payment typically includes a deferred payment for the sale of capital property where the vendor provides a disguised loan to the purchaser. The deferred payments include both the sale price and interest for the disguised loan. See *Groulx v. MNR*, 67 DTC 5284; [1967] CTC 422 (SCC).

[112] Subsection 214(7). These debt obligations include bonds, debentures, bills, notes, mortgages, and similar obligations. The amount of gain is the amount by which the price for which the obligation was transferred exceeds the price for which the obligation was issued. If the obligation was previously transferred to the non-resident by a resident of Canada, the deemed interest is the difference between the price on the occasion of the second transfer and the price on the occasion of the first transfer: subsection 214(7.1). The Canadian transferee is deemed to have paid the interest. This provision does not apply where the interest is otherwise exempt from withholding tax under subparagraph 212(1)(b)(ii), (iii), or (vii): subsection 214(8).

[113] Paragraph 260(8)(a).

[114] Paragraph 260(8)(b).

[115] The determination of the debtor's residence is presumably made at the time interest is paid or credited.

residence-of-payer rule has been accepted by Revenue Canada to determine the source of interest.[116]

The residence-of-payer rule is not the only source rule for interest. Technically, the Act modifies the residence-of-payer rule by either deeming a non-resident to be a resident for part XIII purposes (for example, paragraph 212(13)(f) and subsection 212(13.2)) so that interest paid by the non-resident is subject to part XIII tax, or exempting certain interest paid by Canadian residents from part XIII tax so that the interest is free from Canadian taxation (for example, subparagraphs 212(1)(b)(iii), (viii), and (ix)). These technical provisions have the same effect as source rules. They reflect two distinct source criteria:

1) The source of interest is the location of real property that is used as security for the indebtedness. For example, paragraph 212(13)(f) provides that where a non-resident person pays interest on any indebtedness secured by real property situated in Canada, or by an interest in such property, the payer is deemed in respect of that payment to be a resident of Canada to the extent that the amount so paid is deductible in computing the payer's Canadian source income. Subparagraph 212(1)(b)(viii) contains a similar provision with respect to interest paid by Canadian residents.[117]

2) The source of interest is the place in which the business that pays the interest is carried on. For example, subsection 212(13.2) provides that a non-resident person is deemed to be a Canadian resident with respect to certain interest payments if

a) the non-resident's business was carried on principally in Canada, or the non-resident has productive activities in Canada, and

b) the interest is deducted in computing Canadian source business income.[118]

Clause 212(1)(b)(iii)(E) provides that where a Canadian resident pays interest in respect of a business carried on outside Canada and deducts the interest payment in computing income from that foreign business, the interest is exempt from Canadian withholding tax.[119]

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[116] Revenue Canada has indicated that "[w]here interest is earned . . . the residence of the debtor ordinarily determines the territorial source of the income": IT-270R2, supra footnote 41, at paragraph 29.

[117] Subparagraph 212(1)(b)(viii) applies where interest is paid by a Canadian resident on borrowed money on the security of a mortgage on real property situated outside Canada and the interest is deductible in computing income.

[118] A similar rule is contained in subsection 214(9): where certain debt obligations are transferred to a non-resident person carrying on business in Canada, the transferor is deemed to have realized interest income for purposes of the withholding tax and the transferee may deduct the interest in computing income earned in Canada. The non-resident transferee is deemed to be a resident of Canada with respect to the transfer of the obligation and must withhold tax from the deemed interest payment.

[119] This provision provides an exemption from Canadian withholding tax where (1) the interest is payable by a Canadian resident in a foreign currency to a person with whom the payer

(The footnote is continued on the next page.)

The common element of these rules is the deductibility of interest in computing income. The rationale is to preserve Canada's tax base. Under the formalistic residence-of-payer rule, interest paid by a non-resident corporation that derives substantial income from carrying on business in Canada is not treated as Canadian source income. Therefore, when interest payments are deductible by the non-resident corporation in computing its Canadian source business income, interest paid to non-resident creditors will escape Canadian taxation. The place-of-real-property rule and the place-of-business rule prevent that result.

The above source rules apply for purposes of part XIII tax. It is unclear whether the place-of-real-property rule and the place-of-business rule apply for other purposes of the Act. Revenue Canada's administrative position on this issue is ambiguous.[120] The ambiguity is generally resolved by the source rule in Canada's tax treaties.

Canada's tax treaties contain a source rule for interest, which is based on article 11(5) of the OECD model.[121] The territorial source of interest is determined by the residence of the payer or the location of the permanent establishment (or fixed base) that bears the interest expense.[122] The place-of-permanent-establishment (or fixed base) test overrides the residence-of-payer test in the case of any inconsistency. For example, article XI of the Canada-US treaty provides that interest paid by a Canadian resident company to a US

[119] Continued . . .
deals at arm's length; (2) the interest is payable on an obligation entered into in the course of carrying on a business in a foreign country; and (3) the interest payable on the obligation is deductible by the payer in computing its income from the business in that country for Canadian tax purposes. See also subparagraph 212(1)(b)(ix), which provides that interest payable in Canadian currency on an amount in Canadian currency deposited with a foreign branch of a Canadian financial institution is exempt from Canadian withholding tax. Although not listed as a condition, the fact that the interest payment is deductible by the Canadian resident in computing its worldwide income for Canadian tax purposes in respect of the business of the foreign branch is probably a rationale for this rule. In addition, pursuant to subparagraph 212(1)(b)(v), interest payable to an arm's-length person on an obligation entered into in the course of carrying on a life insurance business in a foreign country is exempt from Canadian withholding tax.

[120] For purposes of residence taxation, Revenue Canada expressly leaves open the possibility of tests other than the residence-of-debtor rule by stating that this rule applies "ordinarily": IT-270R2, supra footnote 41, at paragraph 29. Revenue Canada does not clarify whether the place of situs of real property or the business that bears the interest expense constitutes an exception to the general rule.

[121] Article 11(5) of the OECD model provides, "Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

[122] For a discussion of the potential problem of dual source caused by article 11(5) of the OECD model, see John F. Avery Jones et al., "Tax Treaty Problems Relating to Source" [1998], no. 3 *British Tax Review* 222-50, at 225-33.

resident is deemed to arise in Canada, as is the case under the residence-of-debtor rule in the Act. However, if the indebtedness is incurred in connection with, and the interest is deductible in computing the income attributable to, a permanent establishment (or fixed base) of a Canadian or US resident, interest is deemed to arise in the country where the permanent establishment (or fixed base) is located, not the country of residence of the payer. Accordingly, if a Canadian resident that has a permanent establishment in Japan pays interest to a US resident and the interest is borne by the permanent establishment, the interest is not sourced in Canada and no Canadian withholding tax will be imposed on it. However, if a US resident that has a permanent establishment in Canada pays interest to a Japanese bank and the interest is deductible in computing Canadian source income attributable to the permanent establishment, the interest is deemed to be sourced in Canada.[123]

Source of Dividend Income

Meaning of "Dividend"

The Act does not define "dividend."[124] Subsection 248(1) simply provides that a dividend includes a stock dividend. The ordinary meaning of "dividend" has been established by the courts. In some old English cases, which have been generally accepted for Canadian tax purposes, the courts have determined that any pro rata distribution from a corporation to its shareholders is a dividend, unless the distribution is made on the liquidation of the corporation or on an authorized reduction of corporate capital.[125] A dividend also includes a deemed dividend under section 84.[126] In addition, for purposes of non-resident withholding tax, dividends include benefits conferred by a corporation on its shareholders[127] and deemed

[123] In this situation, what is the rate of withholding tax—the Canadian domestic rate of 25 percent, the Canada-US treaty rate, the US-Japan treaty rate, or the Canada-Japan treaty rate? The Canada-US treaty will deem the source to be Canada, whereas the US-Japan treaty will deem the source to be the United States under the first test in article 11(5) of the OECD model. The answer is probably the domestic rate or the Canada-Japan treaty rate.

[124] As in the case of interest, dividends may constitute business income, as they may be, for example, to an investment dealer in some circumstances. In general, however, dividends constitute income from property.

[125] See, for example, *Hill v. Permanent Trustee Co. of New South Wales*, [1930] AC 720 (PC); and *Inland Revenue Commissioners v. Burrell*, [1924] 2 KB 52 (CA). Where a distribution is made on the liquidation of the corporation or on an authorized reduction of corporate capital, it may give rise to a capital gain or loss on the particular shares, subject to the deemed dividend rules in the Act.

[126] Section 84 deems a dividend to be paid where a corporation increases the paid-up capital in respect of the shares of any class of its capital stock; distributes funds or property on the winding up, discontinuance, or reorganization of its business; redeems its shares or purchases its shares for cancellation; or reduces the paid-up capital in respect of any class of shares of its capital stock otherwise than by way of a redemption, acquisition, or cancellation of the shares.

[127] Section 15 and paragraph 214(3)(a). Indirect benefits under subsection 56(2) are also deemed to be dividends under paragraph 214(3)(a).

dividends arising from non-arm's-length sales of shares of a Canadian corporation in a surplus-stripping situation.[128]

Territorial Source Rules

The territorial source of dividends is generally the country of residence of the company paying the dividends. Although this rule is not explicitly set out in the Act, it is implied by subsection 212(2) and section 90. Subsection 212(2) provides that withholding tax applies to non-residents in respect of dividends paid or credited to them by corporations resident in Canada. Although there is no reference here to "source," the implication is that the residence of the payer corporation determines the source of dividends. Section 90 provides a similar implicit rule with respect to dividends received from foreign corporations.[129] This rule has also been accepted by Revenue Canada for purposes of section 126.[130]

The residence of a corporation is established under Canadian domestic law. If a corporation is considered a resident of both a foreign country and Canada, dividends paid by the corporation are considered to have a Canadian source because the corporation is resident in Canada.[131] However, if a corporation that is otherwise a resident of both Canada and a treaty country is deemed to be a non-resident of Canada under the treaty, the territorial source of the dividends paid by the corporation is not Canada because of subsection 250(5).

In contrast to the treatment of interest income, there are no exceptions to the general residence-of-payer rule for dividends. Therefore, even if a non-resident company derives most of its income from carrying on business in Canada, dividends paid by the company are not considered to have a Canadian source. Canadian source taxation is protected to some extent by a "branch tax" under section 219. In general, the branch tax is imposed on the Canadian source after-tax business income derived by a foreign

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[128] Section 212.1. The effect of this provision is to trigger either an immediate deemed dividend or a deemed dividend under subsection 84(2) when the corporation is liquidated.

[129] Section 90 provides that a taxpayer resident in Canada must include in income dividends on a share of the capital stock of a corporation not resident in Canada. The place where a foreign affiliate derives its income and the nature of the income are relevant to the determination of the affiliate's surplus accounts (that is, exempt surplus, taxable surplus, or pre-acquisition surplus) but are not relevant to the "source" of dividends paid by the affiliate.

[130] IT-270R2, supra footnote 41, at paragraph 32. Revenue Canada states that the territorial source of dividends from foreign countries will "ordinarily" be the country of residence of the payer corporation.

[131] Revenue Canada states, ibid., at paragraph 30, "However, where a company incorporated in a foreign jurisdiction is resident in Canada, the payment of dividends by that corporation to non-residents of that foreign country (including Canadian residents) may require the payment of withholding tax to the foreign jurisdiction. In these circumstances the dividend paid to a Canadian resident is generally not considered as income from sources in that foreign jurisdiction but as income from Canada."

corporation through a Canadian branch. It is the equivalent of a withholding tax on dividends paid by a Canadian subsidiary of a foreign corporation.[132]

Canada's tax treaties provide that dividends may be taxed in the country in which the payer corporation is resident.[133] The source of dividends is thus determined by the residence of the payer. These treaties also contain what might be described as a negative source rule, stating that dividends do not have their source in the country in which the profits out of which the dividends are paid are derived.[134] This rule appears to prohibit the levying of a branch tax. In order to preserve the right to levy such a tax, Canada's treaties often add a paragraph to specifically allow the imposition of a branch tax.[135]

Source of Rent and Royalties

Meaning of "Rent" and "Royalties"

The Act does not provide a comprehensive definition of either "rent" or "royalty," but paragraph 212(1)(d) includes certain payments as "rents" or "royalties" for withholding tax purposes. The courts have dealt with the ordinary meaning and the extended meaning of these terms in several cases. Canada's tax treaties generally define the term "royalty."

Ordinary Meaning

Rents and royalties generally represent payments for the use of property. A "rent" is generally a fixed payment (usually periodic) for the use of property for a given period of time, after which the right to use the property expires (that is, the right reverts back to the owner).[136] The term "royalty" connotes a payment calculated by reference to the use, or to the production or revenue or profits from the use, of the rights granted. The

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132 The rate of tax imposed under section 219 is 25 percent.

133 This provision is based on article 10(2) of the OECD model.

134 This rule is based on article 10(5) of the OECD model: "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

135 Examples are article X(6) of the Canada-US treaty and article X(7) of the Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980 and October 16, 1985. The additional paragraph usually starts with the wording "Nothing in this convention shall be constructed as preventing" and therefore authorizes the imposition of a branch tax on the earnings attributable to a permanent establishment.

136 See comments by the Federal Court of Appeal in *The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*, 80 DTC 6272; [1980] CTC 352 (FCA).

original meaning of "royalty" as "rights belonging to the Crown jure coronae" has been considered by Canadian courts as no longer applicable for Canadian tax purposes.[137] The courts have held:

> The term "royalties" normally refers to a share in the profits or a share or percentage of a profit based on use or on the number of units, copies or articles sold, rented or used. When referring to a right, the amount of the royalty is related in some way to the degree of use of that right. . . . Royalties, which are akin to rental payments, . . . are either based on the degree of use of the right or on the duration of use to be made of it.[138]

The concept of "use" has been interpreted very broadly. A property is used by a person where the owner of the property allows the person to take possession or make use of the property. For example, land is used where the owner allows another person to excavate and remove gravel from the land. Intangible property (such as a copyright, patent, trademark, or franchise) is used where the assignee/licensee is allowed to exploit the bundle of rights protected by law.

Royalties or rents need to be distinguished from sales.[139] In the absence of statutory rules, the distinction is made on the basis of the facts in each case. In general, if all the legal rights in a property are transferred, the transaction constitutes a sale; if less than all the rights are transferred, the transaction is a lease or licence and the payments are rents or royalties. Because intangible property rights are difficult to value, they are often transferred for consideration that depends on their productivity. An element of contingency in the payment for the use of a property is therefore the essence of a royalty payment.[140] It is generally irrelevant whether the transaction is in the form of a "licence" or "sale" as long as the payment is based on the use or productivity of the property.[141] It is

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137 *MNR v. Wain-Town Gas and Oil Co. Ltd.*, 52 DTC 1138, at 1140; [1952] CTC 147, at 151, per Kerwin J.

138 *Vauban Productions v. The Queen*, 75 DTC 5371, at 5372; [1975] CTC 511, at 513 (FCTD).

139 There are no statutory rules concerning the characterization of transactions as sales or licences/leases. Revenue Canada provides some assistance with respect to software transactions, as will be discussed in part 2 of this article.

140 *Grand Toys Ltd. v. MNR*, 90 DTC 1059; [1990] 1 CTC 2165 (TCC).

141 For example, the following payments have been found to be royalties: proceeds of sales of gravel, sand, shale, and topsoil where the purchase price is payable in fixed instalments (for example, a fixed amount per cubic yard of shale removed) (see *Pallett v. MNR*, 59 DTC 230 (TAB); *Irwin v. MNR*, 63 DTC 251 (TAB); *Flewelling v. MNR*, 63 DTC 489 (TAB); *Mouat v. MNR*, 63 DTC 548 (TAB); and *MNR v. Lamon*, 63 DTC 1039; [1963] CTC 68 (Ex. Ct.)); proceeds of a sale or assignment of a copyrighted sales manual for a fixed price where the payments were based on a percentage of products sold by the purchaser (*Gingras v. MNR*, 63 DTC 1142; [1963] CTC 194 (Ex. Ct.)); and proceeds of a sale of a franchise to supply natural gas in return for an amount based on gross receipts from all sales of natural gas under the franchise (*Wain-Town Gas and Oil*, supra footnote 137). Also treated as royalties are proceeds of an assignment by an author to a publisher of the right to publish

(The footnote is continued on the next page.)

also irrelevant whether or not the amount of consideration is fixed or paid in instalments.[142]

It is difficult to characterize a transfer of intangible property as a licence or sale because both licences (transfers of the right to use giving rise to royalty income) and sales (transfers of ownership resulting in the recognition of sales profits) involve the grant of rights to the transferee. For example, with respect to copyright or other intellectual property that expires after a prescribed term, a grant of an exclusive right to use the property for the remainder of its life can be identical in effect to a transfer in the form of a sale of the property. In an extreme case where there is a transfer of the exclusive right to exploit an intangible property in all fields of use and media of publication for the remainder of the life of the property and throughout at least one jurisdiction, the transaction is a sale rather than a licence. A transfer of any lesser bundle of rights may be more difficult to classify.[143]

In order to provide certainty to taxpayers, paragraph 212(1)(d) provides deeming rules for the meaning of "rent" or "royalty" in the context of part XIII tax.

Paragraph 212(1)(d)

Under paragraph 212(1)(d), Canadian withholding taxes apply to Canadian source "rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment" that is enumerated in the provision. The scope of this provision is extremely broad.[144] By

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141 Continued . . .
and sell his work where the amount of proceeds was based on the number of copies sold (see *Hould v. MNR*, 65 DTC 624 (TAB)) and payments for the sale of a list of clients by a lawyer based on a percentage of the gross professional income received from his former clientele for a number of years (*Brosseau v. MNR*, 86 DTC 1412; [1986] 1 CTC 2558 (TCC)).

142 For example, in *Vauban Productions*, supra footnote 138, the non-resident taxpayer transferred to a Canadian company the exclusive right to broadcast certain films in Canada. The Canadian company's rights were limited to the period of time for which Vauban had acquired its rights, and the price for the right to show each film was fixed, regardless of the degree of use. Under the contract, the ownership of the films and copyright remained with Vauban and the films. The court held that the payments were royalties and the transaction was a leasing of a right and not an absolute sale. The fact that the consideration was paid in a lump sum and not by instalments was considered irrelevant to the characterization of the transaction.

143 In *Rustproof Metal Window Co. v. IRC*, [1947] 2 All ER 454 (CA), the court found that a transfer of a patent for a lump sum was a licence as opposed to a sale because (1) the licence was a non-exclusive licence and the licensor's right to exploit the patent was not impaired by the granting of other licences; (2) the licence was granted for the specific purpose of enabling the licensee to fulfil a particular contract; (3) the use of the patent was limited to the extent of a specified level of production; and (4) the grant was for a period of time shorter than the life of the patent.

144 For comments, see Catherine A. Brown, "The Canadian Income Tax Treatment of Computer Software Payments" (1994), vol. 42, no. 3 *Canadian Tax Journal* 593-613; Peter
(The footnote is continued on the next page.)

using the words "including, but not so as to restrict," Parliament intended to tax not only payments that had all of the strict legal characteristics of "rent" or "royalty," but also payments enumerated in the provision that may not ordinarily be considered "rent" or "royalty."[145]

Under subparagraph 212(1)(d)(i), payments for the use of "any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever" are taxed as royalties.[146] It is not relevant whether the amount of payments is related to use, production, or profit, or whether payments are provided in a lump sum or periodically. There are some ambiguities in the wording of this provision. For example, why are trade name, patent, and trademark listed after "any property," but not copyright? If the intention was to omit copyright because of the exemption in subparagraph 212(1)(d)(v), that intention is not very clear. Further, should the phrase "secret formula, process or other thing whatever" be read as one related concept, with the word "secret" modifying "process and other thing whatever" as well as "formula," or merely as separate items in the list? In the former case, "other thing whatever" would be limited to things in the nature of a secret formula or process, a somewhat more restrictive view of its scope.

The courts have interpreted the meaning of subparagraph 212(1)(d)(i) in several cases. In *The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*,[147] the taxpayer made a lump-sum payment for the right to use software devised by a US company for ship design. The information obtainable by the use of the software was not secret, in that it could have been worked out by competent technical personnel of the Canadian company with expense and time. The right to use the software was perpetual, in that the Canadian taxpayer could use the software for as long and for whatever purposes it chose, but the taxpayer was bound by contract to use the software only for its own purposes. It could not resell the software. The right was non-exclusive and the US company could license other users to use the same software. The court found that the payment could not be regarded as made for the use of secret processes and formulas, but that it could conceivably have been made for the use of "other like

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144 Continued . . .
K. Rowan-Legg, "International Tax Considerations Relating to the Export and Import of High Technology," in *Report of Proceedings of the Thirty-Fifth Tax Conference*, 1983 Conference Report (Toronto: Canadian Tax Foundation, 1984), 884-901, at 891-95; James R. Wilson, "Tax Treatment of Development, Acquisition, and Transfer of Technology," ibid., 819-65; and Scott L. Scheuermann, "Income and Commodity Tax Aspects of Acquiring and Exploiting Technology," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 45:1-69, at 45:35-42.

145 See comments by the courts in *United Geophysical*, supra footnote 78, at 1105; 146; and *The Queen v. Farmparts Distributing Ltd.*, 80 DTC 6157; [1980] CTC 205 (FCA).

146 Payments made to non-residents for their undertaking not to use or not to permit any other person to use anything referred to in subparagraph 212(1)(d)(i) or (ii) in Canada are also taxed as royalties. See subparagraph 212(1)(d)(iv).

147 Supra footnote 136.

property." However, because the payment was not a "royalty" within the definition of the term in the Canada-US treaty as it then read, it was exempt from Canadian tax. In another case, *The Queen v. Farmparts Distributing Ltd.*,[148] a Canadian company made payments to a US company for (1) an exclusive territorial right to buy "Wonder Matic" machines used in the replacement of automobile exhaust systems for resale in Canada; (2) the concept or technique of merchandising the systems; and (3) the use of the trade name "Wonder Muffler" and related logos. The court found that payments for the right to buy machines and resell them in Canada did not fall within subparagraph 212(1)(d)(i),[149] but the other two payments did. The merchandising concept or technique was found by the court to be a "plan," or perhaps a "process" or "property," as those words are used in subparagraph 212(1)(d)(i).[150]

Revenue Canada's administrative interpretations indicate that subparagraph 212(1)(d)(i) applies to the following transactions: franchise payments, which encompass the use of trademarks, trade names, or industrial designs;[151] payments for the use of blueprints for the layout of plants, buildings, or equipment;[152] payments for the right to use special procedures, processes, or recipes pertaining to a business, whether or not incorporated in a franchise, patent, or trademark;[153] payments for the use of or the right to use prototypes or designs for manufacture;[154] payments for the use of non-scripted live television programming or pre-recorded tapes or records;[155] payments for the right to use a professional athlete's name (the athlete's name was considered by Revenue Canada as the equivalent of a trademark);[156] fees paid under securities lending arrangements;[157] and

148 Supra footnote 145.

149 The court stated that such payments seemed to be quite unrelated to rentals, royalties, or similar payments since they were made irrespective of the extent of use by the taxpayer under the agreements and were unrelated to the profits made by the taxpayer as a result of any use.

150 Although the court found that some part of the payment was within paragraph 212(1)(d), it dismissed the Crown's appeal altogether, apparently because counsel failed to plead that the payment was divisible and rested the Crown's case on the argument that the whole amount was subject to withholding.

151 *Interpretation Bulletin* IT-303, "Know-How and Similar Payments to Non-residents," April 8, 1976, paragraph 11.

152 Ibid.

153 Ibid.

154 Ibid.

155 See Revenue Canada's technical interpretations 5-2680, March 4, 1987; B-3340, March 25, 1982; rrr116, August 18, 1987; and 6074-6, August 10, 1986 (in this article, Revenue Canada technical interpretation document numbers are taken from *TaxPartner* (Scarborough, Ont.: Carswell) (CD-ROM database)). These payments may be exempt from Canadian withholding tax under subparagraph 212(1)(d)(vi).

156 Revenue Canada technical interpretation 9411705, November 7, 1994.

157 Revenue Canada technical interpretation 9530420, November 28, 1995.

payments of the appreciated value of the stock to the lender under a "share appreciation rights" arrangement.[158]

There are some limitations on the broad reach of subparagraph 212(1)(d)(i). For example, payments for the outright purchase (of a patent, trademark, industrial design, or copyright) or assignment of a licence are not covered by this provision, even though the transfer of ownership necessarily includes a right to use the property.[159] Payments for a thing, such as a machine or toy, would be a payment for the thing itself and not a payment for the right to use it for purposes of subparagraph 212(1)(d)(i).[160] Payments for the exclusive right of distributorship are also outside this provision.[161] If the word "secret" is interpreted to modify "formula and other thing whatever," the scope of the provision can be further limited.[162]

Under subparagraph 212(1)(d)(ii), payments for information concerning industrial, commercial, or scientific experience are taxable as royalties where the total amount payable as consideration for such information is dependent, in whole or in part, upon the use to be made of the information or the benefit to be derived from it, upon production or sales of goods or services, or upon profits. Subparagraph 212(1)(d)(ii) differs from subparagraph 212(1)(d)(i) in that the former catches payments only where there is an element of contingency in the payment and the latter applies irrespective of any connection between the payment and use of the property or thing. Also, unlike subparagraph 212(1)(d)(i), subparagraph 212(1)(d)(ii) does not require that the information be used in Canada.[163]

The term "information" is not defined in the Act. Its meaning can be very broad. The information contemplated in subparagraph 212(1)(d)(ii) presumably excludes information that is a property or thing listed in subparagraph 212(1)(d)(i). If the information is a property or thing within the meaning of subparagraph 212(1)(d)(i), payments for such information will be taxed under that provision. For example, a payment made for information used in the fashion business may consist of "designs or models" and

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[158] The arrangement is used as an inducement by high-risk borrowers to lenders so that the borrower may obtain funds at market interest rates. See Revenue Canada technical interpretation 5-4010, December 3, 1987.

[159] IT-303, supra footnote 151, at paragraph 12. Whether or not the transaction is an outright purchase or sale depends on whether the transferee has obtained an absolute right to the property, at least in Canada.

[160] *Farmparts Distributing Ltd.*, supra footnote 145.

[161] Ibid.; and *Grand Toys*, supra footnote 140.

[162] Payments in respect of cost-sharing arrangements are not taxable under paragraph 212(1)(d): subparagraph 212(1)(d)(viii).

[163] Subparagraph 212(1)(d)(ii) applies whether the property is used by the payer or by a third party. For example, where an agreement with a non-resident who furnishes the information provides that the payer has the right to pass on the information to other persons who may make payments to the payer according to the use, benefit, production, sales, or profits that they in turn derive, payments to the non-resident will be subject to subparagraph 212(1)(d)(ii): IT-303, supra footnote 151, at paragraphs 16 and 17.

other information. Payments for the use of designs or models are subject to subparagraph 212(1)(d)(i), whereas payments for other information are subject to subparagraph 212(1)(d)(ii) and taxable only if they are based on use, production, or profits. Similarly, if the information is confidential and can be considered a "secret process" or "secret formula," payments for such information are taxed under subparagraph 212(1)(d)(i).

The determination of whether a payment is based on use, production, or profits must be made on a case-by-case basis. The determination is straightforward in the case of periodic payments based on a percentage of production, sales, or profits. A once-and-for-all payment in a predetermined amount for information (such as the right to attend a viewing or an exhibition) is not considered a payment that is dependent in whole or in part upon use, production, or profits.[164] Where an initial payment of a fixed sum is coupled with future payments depending upon use, production, or profits, Revenue Canada will normally regard the initial payments as separate and may consider the future payments as royalties.[165]

Under subparagraph 212(1)(d)(iii), payments for services of an industrial, commercial, or scientific character are taxable as royalties to the extent that the total amount of the payments is based upon use, upon production or sale of goods or services, or upon profits.[166] Payments based on some other criterion are generally not royalties.[167] Where fees are charged for services on a per diem or similar basis, it is a question of fact whether the amount depends upon the use to be made or the benefit to be derived from the services. In practice, daily or hourly fees are outside the scope of subparagraph 212(1)(d)(iii).[168] Subparagraph 212(1)(d)(iii) does not apply to management and administrative fees or fees for services performed in connection with the sale of property or the negotiation of a contract.[169] Subparagraph 212(1)(d)(iii) is silent on the question of the place where

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[164] Ibid., at paragraph 18.

[165] This will be a question of fact to be determined in each set of circumstances and will depend on several factors, such as the relationship of the payer and the recipient, the nature of the particular business, any history of similar payments, and the degree of certainty that there will be subsequent payments after the initial payment: IT-303, supra footnote 151, at paragraph 17.

[166] Examples of payments that may fall within this provision include fees for technical or production services where the amount of such fees depends in some way upon performance or productivity; charges for product development and marketing knowhow or research that vary in accordance with production or sales; and a finder's fee equal to a percentage of service fees that the payer will obtain from third parties. See IT-303, supra footnote 151, at paragraph 23; and Revenue Canada technical interpretation 9419675, April 11, 1995.

[167] Where a franchisee paid a non-resident franchiser for products at cost plus a variable markup, depending on the volume purchased in a given month in lieu of a royalty and advertising fee, the amount of "markup" was held by the court not to be within paragraph 212(1)(d) of the Act: *Entré Computer Centers Inc. v. The Queen*, 97 DTC 846; [1997] 1 CTC 2291 (TCC).

[168] Revenue Canada technical interpretation 922179A, March 16, 1993.

[169] The exclusion is provided by subparagraph 212(1)(d)(iii).

services are rendered. It may apply to services rendered outside Canada via telephone, the Internet, or other means of communication.

It is not uncommon in practice that information concerning industrial, commercial, or scientific experience is obtained as a result of services provided by the person possessing the information. In such cases, a distinction must be made as to whether the payments are made for the information or for services. Such a distinction is insignificant for purposes of subparagraph 212(1)(d)(ii) or (iii), but it is very important when payments are made to residents of treaty countries, because the definition of "royalty" in Canada's tax treaties generally does not extend to services. Accordingly, a fee for services under subparagraph 212(1)(d)(iii) is not a royalty for treaty purposes and thus is not subject to Canadian withholding tax. In making the distinction, the terms of the agreement and the primary focus of the agreement are important factors to consider. It is possible to classify the whole transaction as a payment for services or a payment for information. For example, where an agreement is labelled a services agreement, avoids any mention of pre-existing knowledge, and focuses, to the extent possible, on the specific tasks to be undertaken by personnel rather than upon the transmission of specific knowledge or information, payments made under the agreement on the basis of use, production, or profits are likely to be viewed as service fees.[170] Similarly, where services rendered constitute the bulk of the contract and the resulting information (such as drawings, designs, or plans) did not exist at the beginning of the contract, payments under the contract will be treated as service fees. Examples include the case of an engineering contract that called for the contractor to deliver to his/her customer the plans and drawings of the plant that he/she was to design and build, or the case of a company that hires the services of a research scientist to do research that ultimately results in the company's obtaining a patent.[171] On the other hand, where the primary obligation under the contract is to convey specialized technical information in some manner, the payments are more likely to be treated as payments for information. In cases where payments are made for both services and information, an allocation must be made.[172]

Under subparagraph 212(1)(d)(v), payments that are dependent upon use or production from property in Canada, whether or not the payments were instalments on the sale price of property other than agricultural land, are taxed as royalties.[173] This provision makes it irrelevant whether

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[170] See Scheuermann, supra footnote 144, at 45:37.

[171] See Revenue Canada technical interpretation RCT-0515, February 26, 1981.

[172] The cases seem to indicate, however, that where payments were combined and only part of the payments was taxable under paragraph 212(1)(d), the whole amount was considered non-taxable if the minister failed to discharge the onus of establishing that part of the payments which was taxable. See *Farmparts Distributing Ltd.*, supra footnote 145; and *Brad-Lea Meadows Limited v. MNR*, 90 DTC 1269; [1990] 1 CTC 2306 (TCC).

[173] Subparagraph 212(1)(d)(v) essentially parallels the wording of paragraph 12(1)(g).

a transaction takes the form of a purchase or a licence or lease of property where payments are contingent on production from or use of the property.

Payments for the use of a copyright in Canada are generally taxed as royalties. However, subparagraph 212(1)(d)(vi) provides an exemption for payments made in respect of the production or reproduction of any literary, dramatic, musical, or artistic work (including computer software).[174] These payments include amounts paid to a non-resident copyright holder in respect of a book for the right to make copies of certain sections of the book and to use the copies in the payer's training material;[175] payments for the right to use photographs in magazines and newspapers;[176] and payments for the right to make copies of custom software for commercial distribution or sublicensing. Subparagraph 212(1)(d)(vi) does not apply to payments for the use in Canada of motion picture films or of films, videotapes, or other means of reproduction used in connection with television.[177]

The meaning of rent or royalty under the Act is modified by the definition of "royalty" in tax treaties. As discussed below, the treaty definition is narrower.

Treaty Definition

The definition of "royalties" in Canada's treaties generally follows the definition of the term in article 12 of the OECD model. Canada departs from the OECD definition in several respects in order to bring the treaty definition more in line with paragraph 212(1)(d) of the Act.[178] The OECD

[174] The term "literary work" is not defined in the Act. Section 2 of the Copyright Act, RSC 1985, c. C-42, as amended, defines the term to include computer software.

[175] Revenue Canada technical interpretation 9207455, June 24, 1992.

[176] Revenue Canada technical interpretation 5-5758, May 11, 1988.

[177] See subsection 212(5), which overrides subparagraph 212(1)(d)(vi). Like paragraph 212(1)(d), subsection 212(5) does not apply to outright purchases. See *Peliculas Sari SA v. MNR*, 80 DTC 1766; [1980] CTC 2864 (TRB). For further discussion of subparagraph 212(1)(d)(v) and subsection 212(5), see Daniel Lang, "Marketing Filmed Entertainment: Strategies To Minimize Canadian Withholding Tax," International Tax Planning Feature (1998), vol. 46, no. 4 *Canadian Tax Journal* 847-64.

[178] Canada's treaties generally provide an exemption from withholding tax for copyright royalties in respect of the production or reproduction of any cultural, dramatic, musical, or artistic work (other than motion picture and videotape royalties, provided that the recipient in the other contracting state is subject to tax on those royalties). In addition, Canada is prepared to eliminate the withholding tax on payments in respect of rights to use patented information or information concerning scientific experience, and on payments made for the use of computer software. Tax has been eliminated on such payments in recent treaties or protocols—for example, those negotiated with Denmark, France, the Netherlands, and the United States. Article XII(3) of the Canada-US treaty provides exemptions for "[p]ayments for the use of, or the right to use, computer software"; "[p]ayments for the use of, or the right to use, any patent or any information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement)"; and "[p]ayments with respect to broadcasting as may be agreed for the purposes of this paragraph in any exchange of notes between the Contracting States." For

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model specifies payments for the right to use "copyright of any literary, artistic or scientific work, including cinematography films, any patent, trade mark, design or model, plan, secret formula or process." Canada adds to this list of items "or other similar intangible property."[179] Article XII(4) of the Canada-US treaty also extends the definition to payments "for the use of, or the right to use, tangible personal property," "gains from the alienation of intangible property or rights to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights," and technical service fees if the fees are periodic and dependent upon productivity or a similar measure.[180]

Territorial Source Rules

There are no specific statutory source rules for rent or royalties.[181] For purposes of source taxation, by specifying what payments are taxable in Canada, paragraph 212(1)(d) implicitly contains some source rules. The two most important source rules are based on the place where the property is used and the residence of the payer. For other purposes of the Act, the source rule seems to be based on the place of use of the property.[182]

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178 Continued . . .
further discussion of these exemptions, see article XII(3) in 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; and Catherine Brown, "The U.S.-Canada Tax Treaty: Its Impact on the Cross-Border Transfer of Technology" (Spring 1996), 9 *The Transnational Lawyer* 79-119, at 96-105.

179 The OECD model includes payments for cinematographic films. Canada is more particular and includes payments in respect of motion picture films and works on film, videotape, and other means of reproduction for use in connection with television (that is, payments subject to subsection 212(5) of the Act).

180 See article XII(4) in the US Treasury Department's technical explanation of the Canada-US treaty, supra footnote 178.

181 Where rent or royalties are taxed as business profits, source rules for business profits will be applicable. In other cases, rent or royalties are separate sources of income—income from property. The source rules for rent or royalties are premised on the notion that property that is leased or licensed is a productive asset in its own right.

182 The place of use has also been accepted by Revenue Canada for purposes of the foreign tax credit: "Where income is derived from rental or tangible property (other than income from a business carried on in a foreign country), the source of such income is considered to be (a) in the case of income from rental or real property, the country where the property is located, and (b) in the case of income from rental of other tangible property, the country where the property is used. . . . Royalty payments have their geographical source in the country in which the related right is used or exploited": IT-270R2, supra footnote 41, at paragraphs 31 and 32. It is unclear whether Revenue Canada also recognizes the residence-of-payer rule in the absence of tax treaties. As a practical matter, foreign source income derived by a Canadian resident will be subject to double taxation if Canadian source rules differ from foreign source rules. For example, royalty income paid by a resident of country X to a resident of Canada for the use of property in Canada is considered sourced in country X on the basis of the place-of-payer rule and sourced in Canada based on the place-of-use rule. If country X levies withholding taxes on the royalty, Canada will not give credit for such taxes because the income is not foreign source income. The result is double taxation. Such conflict of source rules may be resolved through tax treaties.

The place-of-use rule means that the territorial source of a royalty is determined by the place where the property is used. This rule is implied in subsection 212(1): Canadian source taxation applies to payments made to non-residents if they are "for the use of or for the right to use in Canada any property"[183] or are "dependent on the use of or production from property in Canada."[184] This rule is further clarified and strengthened by other provisions in part XIII. For example, subparagraph 212(1)(d)(ix) provides that where a resident makes a rental payment for the use of or the right to use outside Canada any corporeal property, the payment is exempt from Canadian withholding tax. The rationale for the exemption is that the territorial source is outside Canada because the place of use is outside Canada. Similarly, where a property is used in Canada, a non-resident payer is deemed to be a resident for purposes of part XIII.[185] The effect is that as long as the use of property is in Canada, payments for the use are sourced in Canada whether or not the payer is a resident.[186]

Where is the place of use? For tangible property, the place of use is presumably the place where the property is located.[187] For intangible property rights, the place of use is generally the country in which the right is used or exploited. A right can be used or exploited only where the law of the country does not prohibit the use of the right.[188] Practically speaking, intellectual property rights are valuable only because they bar everyone but the holder from exploiting the right. The place where an intangible property right is used or exploited is not always easy to determine. In the case of a patent, case law seems to favour the place where the patent is used by a manufacturer and the place where products made under the patent are sold.[189] The place of use of a design, plan, secret formula, or process is likely determined under the same rules as those in respect of a patent. The place of use of a trademark seems to be the place where the

183 Subparagraph 212(1)(d)(i).

184 Subparagraph 212(1)(d)(v).

185 Subsection 212(13).

186 The rationale for this deeming rule is probably that the economic source of the rent or royalties is in Canada because the payments are made for purposes of earning business income in Canada. In other words, the rented or licensed property is presumably used in the business carried on in Canada.

187 Special rules apply to the use of aircraft and railroad rolling stock for purposes of non-resident withholding tax: subparagraphs 212(1)(d)(vii) and (xi).

188 IT-270R2, supra footnote 41, at paragraph 32.

189 For example, in *International Combustion, Ltd. v. The Commissioners of Inland Revenue* (1932), 16 TC 532 (KB), a French company obtained the exclusive rights to manufacture and sell machinery under a licence from the US patentee. By a contract completed in France, the French company made the English appellant its English agent for manufacture and sale. Payments were made directly from England to the US patentee. The payments were held to be income arising from property in England, and the place of exploitation of the patent was held to be the source of the royalty.

products to which the trademark was affixed were used or sold for consumption.[190] The place of use of a copyright is likely the place where copyrighted products are produced or reproduced or where the products are sold.[191]

Under the residence-of-payer rule, rent and royalties are deemed to arise in the country in which the payer is resident. This rule is implied in subsection 212(1): every non-resident person is liable to tax on royalties paid by a person resident in Canada. The territorial source of the payment is Canada because the payer is a Canadian resident. This rule is subject to the place-of-use rule. Where a non-resident uses property in Canada in connection with a business carried on in Canada, the source is effectively deemed to be Canada.[192] On the other hand, where a Canadian resident uses a property in connection with a foreign business, the source is deemed to be outside Canada.[193] These rules are designed to protect the tax base since payments of rent or royalties are deductible in computing income.

Canada's tax treaties generally permit the source country to impose withholding tax. This practice deviates from the OECD model, which provides that royalties can be taxed only in the residence country and thus provides no source rules for royalties. Because Canada insists on source taxation of royalties, Canadian treaties need a source rule and normally provide one similar to that used for interest. The source of royalties is determined by the residence of the payer or the place of a permanent establishment (or fixed base).[194] The Canada-US treaty also provides for the place-of-use test to apply where the treaty does not otherwise deem the royalties to arise in one of the contracting states under the other rules. For example, if a US resident were to grant franchise rights to a resident

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[190] It is not clear which test is used in Canada. For purposes of paragraph 212(1)(d), if a Canadian resident purchases goods bearing a registered trademark from non-residents for resale in Canada and pays a royalty for the use of trademark, the royalty is subject to Canadian tax. However, if no separate royalty payment is made and the Canadian resident obtains the exclusive right to distribute products bearing the trademark, no royalty is considered to have been paid. In cases where a Canadian manufacturer obtains an exclusive licence from a non-resident to affix the trademark to goods sold in Canada, the trademark is used in Canada. It seems irrelevant whether or not the trademarked goods are consumed in Canada or in a foreign country.

[191] In *Curtis Brown, Ltd. v. Jarvis (HM Inspector of Taxes)* (1929), 14 TC 744 (KB), the English company arranged for publication of the works of various authors who were non-residents and wrote all their works outside the United Kingdom. Royalties less commissions and expenses were remitted to the authors. The King's Bench held that the copyright royalties were annual profits or gains arising from property in the United Kingdom, where the works were copyrighted.

[192] Subsections 212(13) and (13.2).

[193] Subparagraphs 212(1)(d)(ix) and (x).

[194] For example, under article XII(6) of the Canada-US treaty, the source of royalties is generally determined by the residence of the payer. However, if the obligation to pay the royalties was incurred in connection with a permanent establishment or a fixed base in Canada that bears the expense, the royalties are deemed to arise in Canada.

of Mexico for use in Canada and the Mexican resident did not have a permanent establishment in Canada, the royalties paid by the Mexican resident to the US resident for those rights would be Canadian source income under the Canada-US treaty.[195]

Source of Capital Gains

Meaning of "Capital Gains"

Under the Act, capital gains are treated separately from the traditional sources of income, and only three-quarters of gains are currently included in income. A capital gain is a gain derived from a disposition of a property unless the gain is taxed as another source of income (business profit, as in the case of sale of inventory property, or employment income, as in the case of disposition of employee stock options).[196] In general, gains from a disposition of a capital property[197] are capital gains.

Territorial Source Rules

The Act contains no specific rules for the determination of the territorial source of capital gains. With respect to source taxation, the definition of "taxable Canadian property" can be interpreted as an implicit source rule because non-residents are subject to Canadian tax only if the gains are from the disposition of a taxable Canadian property.[198] Source rules for other purposes of the Act are based on Revenue Canada's administrative policy.[199] Tax treaties also contain some source rules that are narrower than the domestic ones.

Under both the Act and tax treaties, the territorial source of capital gains is related to the type of property, such as real property, personal property, tangible and intangible property used in a business, shares, and other types of property. Depending on the type of property, the territorial source may be determined by the situs of the property sold, the place of sale, the place of business in which a property is used, the residence of a corporation whose shares are sold, and other tests.

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[195] This rule is consistent with subsection 212(13) of the Act which deems a non-resident payer to be a resident for withholding tax purposes in respect of rent for the use in Canada of property and imposes withholding tax on the payment.

[196] Paragraph 39(1)(a).

[197] Section 54.

[198] Under subsection 2(3), a non-resident is taxable only on gains derived from the disposition of a taxable Canadian property. The Canadian source-taxation of capital gains depends on whether the property is a taxable Canadian property. Gains from non-taxable Canadian property are not subject to Canadian tax. Therefore, the source of capital gains is tied to the definition of "taxable Canadian property" in subsection 248(1). For further discussion, see Robert Raizenne and Angelo Nikolakakis, "Taxable Canadian Property," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 46:1-72.

[199] *Interpretation Bulletin* IT-395R, "Foreign Tax Credit—Foreign-Source Capital Gains and Losses," July 31, 1991.

The territorial source of gains from the disposition of real property[200] is generally the location of the property.[201] Shares of real estate companies are treated as real property in certain circumstances. For example, a share of a non-resident corporation is deemed to be "taxable Canadian property" if the value of the share is derived principally from taxable Canadian properties that include real property located in Canada.[202] Therefore, the territorial source of the gains from the sale of shares in real estate companies is determined by the location of the underlying real property of the company.

The territorial source of gains from the disposition of personal property is usually the place where the disposition occurs.[203] The most important factor in determining the place of disposition is probably the place where the contract for sale is concluded, but other factors such as the place of payment and the place of delivery may also need to be considered.[204]

Where a property, including tangible and intangible property, is used by a taxpayer in carrying on a business, the source of the gains from the disposition of such property is generally the place where the business is carried on. If the business is carried on in Canada, the property is deemed to be a "taxable Canadian property."[205]

The territorial source of gains from a sale of shares and bonds is generally the place of sale.[206] However, this rule is overruled by statutory provisions that effectively deem the source to be Canada irrespective of the place of sale where the shares are

1) unlisted shares of a corporation resident in Canada;[207]

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200 Real property situated in Canada includes an interest in or an option on such real property; see subsection 115(3).

201 IT-395R, supra footnote 199, at paragraph 3.

202 Subsection 248(1), definition of "taxable Canadian property," paragraph (e). Similar rules apply to an interest in a non-resident trust or a partnership: ibid., paragraphs (g) and (k).

203 IT-395R, supra footnote 199, at paragraph 3.

204 In this respect, case law applicable to the source of business income derived from the sale of personal property is likely followed. Macdonald, supra footnote 3, at paragraph 44,510.

205 Subsection 248(1), definition of "taxable Canadian property," paragraph (b). A capital property used by a non-resident insurer in the year or held in the year in the course of carrying on an insurance business in Canada is also considered to be taxable Canadian property: ibid., paragraph (c), and subsection 138(12).

206 The place of sale is the securities or stock exchange where the securities are disposed of, regardless of the location of the issuer's transfer office. If the sale is not made through an exchange, the place of sale is determined by the location or place of business of the issuer, the location of the issuer's transfer office, the residence of the vendor of the security, or the residence of the vendor's selling agent. Where the business of the issuer is carried on in a different place from the place where the contract is signed, the place of signing of the contract will not necessarily determine the source of the income. See IT-395R, supra footnote 199, at paragraph 3.

207 In this respect, the residence of the corporation is considered the source of gains of the shares.

(2) listed shares of a resident corporation if a non-resident shareholder owns 25 percent or more of the issued shares of any class of the corporation during a five-year period;[208]

(3) unlisted shares of a non-resident corporation whose underlying assets are mostly Canadian real and resource property (a "non-resident real estate corporation";[209] and

4) listed shares of a non-resident real estate corporation if a non-resident shareholder owns 25 percent or more of the issued shares of any class of the corporation during a five-year period.

Therefore, the source of gains from the sale of shares is based on not only the place of sale, but also the type of the company (that is, a private or public company), the residence of the company, and the nature of the underlying assets of the company.[210]

In addition, gains from certain deemed dispositions are deemed to be sourced in Canada. Revenue Canada has stated that where there has been a deemed disposition of property, any resulting capital gain or loss is not considered to be from a foreign source, regardless of the geographic location of the property at the time of that deemed disposition.[211]

Canada's tax treaties generally follow article 13 of the OECD model. This provision allows certain capital gains to be taxed in the source country but does not define the source of capital gains as such. Rather, article 13 specifies what types of gains are taxable in the source country and thus in effect functions as a source rule. In general, gains from the alienation of immovable property or property of a permanent establishment or fixed base are taxable in the country where the immovable property or the permanent establishment or fixed base is situated.[212] Some of Canada's treaties[213] provide that gains from the alienation of shares of a company that is a resident of one country are taxable in the other country if the

208 Subsection 248(1), definition of "taxable Canadian property," paragraph (f).

209 Subsection 248(1), definition of "taxable Canadian property," paragraph (e).

210 A capital interest in a Canadian resident trust (other than a mutual fund trust) or a unit of a Canadian resident unit trust (other than a mutual fund trust) is deemed to be taxable Canadian property: subsection 248(1), definition of "taxable Canadian property," paragraphs (h), (i), and (j).

211 IT-395R, supra footnote 199, at paragraph 3. For example, subsection 128.1(4) deems each taxpayer who ceases to be a Canadian resident to have disposed of most property owned by the taxpayer immediately before becoming a non-resident for proceeds equal to its fair market value. Any gains from the deemed disposition are sourced in Canada. When the property that is deemed to be taxable Canadian property because of an election is disposed of, the gains from the disposition are also sourced in Canada.

212 Gains from the alienation of ships and aircraft operated in international traffic, together with movable property pertaining to the operation of such ships and aircraft, are taxable only in the residence country of the operator of the ship or aircraft.

213 For example, the Canada-US treaty. A similar rule applies to an interest in a partnership, trust, or estate.

value of shares is derived principally from immovable property situated in that country. Canada's treaties with some developing countries, such as China, provide that gains from the alienation of shares of a company that holds non-immovable property are taxable in the residence country of the company if the shareholding exceeds a certain threshold (for example, 25 percent).[214] Gains from the alienation of other types of property, such as personal property and securities, are taxable only in the residence country of the alienator.

Source of Income from Personal Services

Under the Act, income from services is not a separate category of income.[215] Rather, such income is taxed as employment income, business income, royalties, or interest. As discussed earlier, the distinction between employment services and independent personal services is based on the facts and circumstances of each case. Income from independent personal services is generally taxed as business income.[216] For purposes of withholding tax, service fees may be taxed as "interest" (as in the case of standby charges and guarantee fees)[217] or "royalties" (where the services result in the transfer of intangible property or knowhow or where the fees are based on use of or benefit from the services).

The territorial source of income from personal services is generally the place where services are rendered under domestic law[218] and the place of fixed base under tax treaties.[219]

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[214] Gains from other types of property are generally taxable only in the country of residence of the alienator. However, Canada's treaties preserve the right to tax at source, according to domestic law, gains derived by an individual resident in the other contracting state who was a resident of Canada at any time during a period of years (normally six) preceding the alienation of the property.

[215] For further discussion, see Bradley A. Sakich, "Inbound Personal Services," in the 1996 Conference Report, vol. 2, supra footnote 198, 44:1-45; and W. Gordon Williamson, "Performance of Services: Outbound," ibid., 43:1-30.

[216] In cases where a distinction must be made between income from the sale of goods and income from the provision of services (as in the case of section 125.1, for example), the courts examine the substance of the agreement between the parties. In *Dixie X-Ray Associates Limited v. The Queen*, 88 DTC 6076, at 6079 (FCTD), McNair J stated, "The test for determining whether a contract is one for the sale of goods or for the supply of services is to ask the question: What is the substance of the contract? If the substance of the contract is the production of something to be sold and the transference of property therein to a buyer then the contract is a sale of goods. But if the real substance of the contract is the skill and labour of the supplier in the performance of work for another then that is a contract for work and labour, notwithstanding that property in some materials may pass under the contract as accessory thereto." See also *Tenneco Canada Inc. v. The Queen*, 87 DTC 5434 (FCTD), aff'd. 91 DTC 5207 (FCA).

[217] Subsection 214(15).

[218] See the discussion above under the heading "Source of Income from Office or Employment."

[219] See article 14 of the OECD model.

Source of Other Income

Source rules for income other than the types of income mentioned above are less clear. Where payments are made to non-residents, generally part XIII of the Act effectively considers the source of the payments to be Canada if the payer is resident in Canada. Examples are paragraph 212(1)(a) concerning management and administration fees, paragraph 212(1)(c) concerning income of or from an estate or trust, paragraph 212(1)(h) concerning payments of a superannuation or pension benefit, and paragraph 212(1)(j.1) concerning payments of retiring allowances.

Conclusions

Canadian source rules are not specified in the Act. They are either implicit in various provisions of the Act or stated in Revenue Canada's interpretation bulletins on the basis of common law principles. In general, source rules for purposes of source taxation are more specific than those for residence taxation, reflecting Canada's policy emphasis on the taxation of non-residents and concerns with enforcement issues.

The policy objectives for Canada's source rules seem to be threefold. First, these rules recognize the legitimacy of Canada's claim to tax on a source basis because the income has a clear connection with Canada. Examples are rules applicable to income from carrying on business in Canada and income from services performed in Canada. The economic activities producing these types of income clearly take place in Canada. Second, some source rules are based on enforcement concerns. For example, the residence-of-payer rule for interest, dividends, rent, or royalties is easier to enforce than other rules when Canadian taxes on these items of income are collected by way of withholding at source. The territorial source rules for capital gains also reflect these enforcement issues. An example is the treatment of gains from the sale of shares of publicly traded companies. Third, other source rules are designed to protect the Canadian tax base. These rules include the deeming rule under paragraph 115(2)(c) with respect to employment income and the rules in part XIII that deem the source of interest and royalties to be Canada where the interest or royalties are deductible by the non-resident in computing income for Canadian tax purposes.

The lack of statutory source rules and the limited case law make the application of source rules very uncertain in many cases. Because the existing source rules are based on the characterization of income and the determination of the geographical location of income creation by relying on the physical presence of property, business, or personnel, the uncertainty will be exacerbated in the world of e-commerce. One reason is that e-commerce blurs the characterization of income and, unlike traditional commerce, does not require a taxpayer to have any physical presence in a country in which income is derived. Another reason is that the rapid increase in e-commerce means that a growing number of domestic transactions will become cross-border transactions. Uncertain source rules will be called upon to apply to more transactions. The features of e-commerce and their implications will be discussed in part 2 of this article.