A common mistake when analyzing the tax implications of a cross border transaction is to jump too quickly to the ramifications of a tax treaty without first having a clear handle on the tax implications under the Income Tax Act (Canada) ("ITA"). A related issue is that even though a tax treaty generally trumps the ITA with respect to any inconsistencies between the two, that should not be interpreted to mean that the treaty, in and by itself, can charge tax. This article will describe these common mistakes in the context of an interesting issue that arose in a recent Canada Revenue Agency ("CRA") audit of a company resident in India ("NRCO") that carried on a service business in Canada through a permanent establishment ("PE") and the debate that took place regarding the interaction of Article 7 of the Canada-India Tax Treaty ("Canada-India Treaty") and the relevant taxing provisions of the ITA.

Audit Scenario

The CRA proposed to assess NRCO on all profits earned on its Canadian customer service contracts, regardless of whether the services were performed inside Canada ("onshore services") or outside Canada ("offshore services"). CRA’s rationale was based on its interpretation of Article 7 of the Canada-India Treaty and on the principle that a tax treaty overrides the ITA. NRCO did carry on its business in and outside of Canada and it did have a PE in Canada, so those facts were not under dispute. Certain provisions of the Canada-India Treaty are based on the UN Model Tax Convention ("UN Model") and not the OECD Model Tax Convention ("OECD Model"). More particularly, the scope of the Business Profits Article of the Canada-India Treaty (i.e. Article 7) is extended to include certain profits of an enterprise even though the activities are not directly carried on through the PE. The underlying principle of this "force of attraction" rule, in brief, is generally that when an entity has a PE in another country, the host or source country has
the right to tax the enterprise for similar business activities which take place in that country, whether through the PE or not. In the case of the force of attraction rule in Article 7 of the Canada-India Treaty, it even goes further than the force of attraction rule in the UN Model and allows Canada or India, as the case may be, to tax similar business activities carried on outside its country. Consequently, CRA proposed to assess NRCO on its profits earned from offshore services based on the force of attraction rule in Article 7(1)(b) of the Canada-India Treaty.

### Relationship between Tax Treaties and Domestic Tax Law

Tax treaties are international agreements between sovereign states and create rights and obligations only on the states themselves. Canadian tax treaties require the tabling in Parliament of an implementing act to which the treaty is attached as a schedule. Each implementing act provides that, subject to one exception, the provisions of the particular tax treaty in question will prevail over the provisions of any other law to the extent of any inconsistency. The exception is the Income Tax Conventions Interpretation Act ("ITCIA") that is expressly intended to override Canada's tax treaties. Given the fact that Canada's tax treaties prevail over the provisions of the ITA (subject to the provisions of the ITCIA), the question sometimes arises, as it did by CRA in this particular case, as to whether tax treaties are always relieving in nature or whether they can have the effect of imposing a tax liability on a person (e.g., NRCO) where none exists under domestic legislation.

Canada is a country that categorically views tax treaties as strictly relieving in nature. For example, Canada inserts a tax benefit rule in all of its tax treaties that clearly states that the treaty in question shall not be applied to deprive a taxpayer of any benefit, including an "exclusion" or "exemption", otherwise available under domestic tax law. It is also the author's understanding that tax treaty Bills are not considered "money" or "charging" Bills, allowing greater flexibility in tabling the legislation in Parliament. For example, treaty legislation can be first introduced in either the House of Commons or the Senate, whichever is more convenient because it is not a "charging" Bill (i.e., does not increase the tax burden of the taxpayer). The end result is that Canada's tax treaties prevail over any inconsistent provision of the ITA but only to reduce, not increase, the tax burden on the taxpayer.

Finally, on a pure technical reading of the general text of the distributive articles of a tax treaty based on either the OECD Model or UN Model, the relevant provisions are generally only establishing whether the Treaty is maintaining, reducing or denying the host
or source contracting state's taxing rights otherwise established under its domestic tax laws. For example, the key wording in paragraph 1 of Article 7 of the Canada-India Treaty states that "If the enterprise carries on or has carried on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to" that permanent establishment. (underlining for emphasis)

Resolution of the Matter by CRA

After lengthy internal deliberations, CRA did finally agree that it could not tax NRCO for profits attributable to offshore services. However, other issues in these scenarios are not so easy to resolve and remain unresolved with respect to NRCO. For example, Article 7 of the Canada-India Treaty, like most of Canada's tax treaties, does not fully endorse the full authorized OECD approach ("AOA") in computing income attributable to a PE and, arguably, does not provide for notional expenses. This leaves open the possibility of some significant departures, by CRA, in adhering to the OECD Transfer Pricing Guidelines when computing income attributable to the PE in Canada. As the starting point for determining the Canadian tax implications of a cross-border transaction is to first compute profits under the ITA, consider a scenario where the computation of a non-resident's Canadian source business income for purposes of sections 4 and 9 of the ITA is less than the business profits that would be computed for purposes of Article 7 of the particular treaty. In other words, is it possible for the juridical principles of section 9 (e.g. the "truer picture of income" principle) to apply in a manner that supports a lower computation of Canadian source business income for a non-resident of Canada than those profits that would be computed for purposes of Article 7 of the Treaty?

There has been very little guidance issued by the CRA regarding the computation of income from a geographical source (sections 4 and 9 of the ITA) and how these rules interact, if at all, with the AOA and international standards such as the OECD Transfer Pricing Guidelines. For example, can a non-resident of Canada who is a resident of a non-treaty country and carries on its business partly in Canada through a branch and partly in its home country, compute its Canadian source business income for purposes of sections 4 and 9 of the ITA following the AOA and OECD Transfer Pricing Guidelines? If so, why would this approach, for purposes of the ITA, not apply to a non-resident who resides in a treaty country that does not have a modern business profits article in its treaty with Canada which fully endorses the AOA? These are complex issues that are well beyond the scope of this article, however, taxpayers should be warned that even though CRA cannot use the provisions of a tax treaty to impose tax on the profits of a non-resident of Canada reasonably attributable to offshore services, they can make life fairly difficult for
the taxpayer where the business profits article of a particular treaty has significant departures from Article 7 of the 2010 OECD Model, the latter of which fully endorses the AOA.

**Closing Comments - Always Start with the ITA!**

In closing, and the author's real purpose behind this article, was to remind taxpayers, tax advisors and tax administrators of the importance of starting your analysis of cross border transactions with the ITA. As explained above, Canada's tax treaties are generally relieving in nature and do not impose tax on a taxpayer. Consequently, if after researching the provisions of the ITA and no tax liability arises, that is likely the end of the process. The author, having spent 32 years with the CRA and now close to 5 years in private practice, has seen countless cases in both worlds where significant time and resources have been expended on researching tax treaty matters on cross-border transactions that were not even taxable under the ITA. In most cases the tax consequences under the ITA are obvious, but not always.

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