Deemed Services PEs - Subcontractors vs Agents - CRA Adds Fuel to the Fire

By: Jim Wilson and Pierre Alary

The Canada Revenue Agency's ("**CRA**") Income Tax Rulings Directorate recently released a technical interpretation[1] which may invite CRA auditors to continue this increasingly common and highly alarming trend. There has been a trend by auditors to conclude with apparent ease that a parent-subsidiary or contract-subcontractor relationship is in fact an agent-principal relationship for purposes of Canada's bilateral tax treaties. As we discuss below, the agency threshold is not easily met under Canadian agency law, and the frequent jump by CRA auditors to conclude that an agency relationship exists, is creating significant tax uncertainty for Canadian and foreign entities.

The recent technical interpretation arose when a taxpayer requested the assistance of the CRA to determine whether Article V(9)(b) of the Canada-U.S. Tax Convention (the "**Treaty**") would apply to deem a US company to have a permanent establishment in Canada in the following hypothetical fact scenario.

USco1 [a US company] entered into a contract to provide services to Canco, a customer resident in Canada. USco1 engaged USco2 [another US company] to provide the services that USco1 was obligated to provide under the contract with Canco, on behalf of USco1 for Canco. The services are provided over a period more than 183 consecutive days. USco1 and USco2 are not residents of Canada; they are residents of the United States for the purposes of the Treaty. Many employees of USco2 will be involved in performing these consulting services. Canco, USco1 and USco2 are controlled by a common parent company.

Paragraph 9 of Article V was introduced by the Fifth protocol of the Treaty and is generally understood to be the governments' response to the Federal Court of Appeal decision in *The Queen v. Dudney*, 2000 DTC 6169 (F.C.A.)[2]. Article V(9)(b) deems a permanent establishment ("**PE**") to exist for cross-border service providers where the services are provided in the other State for at least 183 days in any twelve-month period with respect to the same or a connected project (commonly referred to as "**deemed services PEs**"). The services must be provided for customers who

1. are either resident in the other State ("**Option 1**"); or

2. have a PE in the other State in respect of which the services are provided ("**Option 2**").

The CRA concluded in this technical interpretation that USco1 and USco2 would both be deemed to have a PE. While we understand why the CRA would interpret Article V(9)(b) in a manner that ensures that Canada maintains its taxing rights in this hypothetical scenario, it is the road travelled by CRA to arrive at its conclusion which we find concerning.

With respect to USco1, CRA opined that USco1 provided services to Canco through the agency of USco2. Thus, USco1 would be providing services to a customer resident in Canada (i.e. Canco) for more than 183 days in a twelve month period with respect to a single project. As a result, USco2 would also be deemed to have a PE in Canada as a result of providing services to a customer (i.e. USco1) that is deemed to have a PE in Canada (in addition to meeting the other factors listed in Article V(9)(b)).

It is important to note that the technical interpretation refers to the possible use of the general anti-avoidance rule ("**GAAR**") in the event that Article V(9)(b) is circumvented. The reference to GAAR would

seem to indicate that CRA may have been concerned by the possibility of U.S. companies circumventing Article V(9)(b) of the Treaty by sub-contracting the work. This appears to be the "evil" CRA was trying to remedy in this case. To avoid such abuse of the provision, it is understandable why the CRA concluded that USco2 had a deemed PE in Canada. However, it is unclear why CRA felt the need to establish an agency-principal relationship between USco1 and USco2. That is, while recognizing the obvious ambiguity within Article V(9)(b) in respect of subcontract scenarios, there would appear to have been a reasonable basis for CRA, based on a purposive approach to treaty interpretation, to conclude that USco2 had a deemed PE in Canada regardless of whether an agency relationship existed. For example, an argument was available to CRA that USco1 "provides services" in Canada "for customers" who are resident in Canada even though they subcontracted with USco2 to have the latter entity physically perform the service in Canada. This would have resulted in USco1 having a deemed PE in accordance with Option 1 listed above. Following this through, as USco2 provides services to its customer, USco1, who has a PE in Canada, USco2 would be deemed to have a PE in Canada pursuant to Option 2 listed above.

The Organisation for Economic Co-operation and Development's ("**OECD**") Model Tax Convention on Income and on Capital ("**OECD Model Treaty**") does not contain a deemed services PE provision similar to Article V(9)(b) of the Treaty, but the OECD Commentary offers an alternative provision for the taxation of services, albeit slightly different from Article V(9)(b) of the Treaty. Interestingly, applying paragraph (b) of the OECD alternative provision to the hypothetical scenario above, and assuming that USco2 was not an agent of USco1, dependent or independent, USco2 would be deemed to have a PE in Canada and USco1 would not be deemed to have a PE.[3] However, given that Article V(9)(b) uses different wording[4] than the OECD alternative provision, and the Department of the Treasury Technical Explanation of the Fifth Protocol ("**U.S. TE**") is silent on the issue of subcontractors in this scenario, there seems to be plenty of room for CRA to support an interpretive policy that would protect source country taxation in these contractor-subcontractor scenarios. Furthermore, both the OECD Commentary to the alternative provision and the U.S. TE would seem to suggest that the intentions of the treaty negotiators were to maintain source state taxation rights provided that the ultimate customer resides in the source state and the services are physically performed in that state for more than 183 days. These three basic factors are met in the scenario above.

Alternatively, and again by avoiding a literal or legalistic interpretation of Article V(9)(b), CRA could have argued that USco2 would be deemed to have a PE under Option 1 because the intention of the reference to services being provided by an enterprise (e.g. USco2) to "customers who are either residents of that State …" was simply to ensure services were in fact physically provided to third party customers in Canada. It is debatable whether the treaty negotiators intended for so much stock to be put on the fact that the subcontractor's "customer" is the general contractor and not the general contractor's Canadian resident customer. This interpretation approach would have been consistent with paragraph (b) of the OECD alternative provision described in paragraph 42.23 of the Commentary since the latter provision does not refer to services provided "for customers".

The use of the "agency" argument in this technical interpretation, when it was arguably not necessary to achieve the desired result, will simply add fuel to the fire of a growing trend we have encountered in our practice. In essence, certain CRA auditors are incorrectly employing the term "agent" to describe parent-subsidiary and contractor-subcontractor relationships. By doing so, CRA auditors are seemingly lifting the corporate veil, even though the courts have made it clear that an agency determination in such a case is not one that should be easily arrived at[5]. It is unclear to us how CRA could arrive at such conclusion in this technical interpretation because, generally speaking, a subcontractor simply enters into a contract of service with the contractor and not an agent-principal relationship. While the technical interpretation issued by CRA provides a very brief description of the facts, we are concerned that there was nothing sufficient in those facts provided to create an agency-principal relationship.

The OECD Commentary to Article 5 of the OECD Model Treaty does not define the term “agent”, but instead attempts to describe what is meant by the terms “agent of a dependent status” versus “agent of an independent status” for the purposes of Article 5. Oddly, the commentary regarding what conditions constitute an Independent Agent would seem to make it virtually impossible, under Canadian agency law, for that entity to be considered an agent at all. Regardless of the confusion between the meaning of “agent” under Canadian agency law versus the OECD Commentary descriptions of these terms, attempting to describe a subcontractor as being an agent of a contractor, even under the broadest definition of agent, is a dangerous practice which should be halted immediately. A determination that an agency relationship exists should only be used as a method of last resort and was, arguably, not necessary in the hypothetical scenario above. Such a determination will only create tax uncertainty and encourage auditors to look through sub-contractors and captive service providers, when making PE determinations with respect to their foreign parent, in a more aggressive manner than they already are.

---

1. 2010-0391541E5 E - Article V (9) of the Canada-US Tax Convention (Released April 13, 2011).

2. In *Dudney*, the FCA ruled that Mr. Dudney, a U.S. resident, was not subject to tax in Canada despite spending 300 days in Canada during the relevant taxation year because Mr. Dudney did not have a fixed base in Canada.

3. For example, if USco 2 is not a dependent agent of USco1, paragraph 42.32 of the Commentary states that paragraph (b) of the alternative provision does not apply to USco1. Furthermore, if USco1 did not direct or control the manner in which the services are performed by USco2, which would be consistent with a non-agency relationship, USco1 would again be exempted from the deemed PE rule (see paragraph 42.43 of the Commentary).

4. For example, Article V(9)(b) uses the words “provides services” instead of “performs services” and also includes the words “to customers”.

5. See *United Geophysical Company of Canada v. Minister of National Revenue*, 61 DTC 1099.

Questions

For more information, please contact:

- Jim Wilson (james.wilson@gowlings.com / Tel: 613-786-0196)
- Pierre Alary (pierre.alary@gowlings.com / Tel: 613-786-0132)