

New Protocol to the Canada-US Tax Treaty: “Permanent Establishment” for Service Providers

The Fifth Protocol (the “**Protocol**”) to the *Canada-US Income Tax Convention* (the “**Treaty**”) adds a new section to the definition of “permanent establishment” which deals with service enterprises, and eliminates the separate rules for providers of independent services. The combined effect of these changes is that the taxation of all providers of cross-border services will be determined under Article VII (*Business Profits*) and the definition of “permanent establishment” will be expanded so that in certain circumstances the activities of cross-border service providers will constitute a “permanent establishment” even though the service provider does not have a fixed place of business in the state where the services are provided.

Background

Article VII (*Business Profits*) of the Treaty provides that the business profits of a resident of a contracting state are subject to tax in the other contracting state only to the extent that they are attributable to a “permanent establishment” in the other state. In general, the Treaty defines “permanent establishment” as a “fixed place of business through which the business of a resident of a contracting state is carried on”. Article XIV (*Independent Personal Services*) provides that income derived by an individual who is a resident of a contracting state from services provided in the other contracting state will be subject to tax in the other state only to the extent the income is attributable to a “fixed base” in the other state that is regularly available to the individual.

The New Rule

Under the new rule, an “enterprise of a contracting state” that provides services in the other contracting state and does not otherwise have a permanent establishment in the other state will be deemed to have a permanent establishment in the other state if one of the following conditions is satisfied:

- (a) the services are performed by an individual who is present in the other state for a period or periods of more than 183 days in any 12 month period and, during the period or periods in which the individual is present in the other state, 50% of the active gross business revenues of the enterprise consist of income derived

from the services provided by the individual in the other state; or

- (b) the services are provided for an aggregate of 183 days or more in any 12 month period and relate to the same or connected projects for customers who are resident in the other state or who maintain a permanent establishment in the other state.

The Diplomatic Notes included in Annex B to the Protocol state that projects will be considered to be connected if they constitute a “coherent whole, commercially and geographically”.

This new rule is subject to the rule that provides that a building site or construction or installation project will only constitute a “permanent establishment” if it lasts for more than 12 months.

The phrase “enterprise of a contracting state” is not defined in the Protocol and is not used elsewhere in the Protocol or the Treaty. The OECD Model Convention, however, defines the term as an enterprise carried on by a resident of a contracting state and Commentary to the OECD Model Convention states that the term “enterprise” applies to the carrying on of any business, which includes performing professional services and other independent activities.

Under the current rules, cross-border service providers have been able to undertake substantial activities in the host state without establishing a “fixed place”

of business, or becoming subject to taxation in the other state. When the new rule comes into effect, the requirement for a “fixed place” of business will effectively be eliminated and cross-border service providers will be required to carefully monitor the amount of time spent in the host state if they are to avoid a permanent establishment, and a resulting tax liability, in that other state.

The new rule will not come into effect until the third taxable year of the relevant enterprise that ends after the Protocol enters into force. In addition, days of presence, services rendered or gross active business revenues that occur or arise before January 1, 2010 will not in any circumstances be taken into account in determining whether this new rule will apply.

As stated above, the Protocol also removes Article XIV of the Treaty. The Diplomatic Notes in Annex B state that this is intended to reflect the negotiator’s understanding that there are no “practical distinctions” between a “fixed base” and a “permanent establishment”. As a result of this change, Article VII (*Business Profits*) and, as a result, the new rules related to cross-border service providers described above will apply to income derived by an individual from independent personal services. If the Protocol is ratified in 2007, this change will take effect for taxable years that begin on or after 2008, and if it is ratified in 2008, the change will take effect for taxable years that begin after 2008.

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

About McMillan LLP's Tax Law Group

Our Tax Law Group ranks among the best in Canada and includes individuals who have been recognized internationally as leading advisers in The Martindale-Hubbell Legal Directory and The Canadian Legal LEXPERT Directory. Always sensitive to our clients' business objectives, we provide comprehensive and pragmatic Canadian tax advice on a wide variety of matters, including corporate reorganizations, mergers and acquisitions, securities, structured financing and derivative products, leasing, and cross-border transactions. Routinely advising clients on compliance matters, we are experienced in negotiating disputes with revenue authorities and litigating tax issues. For further information, please contact one of the members of our Tax Law Group:

Toronto

| | | |
|-------------------|--------------|-------------------------------|
| Sheila Crummey | 416.865.7017 | sheila.crummey@mcmillan.ca |
| Michael Friedman | 416.865.7914 | michael.friedman@mcmillan.ca |
| Mary-Ann Haney | 416.865.7293 | mary.ann.haney@mcmillan.ca |
| Todd Miller | 416.865.7058 | todd.miller@mcmillan.ca |
| Ryan Morris | 416.865.7180 | ryan.morris@mcmillan.ca |
| Ashley Palmer | 416.865.7227 | ashley.palmer@mcmillan.ca |
| Catherine Roberts | 416.865.7202 | catherine.roberts@mcmillan.ca |
| Laura Stoddard | 416.865.7277 | laura.stoddard@mcmillan.ca |
| Michael Templeton | 416.865.7837 | michael.templeton@mcmillan.ca |
| David Wentzell | 416.865.7036 | david.wentzell@mcmillan.ca |
| Jamie Wilks | 416.865.7804 | jamie.wilks@mcmillan.ca |
| Mickey Yaksich | 416.865.7097 | mickey.yaksich@mcmillan.ca |

Montreal

| | | |
|----------------------|--------------|------------------------------|
| Andrew Etcovitch | 514.987.5064 | andrew.etcovitch@mcmillan.ca |
| John Israel Galambos | 514.987.5058 | john.galambos@mcmillan.ca |

mcmillan.ca

McMillan LLP

Toronto | t 416.865.7000 | f 416.865.7048

Montreal | t 514.987.5000 | f 514.987.1213

Lawyers | Avocats