

**2009 IFA –TRAVELLING LECTURESHIP ON ROYALTIES BY NATHAN BOIDMAN  
APPENDICES TO LECTURE OUTLINE**

---

**APPENDIX 75 (MATERIALS ON NOTIONAL INTRA-COMPANY ARRANGEMENTS)**

**Material:**

*Cudd Pressure Control Inc v. The Queen*, 98 DTC 6630 (FCA)

Kristen A. Parillo, "*Cudd* and the Canada-U.S. Protocol, *Tax Notes International*, Vol.. 49, No. 12, March 24, 2008 at Pg. 1000

David A. Ward and Colin Campbell, Letters to the Editor, "A Different View of *Cudd*", *Tax Notes International*, Vol. 49, No. 13, March 31, 2008 at Pg. 1139.

error for the Trial Judge to characterize the whole transaction as being an adventure in the nature of trade and taxable as such. [2] The appeals will be dismissed.

**Cudd Pressure Control (Appellant) v. Her Majesty the Queen (Respondent)**

Federal Court of Appeal, October 19, 1998. (Court File No. A-369 95.)

**Calculation of net industrial and commercial profits attributable to non-resident corporate taxpayer's permanent establishment in Canada — Whether, in determining such profits, taxpayer entitled to deduct "notional rent" charged by it to its permanent establishment for the latter's use of two snubbing units — Income Tax Act, R.S.C. 1985 (5th Supp.), c. 1, as amended, ss. 13(7), (9), 18(1)(a), (d) and 20(1)(a) — Canada-United States Reciprocal Tax Convention, 1942, Articles I and III(1) to (4) — Income Tax Conventions Interpretation Act, R.S.C. 1985, c. 48, s. 4(b).**

The non-resident corporate taxpayer provided its own equipment and employees to perform eight months' work in the form of snubbing unit services on an offshore drilling rig owned by a Canadian resident corporation. In determining its "net industrial and commercial profits" attributable to its permanent establishment in Canada for its year ending June 30, 1985, (as required by the the Canada-United States Reciprocal Tax Convention ("the 1942 Convention")), the taxpayer deducted the "notional" rent theoretically chargeable to its permanent establishment for the use of the said two snubbing units. The Minister disallowed such deduction. In dismissing the taxpayer's appeal (95 DTC 559), the Tax Court of Canada found that the "notional" rent in issue was not deductible. The Tax Court Judge concluded that the taxpayer could only have claimed capital cost allowance for the use of the snubbing units against the income from its permanent establishment, based on paragraph 4(b) of the Income Tax Conventions Interpretation Act. This was because such an expense is allowed under Canada's internal law (i.e., the Income Tax Act). In the Tax Court Judge's view paragraph 4(b) was intended to ensure that permanent establishments taxed on profits under the 1942 Convention could not deduct amounts which were unavailable to Canadian taxpayers in calculating their business income. And since the taxpayer had failed to meet the meaning of "expense" and "incurred" for the purposes of Canadian tax law, its "notional" rent was not deductible in computing its profit for the purposes of Article III of the 1942 Convention. The taxpayer appealed to the Federal Court of Appeal.

**Held:** The taxpayer's appeal was dismissed. The Tax Court Judge committed no reviewable error. He rejected the taxpayer's assertion that its permanent establishment, treated as an independent enterprise, would have rented the snubbing units from the head office. He found that the taxpayer was primarily a service company whose "unmanned standby" charges (for the snubbing units) were not equivalent to rental payments. He also found that the taxpayer would not have acquired the offshore contract had it not been the sole owner of the snubbing units in issue. There was no basis for interfering with these findings of fact. The Minister's assessment was affirmed accordingly.

Counsel: Not available.

Before: Strayer, Robertson and McDonald, J.J.A.

ROBERTSON, J.A. (Strayer J.A. concurring): [1] The primary issue on appeal is whether Judge Sarchuk of the Tax Court of Canada erred in concluding that \$2,516,690 of notional "rent" could not be deducted by Cudd Pressure Control Inc. in computing the net industrial and commercial profit attributable to its permanent establishment in Canada, as required by the Canada-United States Reciprocal Tax Convention ["the 1942 Convention"], for the taxation year ending June 30, 1985.

[2] After carefully summarizing the facts, the experts' testimony, and the parties' submissions, Judge Sarchuk concluded that Cudd could only have claimed a capital cost allowance for the use of the snubbing units against the income from its permanent establishment, based on paragraph 4(b) of the *Income Tax Conventions Interpretation Act*, because such an expense is allowed under Canada's internal law, namely the *Income Tax Act*. He added that paragraph 4(b) was intended to ensure that permanent establish

ments taxed on profits under the 1942 Convention could not deduct amounts which were unavailable to Canadian taxpayers in calculating their business income. Since, in his respectful opinion, Cudd had failed to meet the meaning of "expense" and "incurred" for the purposes of Canadian tax law, its notional "rent" was not deductible in computing its profit for the purposes of Article III of the 1942 Convention. In spite of his general finding that deductions of notional amounts are unsupported by the 1942 Convention, Judge Sarchuk noted that Article III of that Convention specifically requires that there be attributed to the permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise "engaged in the same or similar activities under the same or similar conditions". Judge Sarchuk rejected the appellant's assertion that its permanent establishment, treated as an independent enterprise, would have rented the snubbing units from the head office. He found that Cudd was primarily a service company, whose "unmanned standby" charges were not equivalent to rental payments, and that it would not have acquired the Mobil contract if it had not been the sole owner of a snubbing unit with a pulling capacity of 600,000 pounds.

[3] My colleague Justice McDonald agrees with Judge Sarchuk that, in the circumstances of this case, Cudd could not deduct notional "rent" from

McDONALD, J.A.: [1] The issue to be decided in this case is whether a corporation incorporated outside of Canada but doing business in Canada can deduct an amount for notional rent pursuant to the *Canada-U.S. Reciprocal Tax Convention (1942)* (the "1942 Convention") when a corresponding deduction is disallowed under the *Income Tax Act* (the "Act") for a Canadian company doing the same or similar business in Canada.

#### Facts

[2] The appellant is incorporated in the United States and was at all material times a resident there for the purposes of the 1942 Convention. The appellant was never a resident in Canada for the purposes of the *Income Tax Act*. The appellant is a wholly owned subsidiary of R.P.C. Energy Services ("RPC"), a United States public corporation which provides a variety of services to the oil and gas industry. Similarly, the appellant's business consists of providing technical services to the oil industry, principally through the delivery of equipment and well control services on site.

the net profits derived from its permanent establishment in Canada, pursuant to the 1942 Convention. However, unlike Judge Sarchuk, Justice McDonald does not foreclose the possibility that notional "rent" could be deducted in an appropriate case. With respect, I do not find it necessary to deal with the issue of whether notional expenses are deductible as a matter of law in light of the factual findings made by Judge Sarchuk.

[4] The Tax Court Judge fully considered the factual and legal background surrounding Cudd's provision of the snubbing units to Mobil. It is trite law that an appellate court cannot substitute its own conclusions pertaining to factual matters for that of the trier of fact, unless a clear error appears on the record. Assuming, without deciding, that notional amounts may be deducted in computing the profits attributable to a permanent establishment for the purposes of Canadian taxation, pursuant to the 1942 Convention, I am of the opinion that Justice Sarchuk did not commit a reviewable error in refusing to allow Cudd to deduct an amount for notional rent in the circumstances of this case. In particular, I can find no basis for interfering with his finding of fact that the appellant's permanent establishment, treated as an independent enterprise, would have rented the snubbing units from the head office.

[5] I would dismiss the appeal with costs.

[3] In September 1984 the appellant was contacted by Boots & Coots, a well control company based in Houston, Texas, with respect to an underground blowout in an exploratory gas well being drilled by Mobil Oil Canada Ltd ("Mobil") off the coast of Nova Scotia. The appellant sent representatives to Canada to assess the situation with a view to providing well control services to Mobil. The appellant and Mobil entered into an oral agreement for the appellant to provide snubbing services for a price of US \$15,000 per day.

[4] The principal pieces of equipment sent from the United States by the appellant for the Mobil job were two snubbing units. A snubbing unit is a complicated piece of hydraulic equipment used to remove drill pipe casings or similar equipment from, or force them into, an oil or gas well. The two snubbing units used on this job had respective pulling capacities of 600,000 and 150,000 pounds (the "600 unit" and the "150 unit", respectively), and were owned by the appellant. In addition to these two snubbing units, Mobil was required to provide hydraulic chokes, blowout preventer equipment and hydraulic tongs for use by the appellant on the Mobil job. This equip-

ment was rented from third parties for the duration of the job at a daily rate that ranged from approximately one-half of one per cent to somewhat in excess of one per cent of the cost of equipment.

[5] According to the appellant, in its ordinary course of business, it frequently rents equipment to customers. Although other equipment is rented to be used or operated by its customers, snubbing equipment is provided on an "unmanned standby" basis. In these situations, the services of employees of the appellant are not required for periods of time but it is not appropriate to remove the equipment from the site. The evidence of the appellant's witnesses is to the effect that snubbing units are not kept in stock by suppliers but are custom-made on an order basis from a manufacturer. During the relevant period of time, there were only two manufacturers of snubbing units, Hydrarig of Dallas and Otis Engineering of Dallas-Fort Worth. The minimum time for the manufacture and delivery of a snubbing unit from the date of order was six months for a 150 unit and one year for a 600 unit. The appellant also claims that there is no market for used snubbing units, that these units last indefinitely when properly maintained, and they do not depreciate from either obsolescence or wear and tear.

[6] In 1984-85 the appellant was the owner of the only 600 unit in the world. This unit had been used for only 30 to 40 days before the Mobil job and was used for approximately 120 days between the end of the Mobil job in 1985 and the start of trial. During the Mobil job the 600 unit was in use for most of the working time and the 150 unit was on standby for most of that time. In computing the industrial and commercial profits to be attributed to its permanent establishment in Canada for its taxation year ended June 30, 1985, the appellant:

- (i) included all amounts billed to Mobil as income;
- (ii) deducted all direct labour costs multiplied by a factor, transportation, insurance and similar costs, certain additional labour costs and a portion of its general overhead expenses from its income; and
- (iii) deducted a charge for the notional rent charged by the head office to the permanent establishment for use of the 600 unit and the 150 unit in the amount of \$2,516,690.

[7] The appellant initially derived the notional rent at issue in this case from the daily rental rates it quoted to its customers for unmanned, standby use of each piece of equipment, namely US \$4,800 per day for the 600 unit and US \$2,400 per day for the 150 unit. These amounts were adjusted to account for the degree of usage for each unit during the Mobil job. Accordingly, the

amounts of notional rent claimed were US \$5,000 and US \$1,700 per day, for the 600 unit and the 150 unit respectively. The appellant claims that the adjustments were reasonable considering the use of the equipment, the danger of the situation and the emergency nature of the job. The daily rental charge represented 0.72% per day of the capital costs of the units.

[8] The appellant incurred losses from its operations both prior to, during and after 1984. The appellant's loss for its June 30, 1984 taxation year was US \$10,564,577; for its June 30, 1985 year was US \$8,031,822; for its June 30, 1986 year was US \$7,493,414; and for its June 30, 1987 year was US \$3,594,981.

[9] The Minister disallowed the deduction of \$2,516,690 claimed as notional rent for the snubbing units and assessed tax thereon under Part I of the Act. The appellant appealed.

#### Decision of the Tax Court Judge

[10] The Tax Court Judge upheld the decision of the Minister disallowing the rental deduction on the ground that Article III(1) of the 1942 Convention should not be construed as permitting deductions to be taken of a nature or kind that would not be deductible in calculating business income by Canadian taxpayers under the Act. The Tax Court Judge also found that even if he had concluded that notional rent could be deducted under the 1942 Convention he still would have disallowed the deduction on two other grounds. First, the evidence did not demonstrate that the appellant was in the business of renting equipment. Second, the appellant's business is so unique that it would not have rented the equipment. The Tax Court Judge found that, in the circumstances, the more reasonable assumption would be that the branch purchased the snubbing units from the head office.

#### Analysis

[11] As will be detailed later, I am of the view that in an appropriate case, an amount for notional rent may be deducted by a corporation incorporated outside Canada in computing the industrial and commercial profits attributable to its permanent establishment in Canada, notwithstanding that a resident in Canada can not benefit from a similar deduction. However, on the facts of this case, a deduction for notional rent is not appropriate given that the evidence established that the amount of notional rent was never included as income at the appellant's head office. To allow the deduction in this circumstance would mean that the appellant has avoided being taxed on the rental amount in both Canada and

the United States. The purpose of Canada's bilateral tax treaties is to avoid double taxation and to prevent tax evasion; see *The Queen v. Crown Forest Industries*, 95 DTC 5389 (S.C.C.) at 5396-7. It follows that unless the amount of notional rent is included in the parent corporation's records a corresponding deduction can not be allowed.

[12] I am also of the view that the facts do not establish that in the normal course of business the snubbing equipment would have been rented to the appellant's permanent establishment in Canada. Indeed, it is more likely that the head office would have been contacted directly to take on this contract given that it is the only one to have had equipment of this kind during the relevant period. An independent company in the position of the permanent establishment would not have entered into this type of relationship unless it had the necessary equipment to perform its duties under the contract. In this case, the appellant did not have the necessary equipment and would likely have declined the contract.

#### Interpreting the 1942 Convention

[13] The basic principles to be applied in interpreting the 1942 Convention or any bilateral tax treaty are those found in articles 31 & 32 of the Vienna Convention on the Law of Treaties. These articles provide:

1. A Treaty shall be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes.

(a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties in an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

#### Article 32 — Supplementary Means of Interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable.

[14] Article 3(2) of the OECD Convention (see discussion, *infra*, at para. 22) and section 3 of the *Income Tax Convention Interpretation Act* establish that where a term is not defined in a bilateral tax treaty, definitions from domestic income tax law should be applied unless the context indicates otherwise. In this case, the Tax Court Judge found that because the phrases "net industrial and commercial profits" and "all expenses wherever incurred" were not defined in the 1942 Convention, recourse was to be had to Canada's domestic tax law. Because the *Income Tax Act* prohibits the deduction of a notional expense, the Tax Court Judge found that the amount of notional rent claimed by the appellant could not be deducted under the 1942 Convention.

[15] While the Tax Court Judge applied the correct principles of interpretation for a double tax convention, nonetheless, I am of the view that the language of Article III(1) of the 1942 Convention does allow for the deduction of notional expenses. As a result, recourse to domestic Canadian Income Tax law principles is not essential.

[16] Article I of the 1942 Convention provides:

An enterprise of one of the contracting states is not subject to taxation by the other contracting state in respect of its industrial and commercial profits except in respect of such profits allocable in accordance with the articles of this Convention to its permanent establishment in the latter State.

[emphasis added]

In computing profits, Article III sets out the rule that a permanent establishment is to be treated as a separate entity for income tax purposes:

1. If an enterprise of one of the contracting states has a permanent establishment in the other state, there shall be attributed to such permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profit will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.

In the determination of the net industrial and commercial profits of the permanent establishment there shall be allowed as deductions all expenses, wherever incurred, reasonably allocable to the permanent establishment including executive and general administrative expenses so allocable.

[emphasis added]

[17] Thus, Article III(I) sets out the fiction that a permanent establishment is to calculate its profits as if it were an independent enterprise. It further allows for the deduction of expenses, which may also be fictional, that are reasonably allocable to the permanent establishment. It follows that a deduction for notional rent may be allowed because if the permanent establishment is an independent enterprise, it would be necessary to rent or purchase the equipment in question. As Ian Roxan states in "Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment" (1997) 25 *Intertax* 367 at 371:

If the permanent establishment had been an independent enterprise, then it could have rented the snubbing units from the head office (also a separate enterprise under the assumption) . . . The permanent establishment would then have incurred an obligation to pay the rent. So the rental expense would have been an expense incurred within the meaning that the Crown argued the term had under the Act.

Roxan continues, stating

. . . if we calculate the profit of the permanent establishment as if it were an independent enterprise, that is using the notion of treating it as an independent enterprise, it is entirely consistent to treat the permanent establishment as if it had incurred the rental expense . . . The expense is no more notional than the idea of treating the permanent establishment as an independent enterprise, which is required by the Convention.

[emphasis added]

[18] Albert A. Ehrenzweig and F.E. Koch provide further support for the concept that the two enterprises should be treated separately, i.e., as if they were third parties contracting with each other. This, in turn, supports the idea that a deduction for notional expenses should be allowed. In their commentary on the 1942 Convention, Ehrenzweig and Koch state:

The allocation rule of the Convention is in substance based on the "profit convention for the Allocation of Business Income between States for the Purpose of Taxation (except for the rephrasing of the 'arms length element')." The rule is designed to subject to taxation by the country of establishment that part of the income which is produced in its territory, without regard to the total result of the business of the foreign enterprise maintaining the establishment. In view of its generality, this rule has always been implemented in various ways.

To facilitate a favourable apportionment, the establishment should, in its accounts treat its transactions as if made with an outsider . . . The book entries should be based on terms of similar transactions between the enterprise (or similar foreign enterprises) and third persons in the taxing country; or on customary prices or rates of commission prevailing between third parties for similar transactions in that country; or on the quotations in an independent market.

See Albert A. Ehrenzweig and F.E. Koch, *Income Tax Treaties* (New York: CCH, 1949) at 106.

[emphasis added].

[19] The Commentaries to tax conventions and other extrinsic evidence regarding the intention of the drafters of tax treaties form a part of the legal context surrounding international taxation: see *Crown Forest, supra* at 5396. Accordingly, it is clear that Commentaries to tax conventions and other evidence are to be used as an aid in the interpretation of tax treaty provisions.

[20] The most relevant commentary and other travaux préparatoires relating to Articles I and III of the 1942 Convention are found in the records of the deliberations of the Fiscal Committee of the League of Nations (the "Fiscal Committee") during the 1930s and early 1940s which dealt with Convention provisions concerning the calculation of the profits of a permanent establishment. Of additional significance is Mitchell B. Carrol's report which was delivered to and endorsed by that committee. The Carrol report as well as the Reports of the Fiscal Committee endorse the concept of the separate accounts accounting procedure. As Carrol states:

To summarise, the regime of allocation for enterprises operating in several countries in which they have permanent establishments consists (1) in separating the various items of income and allocating them to their respective sources; (2) if income is derived from the joint operations (of one or more classes) of two or more establishments in different countries, the income is to be allocated or apportioned in accordance with what each establishment would derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Thus, if an independent enterprise would make a profit or receive certain remunerations for the given activity, such profit should be reflected in the separate accounts of the given establishment.

See M.B. Carrol, "Allocation of Business Income: The Draft Convention of the League of Nations" (1934) 34 *Col L.Rev.* 472 at 485-86.

[21] Thus, the separate accounts principle found in Article III(I) which requires the enterprise and the permanent establishment to be treated at arms-length — as separate entities contracting or interacting with one another —

provides the basis for a deduction for notional rent. In *Utah Mines Ltd. v. The Queen*, 92 DTC 6194, this Court held that under the terms of the implementing legislation, the provisions of the Convention prevail over domestic legislation in the event of an inconsistency. Accordingly, the fact that a similar deduction is not provided for Canadian businesses is not relevant because the provisions of the 1942 Convention apply. Having found that the 1942 Convention allows for a deduction of a notional expense for rent, the question then becomes, when is such a deduction for this expense appropriate?

[22] Canada is a member of the Organization for Economic Co-operation & Development ("OECD") which adopted a Model Tax Convention on Income & Capital (the "OECD Convention") in 1977. The main purpose of the OECD Convention is to provide a means of uniformly settling the most common problems which arise in the field of international juridical double taxation: see Krishna, *The Fundamentals of Canadian Income Tax* (Scarborough: Carswell, 1996) at 79. All signatories to the OECD Convention, including Canada, are to follow the OECD Convention as closely as possible in drafting their own bi-lateral treaties.

[23] The relevant commentaries on the OECD Convention were drafted after the 1942 Convention and therefore their relevance becomes somewhat suspect. In particular, they cannot be used to determine the intent of the drafters of the 1942 Convention. However, although the wording and arrangement of the provisions are significantly different in the two conventions, the 1942 Convention follows the same general principles as the OECD model. The OECD Commentaries, therefore, can provide some assistance in discerning the "legal context" surrounding double taxation conventions at international law, and in particular in ascertaining when it is appropriate to allow a deduction for a notional expense.

[24] Article 7(3) of the OECD Convention is similar in effect to the second paragraph of Article III(1) of the 1942 Convention. Article 7(3) provides:

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the state in which the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Thus, both the 1942 Convention and the OECD Convention allow for the deduction of expenses

which are attributable to the permanent establishment. In particular, this provision allows for the deduction of expenses actually incurred by the head office against the profits incurred by the permanent establishment where such expenses are "reasonably allocable to" (1942 Convention) or "incurred for the purposes of" (OECD Convention) the permanent establishment.

[25] The Commentaries to the OECD Convention elaborate on the meaning of this provision. Paragraph 16 of the Commentary states that the purpose of Article 7(3) is to clarify the general directive in relation to the expenses of a permanent establishment that is contained in Article 7(2) — the OECD equivalent to the "separate enterprise" provision contained in the first paragraph of Article III(1) in the 1942 Convention. The Commentary goes on to state:

... [Article 7(3)] specifically recognizes that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

[emphasis added]

[26] Paragraph 17.1 of the Commentary is also particularly helpful in this case as it provides a test to determine when it is appropriate to allow a deduction for expenses. Paragraph 17.1 states:

In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular cir-

circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price i.e. by normally including in the sale price an appropriate profit.

[emphasis added]

[27] In other words, the test proposed in paragraph 17.1 of the Commentary is whether the internal transfer of property or services between the foreign corporation and its permanent establishment in Canada is of the same nature as a transaction in which the companies, in the normal course of business, would have charged a third party a price which included an appropriate profit. Paragraph 17.2 of the Commentary attempts to explain when the answer to that question will be affirmative and when it will be negative:

On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make a sale of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.

[28] Another approach to determining whether an expense should be deducted for a permanent establishment was offered by Caroll. He suggests that the correct approach is to inquire where the risk of ownership lies: with the head office or the permanent establishment. In most cases, the risks of profit and loss are principally borne by the parent company. To account for this, Caroll suggests that the permanent establishment be allowed to deduct from its income an amount to account for the "services rendered" to it, by the head office, i.e. a notional commission or fee which accounts for the risk borne by the head office. This notional fee can be adjusted downward to account for any risks borne by the independent enterprise, just as a fee charged to a third party for services rendered would reflect the risks borne by that party: see M.B. Caroll, *Taxation of Foreign and National Enterprises:*

*Methods of Allocating Taxable Income*, (1933) 4 League of Nations, (Ser. L.O.N.P.: Geneva, 1933.II.A20). See also Roxan, *Judicial Overrides*, *supra* at 373-74.

[29] Having reviewed the evidence, I am satisfied that either under the test provided in the OECD Commentary or under Caroll's methodology, the deduction would not be allowed in the circumstances of this case. The 1942 Convention requires that one consider what an "independent enterprise engaged in the same or similar conditions would do." Given the unique nature of the business conducted by the appellant's head office (i.e. it owned the only 600 unit in the world), it is highly unlikely that an independent enterprise would have rented the 600 unit from the head office, particularly in light of the high rental costs, and then have used it to provide snubbing services to another company, in this case Mobil. Instead, given the nature of the business and the type of equipment at issue, the head office would have been contracted directly to take on the project in question. It is not reasonable to believe that an independent third party would have contemplated entering into this type of contract given it did not have the required equipment and would have incurred exorbitant expense if it chose to rent the equipment. A reasonable third party would have declined the contract all together, or, as noted by the Tax Court Judge, would have purchased the equipment in question. However, this latter option is highly unlikely in light of the facts that a one year lead time was required for the manufacture of a 600 unit and the Mobil job was an emergency situation.

[30] I would also dismiss the appeal on the ground that the purpose of the 1942 Convention is to prevent double taxation and to prevent tax evasion. The preamble to the 1942 Convention states that one of the purposes of these bi-lateral treaties is to prevent tax evasion:

The government of Canada and the Government of the United States of America, being desirous of further promoting the flow of commerce between the two countries, of avoiding double taxation and of preventing fiscal evasion in the case of income taxes, have decided to conclude a Convention ...

[emphasis added]

[31] The Supreme Court of Canada has addressed the issue of tax avoidance in the context of bilateral tax treaties in *Crown Forest Industries*, *supra*. It made the following comments at 5397:

In the case at bar, I underscore that there is no need to prevent double taxation because the U.S. has declined to tax Norsk's revenue. Although this does not affect Norsk's tax liability, the effect is still that Norsk is not

required to pay any tax in the United States by virtue of the s. 883(1) exemption, this exemption arising by virtue of a reciprocal arrangement between the U.S. and the Bahamas, where Norsk is incorporated. Further, it is unclear whether the specific rental income at issue is, even independent of the exemption, subject to taxation in the U.S., because, pursuant to s. 864(c)(4) of the *Internal Revenue Code*, it might not be considered to be effectively connected with the conduct of Norsk's American trade or business. Allowing Norsk to benefit from the Convention in this case would actually lead to the avoidance of tax on the rental income because the liability for tax asserted by the Canadian authorities would be reduced notwithstanding that the United States chooses not to impose any tax thereon or does not even have the jurisdiction therefor.

[emphasis added]

[32] The evidence of Ms. Herron, the Chief Financial Officer of the appellant and its parent corporation, RPC, is that the amount of notional rent claimed by the appellant was not included as income in the parent company's tax return. In cross-examination she was asked the following question:

Q. The amount of \$2,942,416 which was set up as notional rent, is, I take it, not included anywhere here in the revenues which are reported in this return?

A. It's an elimination. This is a consolidated return of RPC Energy Services and all subsidiaries, so if it were included, which it wasn't, it would eliminate anyway. There would be the income and then off-setting expense.

[emphasis added]

Because the amount of notional rent was never included as income in the RPC's records, the permanent establishment may not derive the corresponding benefit of a deduction for rent. To allow such a deduction would lead to the avoidance of tax on the rental income attributed to the parent, similar to the result in *Crown Forest, supra*.

[33] While no actual money had to exchange hands between the appellant, Cudd Pressure Control Inc., and its parent, RPC (indeed, the point is that the expense is notional), it nevertheless must be included as income in the parent corporation's return so that, if necessary, it can be subject to tax. Including the amount of notional rent in the parent corporation's return also accords with the separate accounts principle. Under this method, profits and expenses must be reflected in the separate accounts of the permanent establishment and the parent corporation: see Carroll, *Draft Convention, supra*. The appellant can not derive the benefit of having its profits drastically reduced and then not have the amount included as income in the parent corporation's records. If this were not the case, then the payment of rent would never be subjected to tax.

[34] Before concluding, one further comment is necessary in respect of an argument advanced by the Minister. The Minister claims that it would be contrary to the purpose of the 1942 Convention to allow a foreign corporation's permanent establishment in Canada to deduct notional expenses as this would grant the permanent establishment more favourable tax treatment than its Canadian competitors in the same industry. The Tax Court Judge found this argument persuasive. While there is some merit to this argument, I am of the view that it does not provide a legal basis for disallowing these types of deductions.

[35] If the 1942 Convention allows for a deduction that the Canadian *Income Tax Act* does not and this is seen as unfair to Canadian business then the answer lies with Parliament. The answer cannot be to deny a deduction that is contemplated by a legally binding tax convention. I fail to understand why someone in the appellant's position should be denied a valid deduction on the grounds that the Act does not provide a corresponding benefit to Canadian business. I recognize that there is dicta to the contrary in *Utah Mines, supra*, however, in that case the Court was of the view that the deduction at issue was not contemplated by the 1942 Convention. That is not the case here.

[36] I am of the opinion that if the language of the 1942 Convention allows for the deduction of an expense that language should be followed. Indeed, this view is supported by *Utah Mines, supra*, where, as noted above, the Court held that under the terms of the implementing legislation, the 1942 Convention prevails over domestic legislation in the event of inconsistency. Further, as a member of the OECD, Canada is expected to conform to the OECD Convention in negotiating and interpreting its bilateral tax treaties. If the OECD Convention specifies that a deduction for certain expenses should be allowed, as I have indicated it does in this case, then to the extent that it is possible, Canada should attempt to abide by the Convention as closely as possible.

#### Conclusion

[37] To the extent that the Tax Court Judge's decision may be interpreted as prohibiting the concept of notional contracts, it is clarified so as to allow these contracts and the associated tax deductions under the 1942 Convention, where such notional expenses are supported by the facts of the case. On these facts, however, I am satisfied that the Tax Court Judge was correct to find that a third party would not have agreed to rent

**6638**

**Dominion Tax Cases**  
*Glaxo Wellcome Inc. v. The Queen*

the snubbing equipment. Accordingly, the appellant cannot succeed.

Disposition

[38] The appeal from the Tax Court of Canada is dismissed with costs.

## NEWS ANALYSIS

***Cudd* and the Canada-U.S. Protocol**

by *Kristen A. Parillo*

Taxpayers in the United States and Canada have a new problem to chew on: *Cudd*.

Tax officials from the two countries have been discussing whether a 1998 Canadian court decision that denied a deduction for notional expenses to a U.S. company's Canadian permanent establishment will remain good case law once the fifth protocol to the Canada-U.S. tax treaty is ratified and takes effect, a U.S. Treasury Department spokesperson confirmed to Tax Analysts.

In *Cudd Pressure Control Inc. v. The Queen*, the Canadian Federal Court of Appeal upheld a Tax Court of Canada ruling that *Cudd*, a U.S.-based company that had provided technical services to an oil company drilling a gas well off the coast of Nova Scotia, could not deduct notional rent in computing the net profits attributable to *Cudd*'s PE in Canada. The case required an interpretation of article 3 (business profits) of the 1942 Canada-U.S. income tax treaty.

The appeals court agreed with the Tax Court's determination that notional expenses cannot be taken into account because they do not constitute "outlays or expenses made or incurred" by the taxpayer and are therefore not deductible in computing income under paragraph 18(1)(a) of Canada's Income Tax Act.

The Federal Court of Appeal further accepted the Tax Court's finding that deductions for notional expenses are prohibited under section 4(b) of Canada's Income Tax Conventions Interpretation Act (ITCIA), which provides that PEs cannot deduct amounts that are unavailable to Canadian taxpayers in calculating their business income. (For *Cudd*, see *Doc 98-31581* or *98 TNI 206-19*.)

The Supreme Court of Canada in 1999 refused to hear the taxpayer's appeal, confirming the Federal Court of Appeal's decision as setting precedent. However, some observers have questioned whether *Cudd* will remain viable once the fifth protocol to the Canada-U.S. treaty takes effect in light of the OECD's project on attribution of profits to PEs and the protocol's apparent incorporation of the authorized OECD approach.

**The Authorized OECD Approach**

The protocol to the Canada-U.S. tax treaty was signed on September 21, 2007. It has been ratified by the Canadian Parliament but has not yet been ratified by the U.S. Senate. The Senate on March 13 received

the protocol and referred it to the Foreign Relations Committee. (For the protocol, see *Doc 2007-21595* or *2007 WTD 185-9*.)

The protocol makes one minor change to the language of article 7 (business profits) of the existing Canada-U.S. treaty. It adds “or has carried on” to the sentence in the second paragraph that says “where a resident of a Contracting State carries on business in the other Contracting State through a permanent establishment.” However, in paragraph 9 of Annex B (diplomatic notes), it appears that Canada and the United States have agreed to incorporate the new authorized OECD approach (AOA) to profit attribution.

Paragraph 9 states that “the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.” It further states that “the principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment.”

That language mirrors the analysis set forth in the AOA, which adopts a functionally separate-entity approach that requires the PE to be attributed the profit it would have earned at arm’s length had it been a distinct and separate enterprise performing the same or similar functions under the same or similar conditions. This approach relies on a two-step analysis. First, the PE is assumed to be a functionally separate enterprise with its own functions, assets, and assumed risks. Second, the OECD transfer pricing guidelines are applied, by analogy, to dealings between the PE and the enterprise of which it is part.

The OECD launched its project on revamping article 7 to the OECD model tax treaty in 1998 because of the inconsistent interpretation and application the article received from tax authorities around the world. The goal of the OECD project was to achieve a common interpretation and consistent application of article 7.

The OECD decided to examine how the arm’s-length principle should apply in the context of the relationship between a PE and the rest of the enterprise to which it belongs. Revised versions of parts I-III of the OECD’s report on attribution of profits to a PE — which covered issues relating to PEs in general and to issues in the banking and global trading sectors in particular — were released on December 21, 2006. (For parts I-III of the report, see *Doc 2006-25440* or *2006 WTD 247-18*.)

A revised draft of Part IV of the OECD report, dealing with PE issues relating to the insurance industry, was released on August 22, 2007. (For Part IV of the report, see *Doc 2007-19538* or *2007 WTD 165-11*.)

### Is *Cudd* Mud?

Some observers have questioned whether the new protocol, which appears to have adopted the AOA, will

effectively overrule *Cudd*. The AOA would recognize notional transactions between a PE and its head office.

Several key issues remain unresolved, much to the dismay of practitioners with clients demanding immediate answers. Because of uncertainty over how to apply the OECD’s article 7 project to existing tax treaties, the OECD announced that implementation of the AOA will progress according to a dual-track approach.

The OECD will eventually draft a new version of article 7, complete with new commentary, which will be used when new tax treaties or amendments to existing tax treaties are negotiated. Separately, the OECD will also release new commentary to the existing article 7, importing as much of the AOA as possible so as not to conflict with the existing commentary. The revised commentary to the existing article 7 language can be used for existing treaties.

## Some observers have questioned whether the new protocol will effectively overrule *Cudd*.

The OECD released for public comment a draft revised commentary to the existing article 7 in April 2007. It has not yet released a new draft of article 7 with accompanying commentary. (For the draft revised commentary to article 7, see *Doc 2007-9193* or *2007 WTD 70-14*.)

This two-track approach has caused some confusion among practitioners over the legal effect of the revised article 7 commentary to treaty law and practice.

“I’ve been trying to figure out where we are in this ‘twilight zone’ phase of the OECD article 7 process,” Richard Tremblay, a partner at Osler, Hoskin & Harcourt LLP in Toronto, told Tax Analysts.

Tremblay explained that under the new protocol to the Canada-U.S. tax treaty, it appears that taxpayers would be “in the new world order.” That is, *Cudd* would no longer preclude the deduction of notional expenses by local PEs for foreign entities. However, Tremblay added, “The OECD article 7 language has not been revised yet, just the commentary. So I’m just not sure what the rules are.”

“The in-between position, whereby we are supposed to apply some but not all of the new principles until the actual language of article 7 of the model is revised, is somewhat of a mystery to me,” he said, adding, “I don’t think anyone really has a good handle on what the rules are in this ‘twilight zone.’”

### Other Obstacles

Another thorny issue is that article 7(3) of the Canada-U.S. treaty, the provision permitting the deduction of expenses incurred for purposes of PEs, still contains one very problematic sentence: "Nothing in this paragraph shall require a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the taxation laws of that State."

That language, Tremblay noted, is intended to deal with expenditures like resource royalties, which no one in Canada is allowed to deduct because of the country's resource allowance regime. Taxpayers could argue that an expense such as rent, as in *Cudd*, is not a type of expense that "by reason of its nature" is not generally allowed as a deduction under the tax laws of Canada, though Tremblay acknowledged that notional expenses are different.

Moreover, a taxpayer would still be faced with a statutory obstacle. Section 4(b) of ITCIA provides that PEs cannot deduct amounts that are unavailable to Canadian taxpayers in calculating their business income.

The ITCIA was originally enacted to override the 1982 Supreme Court of Canada decision in *Melford Developments v. The Queen*. In that case, the court had to determine whether a guarantee paid by a Canadian resident company to a German bank was interest and thus subject to withholding tax under Canadian tax law. The court ruled that a term not fully defined in a tax treaty is given the meaning it had for Canadian tax law purposes on the date the tax treaty was entered into.

The Canadian government later enacted the ITCIA to provide an ambulatory approach to article 3(2) of Canada's tax treaties. Article 3(2) states that terms not defined in the treaty are to have the meaning they have under the law of the state whose taxes are in question. The ITCIA clarifies that if a term is not defined in the treaty, it has the meaning in Canadian law as amended from time to time, rather than the meaning it had when the treaty was signed. This provision was intended to allow legal definitions to evolve over time.

Section 4(b) of the ITCIA was implemented because of post-*Melford* concerns that nonresidents could claim deductions in computing profits attributable to a PE that were allowed under Canada's ITA when a tax treaty was signed but that were later disallowed by amendments to the ITA.

### Where Things Stand

In the February 2007 issue of *Beyond Borders*, PricewaterhouseCoopers tax partner Marc Darmono discussed how implementation of the AOA might require harmonizing some parts of Canadian domestic law. Darmono said the broad wording of ITCIA section 4(b) "arguably overreaches" its legislative intent and could be

read, as it was by the Tax Court in *Cudd*, as disallowing expenses under notional contracts between a Canadian PE and its foreign head office.

"It is a fair question whether section 4 of the ITCIA should be amended or even repealed to ensure that it will not prevent the operation of the AOA in Canada," Darmono wrote.

Section 4(b) of ITCIA does, however, state that the prohibition on deducting expenses that are unavailable to Canadian taxpayers applies only "to the extent that an agreement between the competent authorities of the parties to the convention expressly otherwise provides." It is not clear whether "expressly otherwise provides" means the agreement must be in writing.

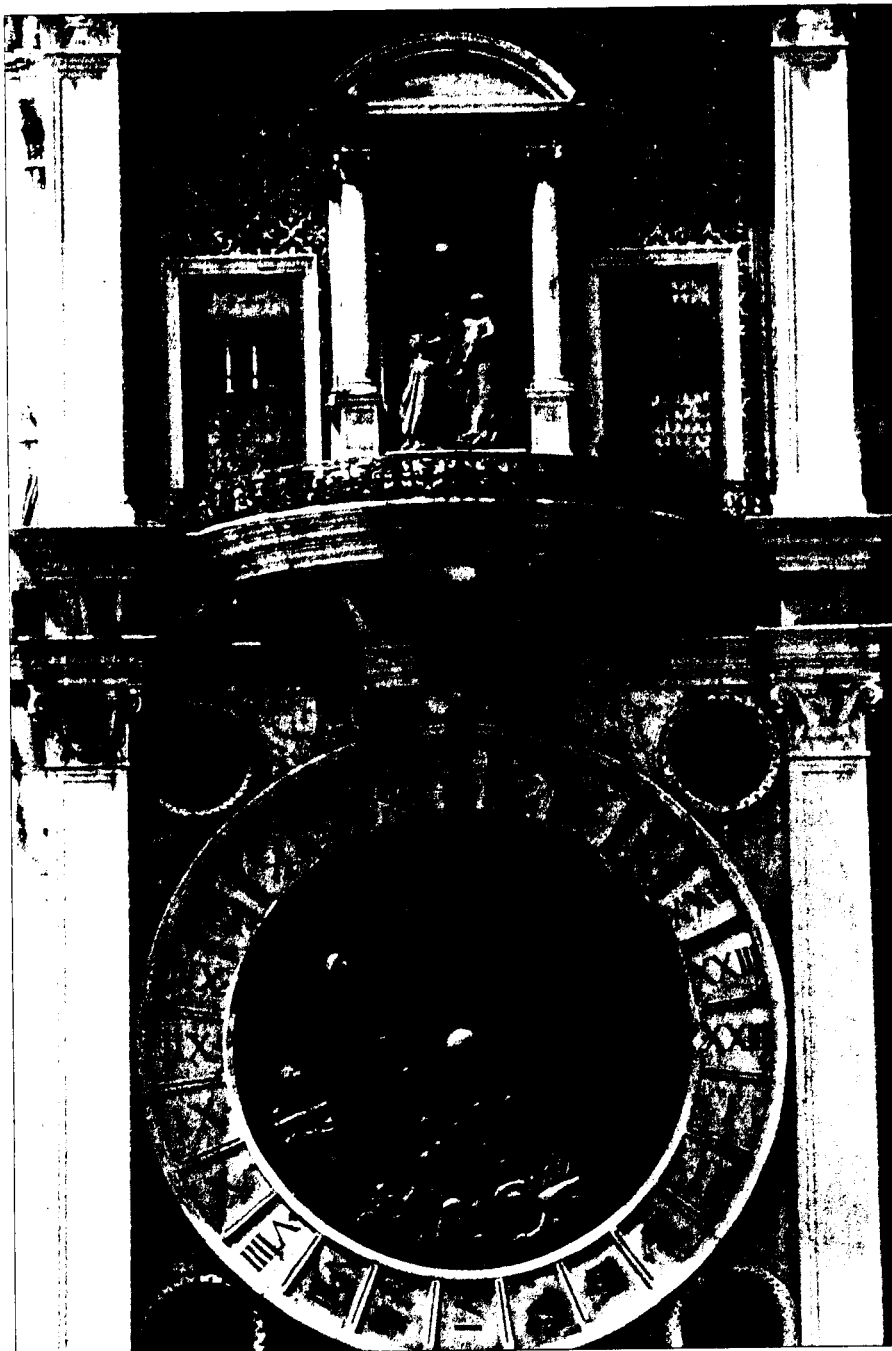
Tremblay said the competent authorities could, as permitted by article 26(3) of the treaty, agree that notional expenses will be deductible expenses under the treaty. That provision gives the competent authorities a broad scope of treaty interpretation and application issues that they may resolve by mutual agreement, including issues regarding attribution of profits; the allocation of income, deductions, credits or allowances; and the meaning of a term used in the treaty.

Such an agreement by the competent authorities could satisfy the "expressly otherwise provides" provision of section 4(b) of the ITCIA.

At this point, it is unclear what approach U.S. Treasury officials are taking with Canadian tax authorities over the issue. A Treasury spokesperson would only confirm that U.S. and Canadian officials are discussing *Cudd* but could not provide any further details.

- ◆ *Kristen A. Parillo is a legal reporter with Tax Analysts. E-mail: kparillo@tax.org*

## Italian Court Settles On Tie-Breaker Rule



Liechtenstein  
Announces Reforms

Notional Expenses  
And the Canada-U.S.  
Treaty

More on the U.K.  
Non-Dom Rules

German Restrictions  
On Tax Losses

Cross-Border  
Estate Planning

Less Than Zero:  
Distributions and  
E&P Deficits

# LETTERS TO THE EDITOR

---

## A Different View of *Cudd*

To the Editor:

The article entitled "*Cudd* and the Canada-U.S. Protocol" does not, unfortunately, accurately describe the decision in the Federal Court of Appeal in *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630 and the method of attributing income to a permanent establishment under Article III of the 1942 Canada-U.S. Tax Treaty. (See *Tax Notes Int'l*, Mar. 24, 2008, p. 1000, *Doc 2008-5995*, or *2008 WTD 55-1*.)

It is important to understand that in the *Cudd Pressure* case the Tax Court judge made a finding of fact, namely, that for the purpose of Article III of the Treaty, the permanent establishment, if it were an independent enterprise engaged in the same or similar activities and under the same or similar conditions, would have acquired the snubbing units in question and have been the owner of those units before it would have been in a position to contract with Mobil Oil Canada Limited. The issue in the case was whether in computing the profits attributable to the permanent establishment a notional rental should be considered to have been paid for the snubbing units on the basis of an assumption that if the head office and the permanent establishment were separate and independent persons, the head office would have retained the ownership and leased the snubbing units to the permanent establishment as a separate entity.

The Judge was not prepared to accept that proposition as a matter of fact and therefore the *ratio decidendi* of the case was that the intra-corporate rentals would not be deductible because the units would not have been rented but purchased.

As we view the case, the balance of the reasons for judgment of the Tax Court judge in which he concluded that as a matter of law, notional expenses are not deductible could be considered as *obiter dicta* in light of that finding of fact.

In the Federal Court of Appeal a panel of three judges heard the case. Two of the three judges were not prepared to reverse the finding of fact of the trial judge and therefore did not consider it necessary to

deal with the legal question as to whether notional expenses could be deducted in respect of dealings as between the head office and the permanent establishment. The third judge, however, although also being bound by the finding of fact of the trial judge, did go on and in a lengthy opinion found that in an appropriate case such notional expenses for intra-corporate dealings could be deductible but because of the finding of fact of the trial judge, *Cudd Pressure* was not an appropriate case for that treatment.

It is noteworthy that Canada has not entered any observation in respect of the Commentary to Article 7 of the OECD Model which was expanded substantially in 1994 after the OECD Council had adopted the November 26, 1993 OECD Report, "Attribution of Income to Permanent Establishments." That expanded Commentary does, although with some limitations, clearly contemplate dealings between the enterprise of the contracting state and the permanent establishment in computing the income attributable to the permanent establishment under Article 7 of the Model. The absence of a Canadian observation even after *Cudd Pressure* had been decided could reasonably be interpreted as an indication that the CRA does not believe that the decision of the Federal Court of Appeal constitutes any bar to the application of the internationally accepted rules for the attribution of income to a permanent establishment. Of course, Canada has not yet officially commented on the various drafts that have been more recently released by the OECD working parties on the attribution of income to permanent establishments and therefore Canada's position on this more expanded and detailed work is not yet known.

Article VII(3) of the present Canada-U.S. treaty concludes with the sentence, "Nothing in this paragraph shall require a contracting state to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the taxation laws of that state." This sentence and the paragraph in which it appears deal only with the deduction of actual expenses incurred for the purposes of the permanent establishment, whether in the state in which the permanent establishment is situated or elsewhere. Section

## LETTERS TO THE EDITOR

---

4(b) of the Income Tax Conventions Interpretation Act also deals with actual expenses incurred. The Technical Notes to ITCIA state that the provisions of that statute "are generally consistent with the extension of Canada and its treaty partners" with regard to the interpretation of tax treaties. Both the concluding sentence of Article VII(3) and section 4(a) of ITCIA are probably redundant from a Canadian perspective as was established in *Utah Mines Ltd. v. The Queen*, 92 DTC 6194 (Federal Court of Appeal), but in any event they do not qualify what the OECD Commentary on Article 7 has described as the "central directive on which the

allocation of profits to a permanent establishment is intended to be based," namely Article 7(2).

Sincerely,

David A. Ward  
Colin Campbell  
Davies Ward Phillips &  
Vineberg LLP  
Toronto  
March 26, 2008

## Are Swiss Banks Cleaning Up Their Act?



Toward  
An International  
Antiabuse Standard

The View Beyond  
*Fokus Bank*

Gibraltar: Back on  
The Blacklist?

U.K. Businesses  
Race Against  
Capital Gains

Compensation and  
The Belgium-U.S.  
Treaty

In Defense of the  
'Its' Argument