I. INTRODUCTION

Canada has executed tax treaties with 90 countries.[1] Where a tax treaty applies, its terms will prevail over domestic law to the extent that the two conflict.[2] However, there are several examples of judgments in which Canadian courts have interpreted the relevant treaty or domestic law in such a way that results in the relevant treaty not applying.

I have divided this paper into two parts. First, I provide an overview of the process of resolving tax disputes in Canada. Second, I provide several examples in which a Canadian court has resolved a conflict between a tax treaty and the *Income Tax Act*[3] by holding that the relevant tax treaty did not apply.

II. TAX DISPUTE RESOLUTION PROCESS IN CANADA

This part of the paper provides an overview of the process of resolving tax disputes in Canada. For the sake of simplicity, I have provided only a general overview of this process. As such, I have deliberated excluded from this overview many of the nuances of the Canadian taxation system.

The *Income Tax Act* generally requires residents of Canada and certain non-residents to file annual income tax returns with the Minister of National Revenue (the "Minister") estimating that person's tax payable.[4] The Minister then assesses the return and sends to

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[1] Department of Finance (Canada), *Notices of Tax Treaty Developments*, online: Department of Finance <http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp>. Canada has signed four other treaties that have yet to come into force. Canada is currently negotiating its first tax treaty with Madagascar. In addition, Canada has executed tax information exchange agreements ("TIEAs") with 16 countries: Department of Finance (Canada), *Tax Information Exchange Agreements Notices of Developments*, online: Department of Finance <http://www.fin.gc.ca/treaties-conventions/tieaaerf-eng.asp>. Canada has signed three other TIEAs that have yet to come into force. Finally, Canada is currently negotiating its first TIEAs with 11 other countries.

[2] *Vienna Convention on the Law of Treaties*, Can TS 1980 No 37.

[3] RSC 1985, c 1 (5th Supp), as amended [*Income Tax Act*].

[4] *Ibid*, ss 150-51.

that person a Notice of Assessment outlining that person's tax payable.[5] The Minister may also reassess that person and send to that person a Notice of Reassessment outlining that person's reassessed tax payable.[6]

The *Income Tax Act* provides a process for taxpayers to contest an assessment or reassessment. First, the taxpayer must file a notice of objection with the Minister.[7] If this does not resolve the dispute, the taxpayer may appeal to the Tax Court of Canada.[8] Once the Tax Court of Canada provides its judgment, either the taxpayer or the Crown[9] may appeal that judgment to the Federal Court of Appeal.[10] Finally, the taxpayer or the Crown may apply to the Supreme Court of Canada for leave to appeal a judgment of the Federal Court of Appeal to the Supreme Court of Canada.[11] This appeal process is also available to non-resident persons who wish to contest the amount of withholding tax withheld by a resident of Canada and remitted on behalf of that non-resident person.[12]

Where a tax dispute involves a tax treaty, the taxpayer may resort to the dispute resolution process in the particular treaty by applying to the competent authority. For example, Article XXVI(1) of the Canada-US Tax Treaty[13] provides as follows:

> Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of

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[5] *Ibid*, s 152.
[6] *Ibid*. Generally speaking, the Minister has a limited amount of time to assess or reassess a person for tax payable: *Ibid*, ss 152(3.1), (4).
[7] *Ibid*, ss 165(1).
[8] *Ibid*, s 169. In some situations, a person or the Crown may also apply to the Tax Court of Canada for a determination of a question of law, a question of fact or a question of mixed law and fact raised by a pleading in a proceeding before that court: *Tax Court of Canada Rules (General Procedure)*, SOR/90-688a, para 58(1)(a).
[9] For the purposes of this paper, the Crown refers to the Attorney General of Canada and the Department of Justice as representative of Her Majesty the Queen: *Department of Justice Act*, RSC 1985, c J-2, s 5.
[10] *Federal Courts Act*, RSC 1985, c F-7, s 27.
[11] *Supreme Court Act*, RSC 1985, c S-26, s 40.
[12] *Income Tax Act*, *supra* note 3, ss 227(7).
[13] *Convention between Canada and the United States of America with respect to Taxes on Income and on Capital* [*Canada-US Tax Treaty*].

> this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case in writing to the competent authority of the Contracting State of which he is a resident or, if he is a resident of neither Contracting State, of which he is a national.

This procedure may require the competent authority of the contracting states involved to endeavour to resolve the dispute. However, a person may not be able to rely on this procedure if that person is not entitled to the benefits under the treaty because, for example, that person is not a resident for the purposes of the treaty.

III. CANADIAN JUDGMENTS IN WHICH TREATY WAS NOT APPLIED

This part of the paper provides several examples of Canadian courts resolving a conflict between a tax treaty and the *Income Tax Act* by holding that the relevant tax treaty did not apply. In particular, I will discuss the following eight cases: *Burnet v Canada*,[14] *Crown Forest Industries Ltd v Canada*,[15] *CUDD Pressure Control Inc v Canada*,[16] *Merrins v Canada*,[17] *Edwards v Canada*,[18] *Garron (Trustee of) v Canada*,[19] *Sundog Distributing Inc v Canada*,[20] and *Alberta Printed Circuits Ltd v Canada*.[21]

a) Burnet v Canada

In *Burnet*, a 1987 judgment of the Tax Court of Canada, Justice Rip (as he then was) held that the Canada-US Tax Treaty (1943)[22] (the "Treaty") did not apply to exempt a capital gain from Canadian tax.

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[14] (1987), 87 DTC 160 (TCC) [*Burnet*].
[15] [1995] 2 SCR 802 [*Crown Forest*].
[16] (1998), 98 DTC 6630 (FCA) [*CUDD Pressure*].
[17] (2002), 2002 DTC 1848 (TCC) [*Merrins*].
[18] 2003 FCA 378 [*Edwards*].
[19] 2009 TCC 450 [*Garron*], aff'd 2012 SCC 14. This case involved a number of other issues; however, for the purposes of this paper, discussion is limited to the question of residence of the Trusts under the Treaty.
[20] 2010 TCC 392 [*Sundog*].
[21] 2011 TCC 232 [*Alberta Printed Circuits*]
[22] *Canada-United States of America Income Tax Convention of 1943*.

The Appellant was the executor of an estate (the "Estate"). In accordance with the terms of will, the executor disposed of certain real property (the "Real Property") located in the Province of Alberta, resulting in a capital gain.[23] Pursuant to the *Income Tax Act*, the Minister assessed the Estate for tax on the capital gain.

The Appellant appealed the assessment, arguing that the capital gain was not subject to tax in Canada. According to the Appellant, the only persons with a vested interest in the Real Property (the "Beneficiaries") were residents of the United States.[24] Therefore, according to the Appellant, Article VIII of the Treaty exempted the capital gain from tax in Canada. Article VIII of the Treaty stated:

> Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

In response to the Appellant's arguments, the Crown argued that the Beneficiaries' interest in the Real Property was not indefeasibly vested, thus precluding application of Article VIII of the Treaty.[25]

Justice Rip rejected the Appellant's argument, finding that Article VIII of the Treaty did not apply. In support of his finding, Justice Rip focused on both the form of the transaction, rather than its underlying economic substance, and the purpose of the Treaty. Justice Rip stated:

> To accept the appellant's submission that the intent of Article VIII of the Tax Treaty was to exempt from Canadian tax the economic benefit of a gain in Canada received by a resident of the United States would compel a court to pierce the corporate veil when a United States controlled corporation, resident in

[23] *Burnet*, *supra* note 14 at 161.
[24] *Ibid* at 162.
[25] *Ibid*.

> Canada, disposes of a capital asset in Canada; as a result of such sale the gain would be reflected in the increase in the value of the shares of the corporation and the corporation would not be liable for tax in Canada since the economic benefit of the gain belongs to the shareholders who are resident in the United States. I cannot agree with this submission. The purpose of the Tax Treaty is for the avoidance of double taxation of a taxpayer. I have difficulty in satisfying myself that Article VIII contemplates the beneficiaries to be the residents or entities of the United States who are exempt from taxation in Canada on gains derived from the sale of the Lands. Article VIII does not, in my view, refer to indirect economic gains, and in particular it does not refer to economic gains of persons whose right to the gains is contingent.[26]

Further, Justice Rip observed that it was not clear that the Beneficiaries' interest in the Real Property was indefeasibly vested.[27]

According to the terms of the will creating the Estate, it was possible for the Beneficiaries to be divested of their interests in the Real Property or for their interests to be diminished if certain contingent interests held by other individuals were to vest.[28] As such, even if Article VIII exempted from Canadian tax the ultimate economic beneficiaries of a gain, it was not clear who those beneficiaries would be.

As a result, Justice Rip dismissed the Appellant's appeal and held that the Treaty did not apply to prevent Canada from taxing the capital gain resulting from the sale of the Real Property.

b) Crown Forest Industries Ltd v Canada

In *Crown Forest*, a 1995 judgment of the Supreme Court of Canada, the Court held that the Canada-US Tax Treaty (the "Treaty") did not apply to reduce the rate of withholding tax on certain rental payments made by the Appellant to a non-resident.

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[26] *Ibid* at 164.
[27] *Ibid*.
[28] *Ibid*.

The Appellant, a resident of Canada, paid rent to Norsk Pacific Steamship Company Limited ("Norsk") for the use of certain barges from 1987 to 1989.[29] Norsk was incorporated in the Bahamas; however, its only office and place of business was in the US.[30] During these taxation years, Norsk paid no US tax on the barge rental payments it received from the Appellant because of an exemption to which Norsk was entitled as an international shipping company under the US Internal Revenue Code.[31] The Appellant withheld tax on the rental payments at a rate of 10%, believing that Norsk was a "resident" of the US under the Treaty. The Minister re-assessed the Appellant, claiming that the Appellant should have withheld tax on the rental payments at a rate of 25%.[32]

The Court had to determine whether Norsk was a "resident" of the US within the meaning of Article IV of the Treaty.[33] Article IV(1) of the Treaty stated:

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature […].

According to the Court, a person is resident under the Treaty only if that person's "liability to taxation operates by reason of one of the listed grounds".[34] Therefore, if Norsk was not so "resident", then the Appellant was liable for the withholding tax that it failed to withhold on the rental payments it made to Norsk.[35]

The Court began by considering the basis for Norsk's taxation in the US. Because Norsk was a foreign corporation engaged in a trade or business within the US, section

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[29] *Crown Forest*, *supra* note 15 at para 4.
[30] *Ibid* at para 4.
[31] *Ibid* at para 6.
[32] *Ibid* at para 7.
[33] *Ibid* at para 2.
[34] *Ibid* at para 25.
[35] *Income Tax Act*, *supra* note 3, ss 215(6).

882 of the *Internal Revenue Code* subjected Norsk to US tax on that portion of its taxable income that is effectively connected with the conduct of its US trade or business.[36] According to the Court, "the fact that Norsk's place of management is in the US is not causally or even proximately connected to the basis of Norsk's tax liability."[37] Therefore, Norsk was not taxable in the US by reason of its "domicile, residence, place of management [or] place of incorporation".

The Court then considered whether Norsk's liability for US tax as a result of being "engaged in a business in the US" amounted to liability to tax "by reason of … any other criterion of a similar nature" to those criteria enumerated in Article IV(1). In reviewing the criteria for residence under the treaty, the Court observed:

> [T]he criteria for determining residence in Article IV, paragraph 1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state. In the United States and Canada, such comprehensive taxation is taxation on world-wide income. However, tax liability for the income effectively connected to a business engaged in the U.S., pursuant to s. 882 of the Internal Revenue Code, amounts simply to source liability.[38]

The Court concluded, "the 'engaged in a business in the U.S.' criterion", which subjected Norsk to US tax on its US-source income, "is not of a similar nature to the enumerated grounds since it is but a basis for source taxation."[39] Therefore, Norsk was not a resident of the US according to the language of Article IV(1).

In support of its conclusion that Norsk was not a resident under the Treaty, the Court considered the purpose of the Treaty. According to the Court, the goal of the Treaty is "to promote international trade between Canada and the U.S., to spare such individuals and

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[36] *Crown Forest*, *supra* note 15 at para 28.
[37] *Ibid* at para 25.
[38] *Ibid* at para 40.
[39] *Ibid*.

corporations double taxation (consequently promoting the equitable allocation of profits of enterprises doing business in both countries)."[40] The Court continued:

> The goal of the Convention is not to permit companies incorporated in a third party country (the Bahamas) to benefit from a reduced tax liability on source income merely by virtue of dealing with a Canadian company through an office situated in the United States. […] 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. […] It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements.[41]

Therefore, Norsk was not a resident of the US pursuant to Article IV(1) of the Treaty.

As a result, the Supreme Court of Canada allowed the Crown's appeal and held that the Appellant was liable for the Canadian tax that it failed to withhold on its rental payments to Norsk.[42]

c) CUDD Pressure Control Inc v Canada

In *CUDD Pressure*, a 1998 judgment of the Federal Court of Appeal, the Court held that the Canada-US Tax Treaty (1942)[43] (the "Treaty") did not permit the Appellant, a foreign corporation with a Canadian permanent establishment ("P/E"), to deduct an amount for notional rental expenses in calculating the profit attributable to the P/E.

The Appellant was incorporated in the US and was the wholly owned subsidiary of RPC Energy Services (the "Parent"). In 1984, the Appellant entered into an agreement with Mobil Oil Canada Ltd. ("Mobil") to provide subbing services in the Province of

[40] *Ibid* at para 46.
[41] *Ibid* at paras 46, 48-49.
[42] *Ibid* at para 69.
[43] *Canada-United States Reciprocal Tax Convention, 1942*.

Nova Scotia. As a result, the Appellant sent two of its snubbing units to the Canadian job site and began proving snubbing services to Mobil.[44]

The Appellant's activities in Nova Scotia constituted a P/E in Canada under the Treaty. As a result, the Appellant included in its income attributable to the P/E all amounts billed to Mobil. However, it also deducted, among other things, a charge for notional rent charged by the Appellant's head office to the P/E for the use of the two snubbing units.[45] The Minister denied the Appellant's deduction for notional rent.[46]

The Appellant appealed, claiming that Article III(1) of the Treaty permitted the deduction for notional rent. Article III(1) stated:

> 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.

According to the Appellant, the notional rent for the snubbing units was a deduction that an "independent enterprise" would have incurred, and therefore was deductible in computing the "net profit" of the P/E.[47]

In its brief judgment, the majority of the Court dismissed the Appellant's appeal, and held that an independent enterprise would not have rented the snubbing units from the Parent.[48]

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[44] *CUDD Pressure*, *supra* note 16 at paras 7-11.
[45] *Ibid* at para 11.
[46] *Ibid* at para 14.
[47] *Ibid* at para 2.

In his concurring judgment, Justice McDonald ultimately agreed with the majority of the Court, but provided a more detailed analysis of the issue. Justice McDonald began his analysis by observing that "Article III(1) sets out the fiction that a permanent establishment is to calculate its profits as it if were an independent enterprise". As such, Justice McDonald held 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".[49] However, Justice McDonald agreed with the majority of the Court that a deduction for notional rent was inappropriate in this case.

Justice McDonald provided two reasons explaining why a deduction for notional rent was inappropriate in this case. First, Justice McDonald found that it would be very unlikely that an "independent enterprise" in the position of the Appellant would have rented the snubbing units from the head office and then have used those units to provide services to another company. Rather, it is likely that "the head office would have been contracted directly to take on the project in question."[50] Justice McDonald continued:

> 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.[51]

Allowing the deduction would not result in a more accurate depiction of the P/E's profit.

Second, Justice McDonald held that a deduction for notional rent would be inappropriate in these circumstances because "the amount of notional rent claimed by the

[48] *Ibid*.
[49] *Ibid* at para 22.
[50] *Ibid* at para 17.
[51] *Ibid* at para 34.

appellant was not included as income in the parent company's tax return".[52] Because "the purpose of the 1942 Convention is to prevent double taxation and to prevent tax evasion",[53] it would be inappropriate for the Appellant to "derive the benefit of having its profits drastically reduced [as a result of the deduction for notional rent] and then not have the amount included as income in the parent corporation's records."[54]

As a result, the Federal Court of Appeal dismissed the Appellant's appeal and held that the Treaty did not entitle the Appellant to a deduction for the notional rent payments.[55]

d) Merrins v Canada

In *Merrins*, a 2002 judgment of the Tax Court of Canada, the Court held that an individual resident in Ireland was not entitled to certain treaty benefits under the Canada-Ireland Tax Treaty[56] (the "Treaty") in respect of certain Canadian-source income.

The Appellant was an individual resident in Ireland who was previously resident in Canada. Due to his prior residence in Canada, the Appellant was entitled to Canadian-source pension income, namely Old Age Security pension ("OAS"), a Canada Pension Plan benefit, and a Superannuation benefit (collectively, the "Pension Income"). In filing his tax return for the 1998 taxation year, the Appellant reported approximately $20 000 in Pension Income. However, the Appellant deducted approximately $15 000 from his Pension Income, relying on the Treaty.[57]

[52] *Ibid* at para 37.
[53] *Ibid* at para 35.
[54] *Ibid* at para 38.
[55] *Ibid* at para 43.
[56] *An Agreement Between the Government of Canada and the Government of Ireland For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (1966).*
[57] *Merrins*, *supra* note 17 at para 4.

In his reasons for judgment, Chief Justice Rip considered the following two questions. First, is the OAS a "pension" for the purposes of Article XI(3) of the Treaty and thus exempt from Canadian taxation? Second, if the Appellant elects pursuant to subsection 217(2) of the *Income Tax Act* to be taxed as though the Appellant were resident in Canada in order to claim certain non-refundable tax credits available only to residents in Canada (the "Section 217 Election"),[58] is the Appellant still entitled to benefits under the Treaty?

In deciding the first issue, Chief Justice Rip observed that Article XI(3) of the Treaty defined a "pension" as "a periodic payment made in consideration for past services". Pursuant to sections 3 and 9 of the *Old Age Security Act*,[59] the Appellant was entitled to OAS because he had attained 65 years of age and resided in Canada for at least 20 years after his attaining 18 years of age prior to his moving to Ireland.

As a result, Chief Justice Rip found that the OAS received by the Appellant was not a "pension" as defined in the Treaty because entitlement to the OAS was not related to the performance of past services. Rather, entitlement to OAS depended on an individual reaching a certain age.[60] Therefore, Article XI(3) of the Treaty did not prevent Canada from taxing the OAS amount received by the Appellant.

Next, Chief Justice Rip considered whether the Appellant could rely on the Treaty to exempt from Canadian taxation his non-OAS Pension Income, namely the Canada Pension Plan benefit and the Superannuation benefit, despite having made a Section 217 Election. According to the Minister, the Appellant could not elect to be taxed as a

[58] By virtue of subsection 217(6), a person who makes a Section 217 Election is also entitled to a credit that effectively excludes from Canadian taxation that person's foreign-source income.
[59] RSC 1985, c O-9.
[60] *Merrins*, *supra* note 17 at para 14.

resident in Canada in order to gain access to non-refundable tax credits, and yet still claim protection under the Treaty as a resident of Ireland to exempt from Canadian taxation his non-OAS Pension Income.[61]

In deciding the second issue, Chief Justice Rip held that the Appellant was not entitled to both the non-refundable tax credits as result of making the Section 217 Election and protection under the Treaty. Chief Justice Rip stated:

> [T]he subsection 217(2) election does not deny [the Appellant] an exemption or a preferential rate of tax pursuant to the Canada -- Ireland Treaty. The election in effect takes the taxpayer outside of the treaty and he or she loses the benefit afforded by the treaty … [I]t is clear that the appellant is not entitled to 'pick and choose' the most favorable mix of the provisions of a treaty and domestic law."[62]

As a result, Chief Justice Rip dismissed the Appellant's appeal and held that the OAS payments were not a "pension" under the Treaty and that the Appellant was not entitled to the benefits under the Treaty having elected to be taxed as a Canadian resident under the *Income Tax Act*.[63]

e) Edwards v Canada

In *Edwards*, a 2003 judgment of the Federal Court of Appeal, the Court held that Article 15(3) of the Canada-China Tax Treaty[64] (the "Treaty") did not apply to exempt from Canadian taxation employment income earned by a pilot in the Hong Kong Special Administrative Region (the "HKSAR").

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[61] *Ibid* at para 22.
[62] *Ibid* at paras 31, 35.
[63] *Ibid* at para 42.
[64] *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income between Canada and the People's Republic of Canada*.

The Appellant was a pilot employed by Veta, an airline based in the HKSAR. During the taxation year at issue, the Appellant was a resident of Canada.[65] According to the Appellant, the Treaty prevented Canada from taxing his income from the airline.

Article 15(3) of the Treaty provided, *inter alia*, that "remuneration in respect of an employment excised aboard a[n] aircraft operated in international traffic by an enterprise of a Contracting State, shall be taxable only in that Contracting State". Article 3(1)(g) of the Treaty defined an "enterprise of a Contracting State" as an enterprise carried on by "a resident of a Contracting State", which term is defined in turn as "a person … liable to tax therein". Accordingly, the Appellant's income derived from his employment with the airline would be exempt from Canadian taxation if the airline was liable to tax in China.

Justice Noël began by considering the scope of the Treaty. He stated:

> Looking first at the language used in the Treaty … it does not appear that [the Treaty] was intended to apply to Hong Kong … Article 3(1)(b) of the Treaty defines the [People's Republic of China (the "PRC")] in terms of where the laws relating to Chinese tax apply, while article 2(1)(b) lists the four Mainland taxes (i.e., taxes not having application in Hong Kong or elsewhere outside of the Chinese Mainland) to which the Treaty shall apply.[66]

Justice Noël continued by observing that the Treaty defines the PRC "in a geographical sense, that is by reference to where, within the territory over which the PRC asserts its sovereignty, Chinese taxes apply."[67]

As such, Justice Noël determined that the HKSAR was not a part of China for the purposes of the Treaty because the Chinese taxes enumerated in the Treaty, which determine the scope and application of the Treaty, did not include taxes levied in the

[65] *Edwards*, *supra* note 18 at para 8.
[66] *Ibid* at para 22.
[67] *Ibid* at para 24.

HKSAR. Further, Justice Noël observed that "the contracting states have expressed their agreement, by exchange of diplomatic notes, that the Treaty was not intended to apply to the HKSAR" where the airline was based.[68]

As a result, the Federal Court of Appeal dismissed the Appellant's appeal and held that the Appellant was not exempt from Canadian tax under the Treaty.[69]

f) Garron (Trustee of) v Canada

In *Garron*, a 2009 judgment of the Tax Court of Canada, the Court rearticulated the test for determining the residence of a trust in Canada, thus holding that Article XIV(4) of the Canada-Barbados Tax Treaty[70] (the "Treaty") did not prevent Canada from taxing certain capital gains realized by two trusts (the "Trusts").

The Appellant, a corporation resident in Barbados, was the sole trustee of the Trusts.[71] The Trusts were settled by an individual resident in the Caribbean island of St. Vincent for the benefit of certain Canadian residents.[72] As part of a corporate reorganization, the Trusts subscribed for shares of newly-incorporated Canadian corporations which, in turn, subscribed for shares (the "Shares") of a Canadian holding corporation. The holding corporation held shares of two operating corporations.[73]

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[68] *Ibid* at para 27.
[69] *Ibid* at para 30.
[70] *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* [*Canada-Barbados Tax Treaty*].
[71] *Garron*, *supra* note 19 at para 2. This case involves other appellants who the Minister assessed as an alternative to its assessment of the Trusts; however, for the purposes of this paper, I will discuss only the trustee's appeals.
[72] *Ibid*.
[73] *Ibid* at para 27.

In 2000, the Trusts disposed of a majority of the Shares, realizing a capital gain of approximately $450 million.[74] The Minister assessed the Trusts for tax on the gains. In response, the Trusts argued that they were residents of Barbados and thus exempt from Canadian tax pursuant to Article XIV(4) of the Treaty, which states: "Gains from the alienation of any property […] may be taxed only in the Contracting State of which the alienator is a resident". Article IV(1) of the Treaty defines a "resident of a Contracting State" as "any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". Therefore, the Trusts were liable to the tax at issue only if the Trusts were resident in Canada.

The Minister argued that this exemption did not apply because the Trusts were effectively managed and controlled by their Canadian beneficiaries, not by their corporate trustee, and thus resident in Canada.[75]

The Appellant, however, submitted that the residence of a trust at common law in Canada is determined by the residence of the particular trust's trustee, and that the actual management and control of a trust is not a relevant consideration.[76] Therefore, according to the Appellant, the Trusts were not resident in Canada and thus not taxable in Canada.

In several past judgments, Canadian courts had found that a trust was resident where its trustee resided. However, Justice Woods did not accept that the residence of the trustee was necessarily determinative of the residence of a trust.[77]

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[74] *Ibid* at para 4.
[75] *Ibid* at paras 4, 15.
[76] *Ibid* at para 125.
[77] *Ibid* at para 135.

For the following reasons, Justice Woods concluded that "the judicial test for residence that has been developed in a corporate context should also apply to trusts".[78] First, "from the point of view of determining tax residence, the characteristics [of trusts and corporations] are quite similar" because "[t]he function of each is, at a basic level, the management of property".[79] Second, applying the same test for corporations and trusts "promotes the important principles of consistency, predictability and fairness in the application of tax law".[80] Finally, Justice Woods observed that there appeared to be no compelling reasons for the courts "to develop a totally different test of residence for trusts than they have for corporations".[81]

Justice Woods then found that, because the trustee "had agreed from the outset to defer to the recommendations" of certain beneficiaries,[82] "the management and control of both Trusts was located in Canada" where those beneficiaries resided.[83] Because the Trusts were liable to Canadian taxation under the *Income Tax Act* by virtue of their residence in Canada, the Trusts were resident in Canada for the purposes of the treaty.[84]

As a result, Justice Woods dismissed the Appellant's appeals and held that the Treaty did not prevent Canada from taxing the Trusts on their respective capital gains.[85] Both the Federal Court of Appeal and the Supreme Court of Canada subsequently affirmed this judgment and this test for determining the residence of a trust for Canadian purposes.[86]

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78 *Ibid* at para 157.
79 *Ibid* at para 159.
80 *Ibid* at para 160.
81 *Ibid* at para 161.
82 *Ibid* at para 194.
83 *Ibid* at para 252.
84 *Ibid* at para 267.
85 *Ibid* at para 400. Justice Woods allowed the appeals of the other appellants who the Minister assessed as an alternative to the Trusts.
86 2010 FCA 309, 2012 SCC 14.

g) Sundog Distributing Inc v Canada

In *Sundog*, a 2010 judgment of the Tax Court of Canada, the Court held that the limitation period prescribed by the Canada-Barbados Tax Treaty (the "Treaty") did not apply to prevent Canada from making certain transfer pricing adjustments (the "Adjustments") to the Appellant's income.

During 1998, 1999 and 2000, the Appellant, a resident of Canada, paid certain amounts to non-arm's length companies registered in Barbados as international business companies ("IBCs").[87] The Minister reassessed the Appellant's income for these taxation years, and made the Adjustments to increase the Appellant's income. The amounts added to the Appellant's income by way of the Adjustments had previously been reported as gross profit by the IBCs and taxed by Barbados.[88]

The Appellant appealed to the Tax Court of Canada, arguing that the limitation period for assessing the Appellant under the Treaty prevented the Minister from making the Adjustments.[89] Accordingly, the Court had to determine whether the applicable limitation period was the five year period described in Articles IX(3) and XXVII(3) of the Treaty or the six year period in subparagraph 152(4)(b)(iii) of the *Income Tax Act*.[90] If the limitation period under the Treaty applied, the Assessments were invalid. However, if the limitation period under the *Income Tax Act* applied, the reassessments were valid.

Article IX(3) of the Treaty provides:

> A Contracting State shall not change the profits of an enterprise in the circumstances referred to in paragraph 1 after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the year in

[87] *Sundog*, *supra* note 20 at para 5.
[88] *Ibid*.
[89] *Ibid*.
[90] *Ibid* at para 2.

> which the profits which would be subject to such change would have accrued to an enterprise of that State. This paragraph shall not apply in the case of fraud, wilful default or neglect.

Paragraph 1, referred to in Article IX(3), provides:

> Where
>
> (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either ease conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Therefore, if Article IX(3) applied to the case at bar, Canada was prevented from making the Adjustments to the Appellant's income because the reassessments in question occurred more than five years after the taxation years to which the Adjustments relate.

Further, Article XXVII(3) of the Treaty provides:

> A Contracting State shall not, after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the taxable period in which the income concerned has accrued, increase the tax base of a resident of either Contracting State by including therein items of income which have also been charged to tax in the other Contracting State. This paragraph shall not apply in the case of fraud, wilful default or neglect.

Therefore, if Article XXVII(3) applied to the case at bar, Canada was similarly prevented from making the Adjustments.

According to Chief Justice Rip, these provisions serve separate purposes:

> Article IX and XXVII of the Treaty serve separate purposes: Article IX of the Treaty is concerned with the taxation of business profits of enterprises in Canada

> and Barbados by both countries and imposes a time limit on the taxation of these profits. Article XXVII(3) imposes a time limit by both countries to assess tax on the same item of income.[91]

The Minister argued that Article XXX(3) of the Treaty prevented the Appellant from relying on the reduced limitation period under either Article IX(3) or XXVII(3). Article XXX(3) states:

> This Agreement shall not apply to companies entitled to any special tax benefit under the *Barbados International Business Companies (Exemption from Income Tax) Act*, Chap. 77 or to companies entitled to any special tax benefit under any similar law enacted by Barbados in addition to or in place of that law.

Based on Article XXX(3), the Minister made the following two arguments. First, because the Treaty does not apply to IBCs, an IBC is not a "resident of a Contracting State" for the purposes of the limitation period in Article IX(3).[92] Second, the Appellant's income had not been taxed in Barbados as contemplated by Article XXVII(3). According to the Minister, Article XXVII(3) applies only if both Canada and Barbados had taxed the Appellant for the same item of income.[93] Because the Appellant paid no tax in Barbados, the Minister contended that Article XXVII(3) did not apply.

Conversely, the Appellant argued that both Articles IX(3) and XXVII(3) applied. First, Article XXX(3), which provides that the Treaty "shall not apply" to IBCs, merely prevents IBCs from obtaining benefits under the Treaty.[94] Therefore, according to the Appellant, Article IX(3) prevents Canada from applying transfer pricing adjustments outside of the five year limitation period. Second, Article XXVII(3) applied because "the income previously reported and taxed in Barbados is the income subject to the

[91] *Ibid* at para 4.
[92] *Ibid* at paras 21-22.
[93] *Ibid* at para 42.
[94] *Ibid* at para 13.

assessments in appeal, notices of which were issued after the limitation period of five years in Article XXVII(3)."[95] Therefore, according to the Appellant, Article XXVII(3) prevented Canada from increasing the Appellant's income through the Adjustments since that income had already been taxed by Barbados.

Chief Justice Rip rejected the Appellant's submissions, finding that Article XXX(3) does not merely restrict IBCs from claiming benefits under the Treaty. He stated, "[i]t is not only the benefits of the Treaty that do not apply to IBCs ... [A]ll of the Treaty does not apply."[96] According to Chief Justice Rip, the Appellant "is attempting to construct Article XXX(3) to read that 'the benefits of' precede the opening words of paragraph 3 so that … paragraph (3) would read: 'The benefits of this Agreement shall not apply to [IBCs]'".[97] As a result, Chief Justice Rip held that Article IX(3) did not prevent Canada from making the Adjustments outside of the five year limitation period under the Treaty because an IBC is not "an enterprise of a Contracting State".[98]

Similarly, Chief Justice Rip rejected the argument that XXVII(3) prevented Canada from making the Adjustments beyond the five year limitation period, stating:

> Article XXVII(3) prohibits a State from increasing a person's tax base by including items of income already charged to tax in the other State; it is not income generally. […] [T]he word "income" and "revenue" (in the French version of Article XXVII(3)) are modified by the words "items of" in English and "éléments de" respectively. It is not income alone, or the quantum of the income, that is addressed in Article XXVII(3); it is a description of what part of income has entered into an account or a "partie constitutrice d'une chose", a constructive or essential part of a thing that is being charged to tax. It is not the general description of income but what the income is composed of, what the income is, that interests Article XXVII(3).[99]

[95] *Ibid* at para 11.
[96] *Ibid* at paras 32, 36.
[97] *Ibid* at para 36.
[98] *Ibid* at para 40.
[99] *Ibid* at para 46.

Chief Justice Rip concluded:

> Canada is taxing the appellant on fees that the two Barbados companies ought to have paid to the appellant but did not. Again, the appellant was not charged tax on management fees or on any type of income by Barbados; the items of income charged to tax against the appellant by Canada are different items of income than were charged to tax to Sun Island Optics and Sun Island by the Government of Barbados.[100]

As a result, Chief Justice Rip determined that the applicable limitation period was the period described in the *Income Tax Act*, not the shortened limitation period under Articles IX(3) and XXVII(3) of the Treaty.[101] Therefore, the Minister did not reassess the Appellant beyond the applicable limitation period.

h) Alberta Printed Circuits Ltd v Canada

In *Alberta Printed Circuits*, a 2011 judgment of the Tax Court of Canada, the Court held that the limitation period prescribed by the Canada-Barbados Tax Treaty (the "Treaty") did not apply to prevent Canada from making certain transfer pricing adjustments (the "Adjustments") to the Appellant's income. In many ways, *Alberta Printed Circuits* is similar to *Sundog*.

The Appellant, a corporation resident in Canada, produced custom circuit boards.[102] By 1999, the Appellant had outsourced some of its production to a non-arm's length Barbadian international business company (the "IBC").[103] During the Appellant's 1999, 2000 and 2001 taxation years, the Appellant paid approximately $4.36 million to the IBC in exchange for this production.[104]

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[100] *Ibid* at para 48.
[101] *Ibid* at para 49.
[102] *Alberta Printed Circuits*, *supra* note 21 at paras 9-10.
[103] *Ibid* at paras 41-49, 96.
[104] *Ibid* at paras 56, 58.

In 2005 and 2006, the Minister reassessed the Appellant's income from its 1999, 2000 and 2001 taxation years. In doing so, the Minister made the Adjustments, adding approximately $3.55 million to the Appellant's income for these taxation years.[105]

As in *Sundog*, the Appellant appealed the Adjustments to the Tax Court of Canada, arguing that the limitation period for assessing the Appellant under the Treaty, which was shorter than the limitation period under the *Income Tax Act*, prevented the Minister from making these adjustments. If the limitation period under the Treaty applied, the reassessments were invalid. However, if the limitation period under the *Income Tax Act* applied, the reassessments were valid.[106]

Justice Pizzitelli began his analysis by adopting the reasoning in *Sundog* that the limitation periods in Articles IX(3) and XXVII(3) did not apply because the IBC was not an "enterprise of a Contracting State". [107] He stated:

> Rip C.J. decided that the five-year limitation period in Article IX(3) did not apply since the wording of paragraph IX(1) requires that, for its application, there must be "an enterprise of a Contracting State" from each of the states concerned, being Canada and Barbados, and that, since the appellant therein was a Barbados International Business Company ("IBC"), which Article XXX(3) specifically excludes from the application of the *Treaty*, it could not as an IBC, be "an enterprise of a Contracting State" for the purposes of Article IX of the *Treaty*. […] Frankly, I am in full agreement with the decision of Rip C.J. on this issue and adopt his reasoning on the non-applicability of the limitation period in Article IX(3).[108]

Justice Pizzitelli continued:

> Rip C.J.'s interpretation of "items of income" as consisting of specific items of revenue is also supported by other provisions of the *Treaty* itself, including

[105] *Ibid* at para 1.
[106] *Ibid* at para 97.
[107] *Ibid* at para 126.
[108] *Ibid* at paras 102-03.

> paragraph VII(6) which begins "Where profits include items of income ...". In my view, Rip C.J. was correct in his interpretation of "items of income".[109]

The Appellant claimed that Article XXVII(3) applied because the Adjustments had the effect of subjecting the same "items of income", namely the payments to the ABC, to both Canadian and Barbadian tax.[110] Justice Pizzitelli rejected this argument, stating:

> First, the Appellant took a business expense deduction for the [fees] paid to [the IBC]. This is an item of expense, not income, notwithstanding that both are of the same quantum. […] It is, in fact, abundantly clear that paragraph XXVII(3) can only deal with a situation where both contracting states exercise jurisdiction to tax the same items of income, presumably items not otherwise covered in the *Treaty*, resulting in the obligation of both contracting states under paragraph XXVII(2) to endeavour to resolve the issue with a view to avoiding double taxation. Secondly, [the Canadian transfer pricing regime] works so as to adjust the income of the taxpayer up or down, not to reduce the expense amount taken as a deduction from the payments made to a non-arm's length party. This is, however, only an <u>adjustment</u> to income. It is not an <u>item</u> of income per se and by no means is this upward adjustment of income in the case at bar also taxed as an additional item of income in Barbados.[111]

In further support of his conclusion that Article XXVII(3) did not apply, Justice Pizzitelli observed that the income in question, namely the fees paid by the Appellant to the IBC, were not "charged to tax" in Barbados, as required by Article XXVII(3).[112] The Appellant had argued that Article XXVII(3) applied because the fees received by the IBC were "charged to tax" in Barbados having been subjected to a 2.5% levy or tax under the *IBC Exemption from Income Tax Act*.[113]

Justice Pizzitelli began his analysis of this submission by considering the definition of "tax" under the Treaty. According to Article II(3) of the Treaty, the term "tax" in the case of Barbados means: "(i) the income tax; (ii) the corporation tax; (iii) the petroleum

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[109] *Ibid* at para 112.
[110] *Ibid* at para 113.
[111] *Ibid*.
[112] *Ibid* at paras 124-25.
[113] *Ibid* at para 115.

winning operations tax; and (iv) the employment levy". Justice Pizzitelli observed that, according to subsections 3(1) and 3(2) of the Barbados *Income Tax Act*, companies pay "corporation tax" and individuals pay "income tax".[114]

Justice Pizzitelli then turned his attention to subsection 10(1) of the *IBC Exemption from Income Tax Act*, which levies a tax on IBCs "in lieu of tax at the rate specified under the [Barbados] *Income Tax Act*". Justice Pizzitelli found that the tax paid by IBCs was not a "tax" as that term is used in the Treaty, stating:

> [T]he tax provided for in the *IBC Exemption From Income Tax Act* is neither the "income tax" - which arguably only applies (as a phrase) to individuals, nor the "corporation tax" prescribed in subsection 3(2) and whose rate is specified in section 43, as the tax in section 10 of the *IBC Exemption From Income Tax Act* is levied <u>in lieu of tax</u> at the rate specified under the Barbados *Income Tax Act*. […] [T]he tax levied under the *IBC Exemption from Income Tax Act* does not count as a "tax" under the *Treaty*. Barbados and Canada chose to establish an inclusive, fixed list of taxes that would be considered "Barbados tax", and that list does not include the tax levied under the *IBC Exemption From Income Tax Act.* In other words, although the Appellant was subject to a tax, it was not subject to "tax" either as that term is defined in the *Treaty*, or within the context of the *Treaty* requirements.[115]

As a result, Justice Pizzitelli relied on the reasoning in *Sundog* and the meaning of a "tax" under the Treaty to determine that the applicable limitation period was the period described in the *Income Tax Act*, not the shortened limitation period under Articles IX(3) and XXVII(3) of the Treaty.[116] Therefore, Justice Pizzitelli dismissed the Appellant's appeal and held the Minister did not reassess the Appellant beyond the applicable limitation period in the *Income Tax Act*.

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[114] *Ibid* at para 120.
[115] *Ibid* at paras 124-25.
[116] *Ibid* at para 126.