TAX DISCRIMINATION: RELIEF UNDER CANADA'S TAX TREATIES?

Saipem UK Limited v. The Queen
2011 TCC 25

KEYWORDS: TAX DISCRIMINATION ■ NATIONAL ■ RESIDENTS ■ PERMANENT ESTABLISHMENT ■ WINDUPS ■ LOSSES

Introduction

In *Saipem UK Limited v. The Queen*,[21] the Tax Court of Canada considered, for the first time in any considerable detail, the application of a non-discrimination provision in one of Canada's double taxation treaties. The non-resident appellant in *Saipem* ("Saipem UK") argued that the loss transfer mechanism in subsection 88(1.1) of the Income Tax Act was discriminatory on the basis of Saipem UK's nationality and its method of carrying on business in Canada through a permanent establishment. Although Saipem UK was ultimately unsuccessful before the Tax Court, the decision is noteworthy both for its consideration of a non-discrimination provision and for its finding, in obiter, that subsection 88(1.1) would indeed apply in a discriminatory manner in certain circumstances. In light of the court's reasoning, it is possible that several other provisions of the Act could be susceptible to challenge.

Background

Saipem UK was incorporated in the United Kingdom and was at all relevant times a non-resident of Canada for the purposes of the Act and the Canada-UK tax convention.[22] Operating in the same group of related companies as Saipem UK was Saipem Energy International Limited ("the subsidiary"), an entity that had similarly been incorporated in the United Kingdom and that was at all relevant times a non-resident of Canada for the purposes of the Act and the Canada-UK treaty.

The subsidiary carried on business in Canada through a permanent establishment and accumulated non-capital losses over several taxation years. Saipem UK acquired the shares of the subsidiary from another member of the related corporate group and wound up the operations of the subsidiary into Saipem UK. In subsequent taxation years, Saipem UK sought to deduct the subsidiary's accumulated non-capital losses against its income attributable to its Canadian permanent establishment. Had

21 2011 TCC 25.

22 The Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980, October 16, 1985, and May 7, 2003 (herein referred to as "the Canada-UK treaty").

the windup qualified under subsection 88(1.1), such deductions would have been permitted.

The minister, however, denied the deductions on the basis that the requirements of subsection 88(1.1) had not been satisfied. Specifically, neither Saipem UK nor the subsidiary was a "Canadian corporation" as defined in subsection 89(1).[23] The relevant portion of the definition reads:

> "Canadian corporation" at any time means a corporation that is resident in Canada at that time and was
>
> (a) incorporated in Canada, or
>
> (b) resident in Canada throughout the period that began on June 18, 1971 and that ends at that time.

Accordingly, to be a "Canadian corporation" as defined in subsection 89(1), a corporation must be resident in Canada at the relevant time and must have been either (a) incorporated in Canada, or (b) resident in Canada throughout the period that began on June 18, 1971.

Although Saipem UK admitted that neither it nor the subsidiary was a Canadian corporation, it contended that the Canadian corporation requirement violated its right, as a national of the United Kingdom, to non-discriminatory treatment guaranteed under article 22 of the Canada-UK treaty. Specifically, Saipem UK claimed that the Canadian corporation requirement in subsection 88(1.1) of the Act violates paragraphs 1 and 2 of article 22 of the treaty, which prohibit discrimination on the basis of nationality and permanent establishment status, respectively. The treaty provisions read as follows:

> Article 22
>
> 1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.
>
> 2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging either Contracting State to grant to individuals not resident in its territory those personal allowances and reliefs for tax purposes which are by law available only to individuals who are so resident.

23 The opening words of subsection 88(1.1) read, "Where a *Canadian corporation* (in this subsection referred to as the 'subsidiary') has been wound up and not less than 90% of the issued shares of each class of the capital stock of the subsidiary were, immediately before the winding-up, owned by another *Canadian corporation* . . . [emphasis added]."

Discrimination on the Basis of Nationality

Nationality Versus Residence

Saipem UK contended that the residence and incorporation requirements in subsection 88(1.1) through the "Canadian corporation" definition amounted to discrimination on the basis of nationality contrary to article 22(1) of the Canada-UK treaty.

The term "national" is defined in article 3(1) of the Canada-UK treaty in respect of both Canada and the United Kingdom. In all cases, a legal person deriving its status as such from the laws in force of Canada or the United Kingdom is a "national" of the respective jurisdiction. The place of incorporation, or continuance, is therefore determinative of a corporation's "nationality."

In many respects, the requirement that a corporation be a "Canadian corporation" in order to access the benefits of subsection 88(1.1) of the Act appears, on its face, to discriminate on the basis of a taxpayer's nationality. Moreover, the place of incorporation is expressly listed as one of two criteria that may be used to qualify under the definition. The only other available criterion by which a non-Canadian-incorporated corporation may qualify as a Canadian corporation is for the corporation to satisfy the difficult hurdle of demonstrating a continuous period of Canadian residence since June 18, 1971.

However, "residence" is a distinct and key concept in the "Canadian corporation" definition and, for the purposes of the Canada-UK treaty, is defined in article 4 of the treaty. Article 4 defines residence, to a large extent, with reference to the domestic law of the respective contracting states:

> "[R]esident of a Contracting State" means 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. But this term does not include any person who is liable to tax in that Contracting State in respect only of income from sources therein.

Under domestic law, a corporation may qualify as a resident of Canada under the common-law "management and control" test or under the statutory deeming provisions in subsection 250(4), which deem a corporation incorporated in Canada after April 26, 1965 to be a resident of Canada for the purposes of the Act. Conversely, subsection 250(5) deems a person otherwise resident in Canada to be a non-resident for the purposes of the Act if the person is deemed by a tax treaty to be resident in another country and not resident in Canada. Accordingly, if a tie-breaker rule of a treaty, such as article 4 of the Canada-UK treaty, finds an entity to be resident in a country other than Canada and deems the entity to not be a resident of Canada, then the entity will not be a resident of Canada for the purposes of the Act.

Despite the two separate concepts of residence and place of incorporation in the "Canadian corporation" definition in subsection 89(1), Saipem UK argued that the definition amounted to a de facto Canadian incorporation test. The Tax Court, however, observed that certain entities incorporated before June 18, 1971 could be Canadian corporations under paragraph (b) of the definition even though they were not nationals of Canada for the purposes of the Canada-UK treaty. It follows that,

where a non-national had its mind and management in Canada at all times since June 18, 1971, it would fall within the "Canadian corporation" definition and be eligible to deduct a subsidiary's losses pursuant to subsection 88(1.1).[24]

Similarly, because of the residence requirement, it could not be said that all Canadian-incorporated corporations would fall within the "Canadian corporation" definition. The Tax Court noted that as a result of subsection 250(5), discussed above, Canadian-incorporated corporations with strong connecting factors to a country with which Canada has a tax treaty might not qualify as Canadian corporations under the Act.[25]

On this basis, the court concluded that the test for residence and nationality had not been collapsed together, as contended by Saipem UK, for the purposes of determining whether an entity was a "Canadian corporation" under the Act.

The category of non-Canadian-incorporated corporations qualifying as "Canadian corporations" under the Act on the basis of their continuous residence in Canada since 1971 is necessarily finite and seems likely to include relatively few entities. However, in obiter, the Tax Court suggested that in certain circumstances, the non-discrimination provision in the Canada-UK treaty could apply to a windup pursuant to subsection 88(1.1) of the Act where a UK-incorporated corporation was resident in Canada for the purposes of the tie-breaker rule in article 4 of the treaty and was seeking to wind up a similarly situated subsidiary. The court stated:

> Finally, I would suggest that, as submitted by the respondent, in a situation where one was comparing the appellant with a corporation that is a Canadian national resident in Canada and having a wound-up subsidiary that is a Canadian national resident in Canada—the appellant (for the sake of argument) also being a resident of Canada and having a Canadian resident wound-up subsidiary and neither entity qualifying as a "Canadian corporation" under subsection 89(1) (because of the year of period of residency)—that situation would give rise to discrimination as the Canadian corporation resident in Canada would be able to deduct the non-capital losses of its wound-up subsidiary under subsection 88(1.1) of the Act while the appellant, also resident in Canada, would not be able to. Article 22(1) of the Canada-UK Treaty would, in my opinion, apply in such a circumstance.[26]

Meaning of "Same Circumstances"

Saipem UK argued that the treatment of a non-resident's permanent establishment in Canada was in all material respects equivalent to that of a Canadian national carrying on such a business in Canada pursuant to the interaction of sections 111 and 115 of the Act. It therefore argued that a business being carried on through a permanent establishment was "in the same circumstances" as a Canadian corporation operating in Canada for the purposes of evaluating treatment under article 22(1) of

24 Supra note 21, at paragraph 49.

25 Ibid., at paragraph 50.

26 Ibid., at paragraph 54.

the Canada-UK treaty. Accordingly, Saipem UK contended that subsection 88(1.1) of the Act is discriminatory because a national of the United Kingdom is subject to taxation more burdensome than the taxation of a Canadian national "in the same circumstances."

Since there had been no domestic decisions interpreting a non-discrimination provision in a tax treaty in any substantive way, the Tax Court referred to a decision of the New Zealand Court of Appeal for guidance.[27] Reviewing a similar non-discrimination provision in the New Zealand-UK tax convention,[28] the New Zealand Court of Appeal concluded that discrimination on the basis of residence did not amount to discrimination on the basis of nationality. The court observed that "residence and nationality, and especially the latter, are treacherous words for they are somewhat artificial when applied to corporate bodies."[29] It nonetheless concluded that discrimination on the basis of residence was not protected under the treaty because differential treatment falling afoul of the non-discrimination provision must be between taxpayers "in the same circumstances" but for their nationality. The court found that "[t]he word 'same' carries the connotation of uniformity, of exactness in comparison. The phrase does not ordinarily mean in roughly similar circumstances: it means in substantially identical circumstances in all areas except nationality."[30] Residence was thus found to be a legitimate criterion by which to distinguish "sameness."

In addition to the New Zealand court's decision in *United Dominions*, the Tax Court considered guidance provided by the Organisation for Economic Co-operation and Development in a commentary on its model convention.[31] *Crown Forest Industries Ltd. v. Canada*[32] was cited by the court as authority for the proposition that extrinsic evidence, such as the OECD commentary, could be used as guidance to the interpretation of tax treaties where the parties to the treaty have not registered an objection to that commentary. Moreover, the Federal Court of Appeal decision in *Prévost Car Inc.*[33] was used to justify the consideration of an edition of the OECD commentary that was released subsequent to the negotiation of the Canada-UK treaty—and indeed, even subsequent to the taxation years in dispute.

27 *IRC (NZ) v. United Dominions* (1973), 3 ATR 686 (NZCA).

28 The Agreement Between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Wellington on June 13, 1966.

29 Supra note 27, at 691.

30 Ibid.

31 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2008).

32 [1995] 2 SCR 802.

33 *Canada v. Prévost Car Inc.*, 2009 FCA 57.

The Tax Court found that the OECD commentary was consistent with the conclusions drawn in *United Dominions*. The commentary stated that a non-discrimination provision would apply only to comparable entities that were in the same situation in all relevant respects other than nationality. Accordingly, distinctions in treatment on the basis of residence would not offend the non-discrimination provision of the model treaty. The commentary stated:

> The expression "in the same circumstances" would be sufficient by itself to establish that a taxpayer who is resident of a Contracting State and one who is not resident of that State are not in the same circumstances.[34]

However, this rather definitive statement was made in connection with language in the model treaty that specifically identified residence as a factor to maintain constant between the comparator taxpayers.[35] That language is notably absent from the Canada-UK treaty. Moreover, Canada has reserved its position on the non-discrimination provision of the model treaty.

Notwithstanding the shortcomings of using the OECD commentary as a guide to interpretation, the view that distinctions on the basis of residence do not, in and by themselves, amount to breaches of the non-discrimination provision appears to be the correct view. The Canada-UK treaty and the Act draw a fundamental distinction between the taxation of residents and non-residents. Whereas residents of Canada are generally subject to taxation on their worldwide income, non-residents are generally subject to tax only on Canadian-source income. Applying this intellectual framework, Canada's tax treaties allocate the authority to tax specific aspects of a taxpayer's financial affairs between the contracting states on the basis of the taxpayer's residence and the location of the sources of income.

The Tax Court ultimately agreed with the conclusions of the New Zealand Court of Appeal and the OECD commentary in finding that taxpayers that are not residents of the same country are not "in the same circumstances" for the purpose of evaluating whether there has been discrimination on the basis of nationality contrary to article 22(1) of the Canada-UK treaty. As an example, the court considered the hypothetical tax treatment of a non-resident Canadian national seeking to wind up a non-resident subsidiary. Since neither the parent nor the subsidiary corporation in such an example would qualify as a Canadian corporation under the Act, owing to their non-resident status, the parent corporation would be ineligible to claim a

34 See paragraph 7 of the commentary on article 24 of the OECD model treaty, supra note 31, quoted in *Saipem*, supra note 21, at paragraph 45.

35 Article 24(1) of the OECD model treaty states, "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, *in particular with respect to residence*, are or may be subjected [emphasis added]."

deduction pursuant to subsection 88(1.1). Since this treatment corresponds to the treatment of Saipem UK, the court concluded that Saipem UK had not been subject to discrimination under the Canada-UK treaty on the basis of its nationality.[36]

Discrimination on the Basis of Permanent Establishment Status

Relying on article 22(2) of the Canada-UK treaty, as set out above, Saipem UK asserted that Canada was prohibited from treating a UK resident's permanent establishment in Canada less favourably than a Canadian national operating in Canada. Saipem UK noted that, pursuant to sections 111 and 115 of the Act, a UK resident with a permanent establishment in Canada could benefit from loss carrybacks and loss carryforwards. Accordingly, Saipem UK argued that denying loss carryforwards of a subsidiary pursuant to subsection 88(1.1) was inconsistent with the scheme of the Act and the treaty, and amounted to discrimination on the basis of permanent establishment status.

Citing the OECD commentary and a text by Brian Arnold,[37] the Tax Court concluded that the appropriate comparison was between the tax burden of that portion of business income carried on by a non-resident that was attributable to a permanent establishment and the burden of taxation on the same business activities carried on by a resident entity, thus clarifying that the prohibited discrimination under article 22(2) of the Canada-UK treaty is on the basis of permanent establishment status and not nationality.

Further complicating the analysis is the wording of article 22(2) of the Canada-UK treaty. While article 22(1) prohibits other or more burdensome taxation of non-nationals, article 22(2) prohibits less favourable taxation of permanent establishments. Accordingly, a contracting state may impose different tax rules on permanent establishments as compared with residents provided that the overall tax treatment is not less favourable.

The Tax Court also cited various portions of the OECD commentary addressing the treatment of losses connected to a permanent establishment. The commentary addressed the treatment of ordinary loss carrybacks and carryforwards, generally suggesting that they should be permitted in a manner analogous to their application to residents of a contracting state. Although it clarified that the applicable losses are those connected to the permanent establishment's own business activities that would qualify for the loss carryforward or carryback, the commentary did not address the transfer of loss deductions from a subsidiary that had been wound up into a parent corporation.

36 Supra note 21, at paragraphs 51-53.

37 Brian J. Arnold, *Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States*, Canadian Tax Paper no. 90 (Toronto: Canadian Tax Foundation, 1991).

The OECD commentary did, however, emphasize that the equal treatment principle was to be applied to a permanent establishment's own activities. It cautioned that the rules do not extend to the relationship between an enterprise and other related enterprises, such as rules allowing consolidation, transfer of losses, or tax-free transfers of property between companies of common ownership. Whereas the treaty rules deal with the taxation of an establishment, these latter activities describe the taxation of an associated group.[38]

More concretely, the Tax Court also satisfied itself that this OECD interpretation was broadly consistent with article 7 of the Canada-UK treaty addressing business income earned through a permanent establishment. The court observed that article 7(2) of the treaty directs that profits attributable to a permanent establishment be calculated as if the permanent establishment were a distinct and separate enterprise dealing wholly independently with the enterprise of which it is a permanent establishment. Article 7(3) of the treaty clarifies that the deductions available to a permanent establishment are those expenses of the enterprise that were incurred for the purposes of the permanent establishment.

Drawing on these observations, the court concluded that

> it would seem logical to infer and conclude that the only loss deductions possible in determining the profits of the [permanent establishment] are those with respect to losses that would be attributable to the [permanent establishment] if it were dealing wholly independently with the enterprise of which it is a [permanent establishment].[39]

Although the court acknowledged that the appellant's arguments were "logical and in line with the spirit of the Act in terms of what is allowed as deductions for losses," it noted that both the OECD commentary and article 7 of the Canada-UK treaty strongly indicated that the non-discrimination principle in article 22(2) of the Canada-UK treaty was applicable only with respect to the taxation of the permanent establishment's own activities and not with respect to intercorporate loss transfers.[40]

Finally, the court also noted that a Canadian enterprise carrying on the same activities as Saipem UK that sought to deduct non-capital losses of a non-resident subsidiary with a permanent establishment in Canada would have similarly been refused such treatment.[41]

Conclusion

Notwithstanding Saipem UK's defeat, the Tax Court's acknowledgment that the Canadian corporation requirement in subsection 88(1.1) of the Act applies in a discriminatory manner in certain circumstances could give rise to future challenges by

38 Supra note 21, at paragraphs 63-65.

39 Ibid., at paragraph 67.

40 Ibid., at paragraph 69.

41 Ibid., at paragraph 70.

nationals of Canada's treaty partners. While Canada has, thus far, had few challenges to its tax laws on the basis that they contravene non-discrimination provisions under Canada's tax treaties, it is not surprising that one of the original challengers of such laws was a UK national. The fiscal authorities in the United Kingdom have frequently been unsuccessful in defending British tax laws that have been challenged as discriminatory by European nationals before the European Court of Justice.[42] It is perhaps possible that this has made British and European taxpayers more attuned to the potential of non-discrimination clauses than their North American counterparts.

Canadian tax law frequently distinguishes tax treatment in a manner that could give rise to distinctions on the basis of nationality, as opposed to simply residence. For example, the Canadian corporation definition that was the subject of the dispute in *Saipem* is also used as a precondition to qualify as a "Canadian-controlled private corporation" and the many associated benefits resulting therefrom.[43] Similarly, several of the corporate reorganization provisions in sections 85 through 88 of the Act are available only to Canadian corporations or "taxable Canadian corporations," which term is defined in subsection 89(1) and incorporates the definition of "Canadian corporation."

Only time will tell whether the issue of discrimination under Canada's tax treaties will become a more litigated area of the law and to what extent Canada's alleged preferential tax treatment of Canadian nationals will be subject to challenge. In the interim, the Federal Court of Appeal will have the opportunity to add its views on the subject since Saipem UK is appealing the Tax Court's decision.

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42 See, for example, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, case C-374/04; [2006] ECR I-11673; *Test Claimants in the FII Group Litigation v. Inland Revenue Commissioners*, case C-446/04; [2006] ECR I-11753; and *Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*, case C-201/05; [2008] ECR I-2875.

43 See the preamble of the definition of "Canadian-controlled private corporation" in subsection 125(7) of the Act.