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TPM-08

The Dudney Decision: Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines

December 5, 2005

Please note that the following Transfer Pricing Memorandum, although correct at the time of issue, has not been updated to reflect subsequent legislative changes since the date of issue. As a result, some information may no longer be valid.

This memorandum does not replace the law found in the *Income Tax Act* and its Regulations. It is provided for your reference. As it may not completely address your particular situation, it would be advisable to refer to the *Income Tax Act*, any applicable Regulation, and relevant case law. You may also want to contact a tax services office of the Canada Revenue Agency for more information.

Introduction

The purpose of this memorandum is to provide guidelines on how to proceed, in view of the Dudney decision, with cases under audit concerning fixed base or permanent establishment (PE) determinations under Canadian income tax conventions (also referred to as [treaties](#)), to provide a framework for general PE determinations, to raise some other considerations and to provide an explanation of the application of the treaty-based waiver guidelines to cases requiring a PE determination.

Background

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The Federal Court of Appeal (FCA) issued a decision in *The Queen v. William A. Dudney* (2000 DTC 6169) ("Dudney") on February 24, 2000, confirming the Tax Court of Canada's decision (99 DTC 147) in favour of the taxpayer. The Supreme Court of Canada refused to grant the Crown leave to appeal the FCA decision.

The issue in Dudney was whether a non-resident consultant providing services at a client's premises in Canada had a fixed base in Canada. The court held that a fixed base was conceptually the equivalent of a PE for the purposes of Article V (Permanent Establishment) and Article VII (Business Profits). Under the terms of the *Canada-U.S. Income Tax Convention*, Canada has the right to tax a resident of the United States who is providing services in Canada only if the person has a fixed base/PE in Canada. Otherwise, the U.S. would have the sole right to tax the income related to those services.

The FCA concluded that Mr. Dudney did not have a fixed base at the client's premises and, consequently, his income was exempt from tax in Canada. The FCA ruled that, to determine whether or not Mr. Dudney had a fixed base in Canada, the factors to be taken into account would include (1) the actual use made of the location in Canada, (2) whether the person had a legal right to exercise control over that location, and (3) the degree to which the location was objectively identified with the person's business. The judge added, "this is not intended to be an exhaustive list that would apply in all cases, but it is sufficient for this case".

When evaluating the factor of the location being objectively identified with the person's business, the FCA discussed Mr. Dudney's inability to carry on all aspects of his business in the space at his disposal. As shown below, generally the definition of a PE within Canada's tax treaties states that the business of the non-resident must be wholly or partly carried on through the fixed place of business, and therefore we are of the view that it is not necessary for the non-resident to carry on **all** aspects of their business at that particular fixed place in order to have a PE in Canada. As a result, cases under audit should be evaluated to determine if the business of the non-resident is partly carried on through the fixed place of business.

When reviewing the factor of control over the location, the FCA put some importance on whether the person had legal control of a space and set out a number of indices to be considered in determining whether a person has the control over the premises at their disposal necessary to establish that those premises could be considered to be a fixed base/PE. The FCA seemed to put some emphasis on the fact that while Mr. Dudney had access to the offices of the Canadian taxpayer, and did use them, his access was limited to the regular office hours of the Canadian taxpayer. While the Dudney case brought attention to the factor of legal control (sometimes referred to as physical control by the CRA), in cases where we cannot demonstrate that the taxpayer had such control, the case should be further evaluated to identify if there are other factors that may establish whether the taxpayer had a fixed base or PE in Canada. All the facts of a particular case should be reviewed in order to assess which factors are most relevant or determinant.

Therefore, when evaluating a PE case, the case should first, where possible, be distinguished from the Dudney case in terms of the facts of the situation. Next the case should be reviewed to determine if a PE exists. This memorandum provides a framework for making PE determinations, including some potential factors to be considered.

PE Determinations

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In general, PE determinations should be made in light of the particular words of a treaty, the jurisprudence, and the Commentary on the OECD Model Tax Convention on Income and Capital (OECD Commentary), taking into consideration departures of the particular treaty from the OECD Model Tax Convention on Income and Capital (OECD Model).

A PE under Canada's tax treaties is defined generally as "a fixed place of business, through which the business of an enterprise is wholly or partly carried on." According to the OECD Commentary on Article 5, this definition contains the following elements:

- 1) There must be a place of business.

- The term "place of business" covers any premises, facilities or installations used for carrying on the business of the non-resident, whether or not they are used exclusively for that purpose.
- A place of business may exist where there is a certain amount of space which is used by the non-resident for business activities.
- A place of business may be situated in the business facilities of another enterprise.
- No formal legal right to use a particular place is required.
- The mere presence of a non-resident at a particular location does not necessarily make that location a place of business.

2) The place of business must be fixed.

a) The place of business must be established at a distinct place.

- There has to be a link between the place of business and a specific geographical point within Canada.
- Where the nature of the business activities is such that these activities are often moved between locations, a single place of business will generally be considered to exist where a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

b) The place of business must have a certain degree of permanency, i.e. it is not of a purely temporary nature.

- Experience from the OECD member countries has shown that PEs normally have not been considered to exist where the place of business was maintained for less than six months.
- One exception may be where the activities are of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years).
- A place of business may constitute a PE even though it exists for only a short period of time, if the nature of the business is such that it will only be carried on for that short period of time. It is often difficult to determine whether this is the case.
- Temporary interruptions of activities do not cause a PE to cease to exist.

3) The business of the non-resident must be wholly or partly carried on through the fixed place of business.

- The activities need not be permanent in the sense that there is no interruption of activities, but the activities must be carried out on a regular basis.
- The business of the non-resident is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel).
- There are a number of business activities which are treated as exceptions to the general definition of PE in paragraph 1 of Article 5 even if the activity is carried on through a fixed place of business. The excepted activities, which are listed in paragraph 4 of Article 5 of the OECD Model and most if not all Canadian treaties, are generally preparatory or auxiliary activities.

These three elements form an appropriate framework for a PE determination.

Some examples of factors that may assist in determining if the elements identified above exist are:

1) There must be a place of business.

- Is the location in Canada a place where the non-resident is performing important functions of its business? If so, that would suggest the location may be a place of business.

- Is one of the non-resident's employees using the office or other facility of another company in Canada to perform the business of the non-resident?
- Look at the relationship between the place and the taxpayer's business. Does the place of business *serve* the business activity, or is it *subject* to the business activity of the non-resident? That is, does the place of business support the business activity, or does the business activity simply occur at the place of business?

2) The place of business must be fixed.

a) The place of business must be established at a distinct place.

- Determine if the place of business has a connection with a specific geographical point within Canada.
- Where the business activities of the non-resident are being performed in many places, a distinct place of business could be the location of the centre of the business activity. It must be established if there is a single distinct place of business (where the business activities constitute a coherent whole, commercially and geographically), or if there is more than one distinct place (each requiring a separate evaluation of whether a PE exists).
 - A coherent whole commercially could be established by a series of related contracts, e.g. with the same client, or for the same entity.
 - A coherent whole geographically could be established where the activities are carried on within a limited geographical area.

b) The place of business must have a certain degree of permanency

- What is the duration of the activities of the non-resident at the particular place in Canada? As stated in the guidelines provided above, generally a PE would not exist where the place of business was maintained for less than six months.
- Is the presence of the non-resident at the place in Canada recurrent? Is the place of business used for only short periods of time, but used regularly over long periods of time? If so, there is continuity of activity, and the place of business should not be considered to be of a temporary nature.

3) The business of the non-resident must be wholly or partly carried on through this fixed place of business.

- Compare the nature of the actual activities carried out in Canada to the nature of the business activities as a whole. Were the activities of relative importance to the enterprise as a whole?
- What is the scale of the activities carried on in Canada in terms of investment, employees or equipment involved and deployed at the place of business in Canada? For example, were there persons with authority to carry on some part of the non-resident's moneymaking activities present at the particular place in Canada?
- Are different aspects of the non-resident's business performed in Canada or are the activities of the non-resident restricted to those originally identified (perhaps by contract)? For example, does the non-resident perform marketing activities; solicit new contracts; follow-up on former contracts; etc.?
- Is the non-resident identified as working at the place of business in Canada (by business cards, letterhead, e-mail address, or being on the office directory, etc.)?

When dealing with situations involving a non-resident parent company and a Canadian subsidiary company, the existence of the subsidiary company does not, in itself, mean that the subsidiary company is a PE of the parent company. The parent company may, however, be found to have a PE if the premises belonging to the subsidiary company are used by the parent company and the premises constitute a fixed place of business through which the parent carries on its own business - i.e. that the elements identified above are satisfied.

In making a determination of whether or not a PE exists, there are numerous factors to be taken into consideration in deciding if the basic elements for a PE exist. The factors are generally outlined in the OECD Commentary and derived from jurisprudence. Which factors are

relevant in any particular case will be largely dependent on the nature of the taxpayer's business. Before making any determination, all the facts of a particular case must be considered. Under a different set of facts, other factors could supersede the factors listed by the FCA in the Dudney decision.

Other considerations

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Other types of PEs

This memorandum focused on the general definition of a PE. Article 5 of the OECD model provides for two other possible types of PEs: First is a PE in relation to a building site, or construction or installation project that lasts more than twelve months. The second type is the PE created by a dependent agent of an enterprise who has, and habitually exercises, the authority to conclude contracts in the name of the enterprise. A dependent agent is a person, whether or not an employee of the non-resident enterprise. The dependent agents may be individuals or companies and need not be residents of, nor have a place of business in the country in which they act for an enterprise. Consideration should be given to whether one of these types of PEs could be applicable to the situation under review. As mentioned above, PE determinations should be made in light of the applicable treaty; some treaties provide for other types of PEs as well.

Employee/Employer Relationships

There may be instances in which an argument can be made that a non-resident independent contractor is, in fact, an employee, rather than an independent contractor, and that the income earned is taxable as employment income. Reference can be made to the CRA publication [RC4110, Employee or Self-Employed?](#) Where the non-resident is determined to be an employee, whether of a Canadian employer, or of a non-resident employer (regardless of whether the non-resident employer has a PE/fixed base), the non-resident employee will be taxable on employment income earned in Canada, subject to any exemptions available in the applicable treaty, such as Article XV of the Canada-U.S. Income Tax Convention.

Additionally, if a non-resident employer is determined not to have a PE in Canada its non-resident employees providing services in Canada are still subject to withholding under section 102 of the Income Tax Regulations (see the current version of Information Circular [IC75-6R2, Required Withholding from Amounts Paid to Non-residents Providing Services in Canada](#)). A treaty-based waiver may be provided for this withholding tax in consideration of a bilateral tax treaty between Canada and the country of residence of the employee.

Treaty-based Waiver Guidelines

The CRA will continue to apply its [Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding](#) and its [Withholding Tax Waiver Guidelines for behind the scenes personnel in the film and television industry](#).

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