WHEN HAVING A REPRESENTATIVE IN CANADA CAN MAKE A FOREIGN COMPANY TAXABLE

Canada, like most countries, taxes non-residents on their income derived from businesses carried on in its territory. In the absence of a tax treaty, the general meaning of "carrying on business in Canada" is very broad and does not even require the existence of a fixed place of business. One of the most important effects of the vast majority of international tax treaties is precisely to permit such taxation only in cases where the non-resident operates through what is called a "permanent establishment" (or a "fixed base" in the case of professionals such as lawyers or accountants).

When a non-resident corporation decides to carry on business in Canada (in a broad sense), it therefore becomes crucial to determine whether or not we are in the presence of a permanent establishment, and whether measures can or should be taken in order to avoid taxation.

Tax treaties do not typically deal with sales or value-added taxes, such as the GST, HST or QST, nor are they the subject-matter of this article. Those taxes are governed by their own rules, so that a corporation which is not subject to income taxation may still have to register for sales tax purposes, with consequent obligations to collect them and report accordingly.

What is a permanent establishment?

The wording of most treaties on this issue is quite similar. Let's take the Germany-Canada treaty (the "Treaty") as an example. The general principle is simple enough in appearance: "...the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on". The Treaty then goes on to list things that constitute a permanent establishment: a place of management, branch, office, factory, workshop, mine, oil or gas well or quarry. A building site or a construction site or installation project can also constitute a permanent establishment, provided it lasts more than twelve months.

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These terms are still quite vague and can be given a broad meaning. For example, there is no requirement that the office, construction site, etc. actually belong to the foreign corporation, if its business is "wholly or partly" carried on through it. Thankfully, the Treaty goes on to provide more specific guidance.

Here are some activities which do *not*, in and of themselves, constitute a permanent establishment under the Treaty:

"(a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or

merchandise or for collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character";

or any combination of the above, so long as the overall activity is of a "preparatory or auxiliary character".

As soon as you leave the strict confines of these exceptions, you may find yourself with the dreaded permanent establishment. For example, referring to (d) above, maintaining an office in Canada for any purpose other than purchasing goods or merchandise or collecting information (for example, using the office to conduct occasional product demonstrations) will fall outside of the exemption.

A broker, agent, importer, wholesaler or distributor does not necessarily constitute a permanent establishment of its foreign principal, as long as it acts independently and in the ordinary course of its business. However, and this is very important, the local representative should not have the ability to conclude contracts (i.e. make commitments) on behalf of its principal, unless those commitments only relate to the matters described in paragraphs (a) to (e) quoted above. This is not usually a problem with distributors because they purchase the goods in their own name and then sell them for their own account. In the case of an agent, however, the crucial point is that the agent never be allowed to accept purchase orders in the territory. Its job is to solicit and receive customers' orders. It is up to the principal to accept them, and to send customers notification of its acceptance, from the comfort of its own foreign base. Once the order is accepted, and a legal relationship is formed between the principal and the customer, it is okay under (a) above for the agent to fill the order by arranging for delivery of goods stored under its control.

What then?

Being found to have a permanent establishment in Canada may or may not translate into higher taxes overall, as any taxes payable in Canada may give rise to a credit in the home country. But the allocation of revenues and expenses to the Canadian branch can be a messy business; so, in most cases, companies will be well advised to take advantage of the applicable tax treaty and avoid taxation of the parent company entirely. This will sometimes be achieved by incorporating a Canadian subsidiary, as the Treaty makes clear that a subsidiary or affiliate will not usually be considered to be a permanent establishment of its parent company. Care must be taken in defining its role and responsibilities, in particular to make sure that the subsidiary is acting for its own account and not as its parent's agent. A clear delineation of responsibilities between the corporate entities will preferably be reflected in a simple written contract between them.

An ounce of prevention...

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Bernard Lette
Lette LLP
20 Queen Street, West, #3300
Toronto ON M5H 3R3
Direct: 416-971-4898
Email: blette@lette.ca