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THE USE OF SUBSTANTIAL EQUIPMENT OR MACHINERY AT ANY TIME DURING THE YEAR AS A PERMANENT ESTABLISHMENT

Fred Feingold

U.S. rulings indicate a liberal interpretation by the United States of the provision in the Canada-U.S. income tax treaty providing that the use of substantial equipment or machinery at any time during the year constitutes a permanent establishment.

Article I of the Canada-U.S. income tax convention (the treaty) provides that an enterprise of one State (e.g., Canada) shall not be subject to tax by the other (the United States) in respect of its industrial and commercial profits except to the extent such profits are allocable to a permanent establishment maintained in the other State (the United States).

While the term "permanent establishment" has been defined in section 3(f) of the Protocol to the treaty (the language of which has remained unchanged since 1950), there still remains some confusion regarding the proper interpretation of the second sentence of section 3(f).[5] That sentence reads:

> The use of substantial equipment or machinery within one of the contracting States at any time in any taxable year by an enterprise of the other contracting State shall constitute a permanent establishment of such enterprise in the former State for such taxable year.

If interpreted literally, the *use* of equipment determined to be "substantial" for even one day during the taxable year[6] would render the user as having a permanent establishment during the year. Moreover, under a literal reading, the user need not own or maintain[7] the equipment which is determined to be substantial; the threshold requirement is met upon mere use.

Given the subjective nature of the term "substantial," it is easy to see how a literal interpretation of this language could lead to uncertainty. Is equipment substantial, for example, when it meets some objective test of size or value? Or is the test to be applied on the basis of comparative value to the enterprise as a whole or possibly to the worth to the project in the host contracting State?

The uncertainty suggested above has led to some suprising and often inconsistent positions being advanced upon audit both in Canada and the United States. Not so long ago, for example, there was a period when Canada appeared to be taking the position on audit that a U.S. enterprise presenting a concert in Canada for even one day had a permanent establishment in Canada because it used substantial equipment—that is, electronic equipment such as microphones. Possibly in retaliation, it is understood that in one case the United States took the position that a Canadian golfer had a permanent establishment in the United States solely because of the use of substantial equipment. Astonishing as it may seem, it was not his golf clubs that were determined to be the substantial equipment but rather it was the use of his talent as a golfer that was being advanced as the substantial equipment.

The latter illustration is obviously an extreme position (which, incidentally, was dropped after consultation at a higher level), and apart from its amusement value is not of significance. Indeed, the IRS subsequently issued a series of private rulings that made it clear that it would no longer push for a literal reading of the substantial equipment language or for a broad definition of that term. Letter Rulings 7946043 (date not given), 7943045 (July 25, 1979), 7937060 (June 14, 1979), and 7846024 (August 16, 1978) state that providing scenery, properties, wardrobe, and technical equipment does not constitute use of substantial equipment or machinery within the meaning of section 3(f) of the Protocol. The position indicated by these rulings appears consistent with the history of the provision and a published ruling that deals with an analogous situation.

Concurrent with the addition of the troublesome language in section 3(f) of the Protocol, the report of the Secretary of State, in discussing the proposed amendment to section 3(f), used the following language:

> This [amendment] . . . in practical effect, merely [is] a clarification and is consistent with the interpretation heretofore adopted with respect to the convention and protocol of 1942. The importance of this clarification arises mainly from the fact that American enterprises are engaged regularly in Canada in building roads, installing public utility projects, and that much of this work extends over only portions of the year, such as work of a seasonal character.[8]

Thus insofar as the United States is concerned, the intent of the language appears clear: to require a tax in the country of source at least in those cases where the enterprise of one State regularly carries on construction work in the other. Moreover, it appears to have been intended that the source country could impose its tax for a year regardless of whether in that year the activity was of continuous duration.

That this was intended is not unusual. Several of the income tax conventions to which the United States is a party provide that a construction site of a specified duration constitutes a permanent establishment.[9] Moreover, even in the absence of the inclusion of language specifying a minimum period necessary for a construction site to constitute a permanent establishment, the United States had some time ago taken the position that although in the absence of language to the contrary, construction-related activities may not constitute a permanent establishment, actual construction activities may constitute a permanent establishment even in the absence of an express provision in the treaty so providing.[10]

The current U.S. position is stated in Revenue Ruling 77-45.[11] In the ruling, a Canadian corporation (M) was a consulting engineering firm engaged in the planning and design of manufacturing plants. M contracted to plan and design a plant located in the United States. The plant was constructed by a general contractor under contract with M's U.S. client.

M had employees in the United States who performed various activities including inspection and making minor changes in plans and specifications. These employees were not authorized to make major decisions that would affect basic plan designs or result in significant departures from the construction contract. Moreover, the employees were under the supervision of and in continual contact with higher level project managers in Canada. The on-site employees of M worked in a construction shed provided by M's client. M had only one project in progress in the United States during the taxable year and its duration would not exceed one year. In holding that M did not have a permanent establishment in the United States, the ruling stated:

> The definition of "permanent establishment" in section 3(f) of the Protocol does not specifically include a construction site. It is the view of the Internal Revenue Service that, in the absence of specific treaty language to the contrary, a construction site of any significant duration is generally considered to constitute a permanent establishment even if a treaty's permanent establishment article is silent as to such site. It is also the view of the Service that planning and supervision carried on by a building contractor are part of the activity allocable to its construction site permanent establishment. Planning and supervision of construction work do not of themselves, however, make a construction site a construction site of the enterprise that plans and supervises construction. Thus, since M's activities are restricted to supervision and planning, whether they constitute a permanent establishment

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[5] The sentence was added by Article I(o) of the Supplementary Convention, dated June 12, 1950, relating to income taxes between the United States and Canada.

[6] Compare Article 5(3) of the 1977 OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital (the OECD treaty).

[7] Compare Article 5(3)(g) of the Israel-U.S. income tax convention (not yet ratified).

[8] U.S., Department of State, *Report of the Secretary of State on the Supplementary Convention relating to Income Taxes between the United States and Canada of June 12, 1950*. Reprinted from U.S. Congress, Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions*, vol. 1 (1961), 500.

[9] See, for example, Japan-U.S. income tax convention, March 8, 1971, Article 9(2)(g); 23 U.S.T. 967; T.I.A.S. no. 7216 (24 months); France-U.S. income tax convention, Article 4(2)(h); 19 U.S.T. 5280; T.I.A.S. no. 6518 (12 months).

[10] S. Exec. Rep. No. 10, 88th Cong., 2d Sess., 67 (1962). The ruling is consistent with the commentary on Article 5 of the OECD treaty. Paragraph 16 of the commentary provides that ". . . planning and supervision is not included [in the term 'building site or construction or installation project'] if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising work."

[11] 1977-1, C.B. 413.

must be considered without regard to determinations applicable to construction sites.

In the instant case, the activities of M and its employee consist primarily of planning and supervision of the construction activities. M's employees in the United States are not authorized to make major decisions concerning basic plan design. In addition, M's employees use a building and furniture provided by M's client without separately bargained for consideration; and the duration of the project will not exceed 1 year. Thus, the presence and activities of M's employees do not constitute the maintenance of a permanent establishment by M in the United States within the meaning of section 3(f) of the Protocol to the Convention.[12]

In summary, it appears that the issuance of Revenue Ruling 77-45, taken together with the issuance of the private letter rulings referred to above, may indicate that the IRS's current position is to apply the "use of substantial equipment or machinery" language only to situations relating to equipment or machinery being used at construction sites. Where a construction site is maintained by the taxpayer for some significant period, a permanent establishment will be found to exist. While this would be consistent with the history of the language of this provision, the omission in the ruling of the reference to the substantial equipment provision continues to leave some residual concern on this issue in situations where equipment or machinery is being used in the United States other than with respect to construction sites.

RULING RAISES FAVOURABLE IMPLICATIONS FOR CREDITABILITY OF CANADIAN CAPITAL GAINS TAX ON LIQUIDATING DIVIDEND

Stanley Weiss

A private ruling may have favourable implications for the allowance of a U.S. foreign tax credit for Canadian capital gains tax on a liquidating dividend.

Under U.S. tax rules, as set forth in the proposed regulations relating to the foreign tax credit, a foreign tax is creditable only if it is computed on the basis of "realized net income" to a degree equivalent to that under the U.S. income tax. It is not clear whether a foreign tax that does not meet this test still would be allowed as a credit under the applicable tax treaty, such as the present Canada-U.S. income tax convention.

Concern has been expressed whether the Canadian capital gains tax is creditable where it is imposed under circumstances that do not constitute a realization event by U.S. standards. A private letter ruling recently released by the U.S. Internal Revenue Service, relating to the portion of the Swiss National Defense Tax imposed on net profits, suggests that the "realized net income requirement may not be construed as narrowly as was feared.

While a private ruling cannot be relied upon by taxpayers other than the one to whom it is issued, it often provides some useful insight into the IRS's thinking and may be embodied eventually in a revenue ruling of general application. The private ruling in question—LTR 8002065, dated October 17, 1979 — involved the distribution of the stock of a foreign subsidiary by a Swiss holding company to its U.S. parent. Under Swiss tax law, such a distribution is treated as a sale for fair market value by the distributing corporation and therefore is subject to the Swiss National Defense Tax. Although a distribution of property ordinarily is not regarded as a realization event to the corporation for U.S. tax purposes, the Swiss tax nevertheless was held to be creditable. The ruling does not discuss this issue directly but finds generally that the Swiss National Defense Tax is computed in a manner similar to the computation of taxable income under U.S. principles.

Under Canadian law, too, corporate distributions of property, including the stock of other corporations, are treated as taxable sales at fair market value by the distributing company. Unlike Switzerland, where the gain is taxed like any other corporate income, Canada has a separate capital gains tax, but it is difficult to conceive how this factor could be regarded as decisive. It also is unclear what implications this ruling might have for the creditability of the Canadian capital gains tax imposed on gifts or at death or on the appreciation in value of property owned by Canadian residents upon their departure from Canada. It is hoped, however, the ruling portends a more liberal view by the IRS than anticipated on these issues as well.

[12] Ibid.

REVENUE RULING DENIES TREATY ADVANTAGES TO CANADIAN RESIDENTS WHO WERE FORMERLY U.S. CITIZENS

Sidney I. Roberts

Canadian residents who were formerly U.S. citizens may be denied the benefits of the Canada-U.S. income tax treaty, according to the Internal Revenue Service.

A recent Revenue Ruling (79-152),[13] which denies treaty advantages to certain former U.S. citizens, appears to be contrary to the intention of Congress.

The ruling may be applicable to a broad spectrum of Canadian residents, ranging from the U.S.-born wife of a lifelong Canadian resident who relinquishes her U.S. citizenship, to an emigrant from the United States who prefers Canadian citizenship or, as in the ruling, relinquishes U.S. citizenship and residence for the purpose of avoiding capital gains tax. (The United States does not impose a departure tax on unrealized capital gains.) Moreover, the ruling is retroactive to 1967.

As is well known to Canadian tax professionals, the United States generally taxes its citizens resident abroad on their worldwide income. In 1966, Congress enacted section 877 of the Internal Revenue Code, intended to frustrate tax avoidance through relinquishment of U.S. citizenship. Section 877 provides that such relinquishment after March 8, 1965 for the purpose of avoiding U.S. tax subjects the expatriate, now a foreign taxpayer, to U.S. tax at the same rates as are applicable to U.S. citizens for the succeeding ten years. The tax, however, is imposed only on U.S. source income, expanded for this purpose to include gains from the sale of U.S. real property, stock of U.S. corporations, and debt obligations of U.S. corporations or other U.S. persons.

Whether the relinquishment of U.S. citizenship had "for one of its principal purposes" the avoidance of U.S. tax may be a difficult issue to resolve in an expatriate's favour in a particular case. This is especially so since the Internal Revenue Service is aided by a provision that imposes on the expatriate the burden of proving that his loss of citizenship did not have the "bad" purpose if the Service first establishes that it is reasonable to believe that his loss of citizenship would result in a substantial reduction in his U.S. income tax.

In the case of a Canadian resident who was formerly a U.S. citizen and to whom the provisions of section 877 are applicable, the issue arises whether section 877 prevails over the Canada-U.S. income tax treaty. For example, are the capital gains exemption and the reduced 15 per cent U.S. tax rate available under the treaty or are they denied, by virtue of the provisions of section 877, to a resident of Canada not engaged in business in the United States?

The key to the answer should lie in the "saving clause" of the treaty, Article XVII, which provides that notwithstanding the provisions of the treaty, the United States may include in the income of (*inter alia*) "its citizens" all income that is taxable under U.S. internal law. The issue, then, is whether a former U.S. citizen is a citizen of the United States under U.S. internal law. If he is not, taxation under section 877 would seem to be foreclosed by the treaty.

The ruling does not find that our Canadian resident is a U.S. citizen under U.S. law. Rather, stating that the saving clause was intended to "preserve taxation on the basis of citizenship," it finds that taxation under section 877 "is a manifestation of United States taxation on the basis of citizenship" under which "the taxpayer remains subject to tax as a United States citizen within the meaning of the treaty 'savings clause.'" On this basis, the ruling denies him the benefits of the treaty.

Legislative History

Canadian tax professionals have become accustomed to the strange U.S. predilection for emphasizing legislative history rather than legislative language. Indeed, as early as 1954, a Canadian writer in the *Canadian Bar Review* gibed that, in the United States, whenever the legislative history is ambiguous, it is permissible to refer to the statute.

The legislative history of section 877 indicates quite clearly that Congress did not intend to change any advantage afforded by a treaty. The earliest version of the bill was accompanied by an explanation prepared by the Treasury Department itself, stating that section 877 "would not apply if contravened by the provisions of a tax convention with

[13] 1979-1 C.B. 237.