The Meaning of 'Enterprise,' 'Business' and 'Business Profits' Under Tax Treaties and EU Tax Law

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11.1. Function of the concept of “business” in Canadian tax law

Canadian domestic tax law does not employ the concept of “enterprise”, so the first part of this Country Report focuses solely on the role of the related concept of “business” in Canadian law.

To an income tax theoretician, the need to determine whether income is from a business or enterprise, or the need at all for a concept such as business or enterprise in an income tax statute, must appear to be a bit of a mystery. Why would tax practitioners have a need for such a concept? After all, the proper tax base for an income tax is simply income. If a person has income they should be taxed on the amount of that income, irrespective of its source and irrespective of the characterization of the activity that led to that income. Most tax theoreticians agree that the most appropriate definition of “income” for the purposes of a tax system designed to tax persons on the basis of their ability to pay is that given by Henry Simons in his 1938 classic, Personal Income Tax: The Definition of Income as a Problem of Fiscal Policy: “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question.” Clearly, this definition does not suggest the need to determine whether income has a source in a business or enterprise or suggest any other need for such a concept in tax law.

In Canada, in 1967, the well-known and justly praised Royal Commission on Taxation (the Carter Commission) sought to operationalize the Schanz-Haig-Simons definition of income and construct an ideal income tax based upon it. If the Commission’s recommendations had been followed by the Canadian government, the concept of business or enterprise would have only a minor role in the Canadian tax system. The Commission argued for a comprehensive definition of income:

We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals and families. If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power, or it fell in his lap without effort.

In 1972, when the Canadian government completely revised its income tax, it implemented a number of the recommendations of the Carter Commission; however, the income tax continued to be premised on the English legal concept of income instead of the comprehensive Schanz-Haig-Simons concept. Consequently, the concept of business or enterprise continues to play a central role in the design and implementation of the Canadian income tax. The various important uses of the concept might be divided into four categories.

First, all income tax systems must distinguish between non-deductible personal expenses and deductible expenses that are incurred to earn income. In an equitable income tax system, two individuals who personally consume goods and services of the same value should bear the same amount of tax. Thus, personal expenses should be non-deductible, but if an expense does not yield any personal benefits and is incurred to earn income,
the expense should be deductible since the resulting income will be taxable. The concept of business is often an issue in Canadian tax law in delineating this margin. If a taxpayer is carrying on an activity, it must be a business for expenses to be deductible.

Second, under Canadian tax law, in order to be taxable, income must have a source; in particular, it must be derived from an employment relationship, property, a business or the disposition of capital property (and hence be taxed as a capital gain). Even though the general charging provision of the Canadian Income Tax Act is broadly worded (s. 3 provides that income includes “income from the year … from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer’s income for the year from each office, employment, business and property”) the Canadian Supreme Court has basically held that unless income can be attributed to one of the specifically enumerated sources it is not income for tax purposes. These judicial holdings reflect the influence of the English concept of income on Canadian tax law. To be taxable, income must be a recurring and expected amount, the result of productive economic activity and derived from a source. Thus, numerous amounts are not taxed under Canadian law, such as gifts, windfalls, found property, winnings from gambling, lotteries and other games of chance, and amounts such as punitive damage awards. However, if amounts such as these can be characterized as income from business, they are then subject to tax. Under Canadian income tax law, another purpose of the concept of business is therefore to distinguish between amounts that are not taxable because they do not have a source and amounts that are taxable because they can be characterized as having a business source.

A third function of the concept of business under Canadian tax law arises since, although they are aggregated in calculating a taxpayer’s taxable income, the various broad sources of income – employment, property, business, and capital gains – are each treated somewhat differently, both for administrative and policy reasons. It is therefore necessary to distinguish among these various sources of income. Although making this distinction is usually a straightforward task, the concept of business shares an ambiguous margin with each of these other concepts. In Canadian tax law, the question of whether an activity is a business (or enterprise) often arises in the context of categorizing a receipt either as a business receipt or a receipt that should more appropriately be taxed as being from one of these other sources.

Finally, the business concept is used in Canadian income tax law as a geographic threshold. A non-resident might be carrying on commercial activity in Canada, but unless that activity amounts to “carrying on a business” in Canada, the profits from the activity will not be taxed in Canada under the domestic tax law.

The meaning of “business” (or “enterprise”) as used in Canadian income tax law is discussed in turn under each of these four purposes it serves. However, first, the use of the concept in Canada in non-tax law will be briefly reviewed.

11.2. The meaning of “enterprise” and “business” in Canadian non-tax law

The concept of business is employed in almost every area of Canadian law: contract law; labour and employment; intellectual property; municipal and real property law; bankruptcy; securities regulation; commercial law; and business associations.

As in tax law, the function of the concept of a business serves several broad purposes: to distinguish some kinds of regulated activities from other kinds of regulated activities; to establish a sufficient level of activity for regulation to apply; and to establish a geographic nexus. Of course, the use of the concept in tax law of distinguishing between non-deductible personal expenses and deductible business expense in order to arrive at an individual’s ability to pay has no parallel in other areas of law. In the following brief discussion labour law is used to illustrate the broad uses of the concept in other areas of law.

First, in some instances, the concept of business is used to assist decision-makers to distinguish between different types of regulated activities. For example, if a person is an employee, the payer is bound by the employment standard legislation (and must pay minimum wages, provide for holidays, etc.), but if there is a

5. A number of miscellaneous sources of income are specifically subject to tax in s. 56 of the Act.
business relationship between the payer and payee, these standards do not apply. Generally, the structure of the operations is irrelevant for determining whether an activity constitutes a business. As stated in Syndicat des travailleurs(euses) de Murray Hill, “[t]he crux of the definition of business [in the Canada Labour Code] is not the corporate structure or the concept of a corporate entity but rather the type of operation.”

Second, the concept of a business may be used to identify circumstances where a sufficient degree or particular type of activity is required before regulation applies. For example, in British Columbia Radio, the issue was whether taxi zones – i.e. designated areas on public streets where automobiles for hire may stand and solicit passengers – were “place(s) of business, operations or employment”. If the zones were places of business, then the plaintiff driver’s union was permitted to picket the sites during a legal strike. Since the court found that the zones were places where the plaintiff conducted its operations, it held that the zones were places of business. Similarly, in Tobique Band Council, the Court was required to consider whether the Canada Labour Code applied to a particular employer. For the Code to apply, the employer had to be an undertaking or business. The Court accepted a definition of business given in a much earlier case that suggested that the word means “almost anything which is an occupation, as distinguished from a pleasure – anything which is an occupation or duty which requires attention.” The judges in the case further noted that the word “business” can apply to operations that are carried on without an expectation of profit. Similarly, it might be noted that in the intellectual property context, the concept of business has been given an equally broad interpretation. The Trade Marks Act protects any “person”, a concept which includes a lawful association engaged in business. In considering the degree of activity or scope of the word “business” in this context, the Board held that “the word ‘business’ … does possess a broad definition and could encompass any ‘purposeful activity’ which might well … be charitable or educational in purpose.”

In the third instance, some Canadian regulations use the concept of business to frame a geographical connection to an activity. Again, in labour law, delineating an employer’s place of business is important for establishing where employees may picket. Although labour law is a divided jurisdiction and varies in each of Canada’s provinces, the reasoning in Newfoundland & Labrador Hydro, interpreting the federal legislation, is illustrative:

> [Subsection (1) of Section 124 [of the Labour Relations Act, 1977, S.N. 1977, c. 64] allows picketing only at the employer’s place of business, operation or employment…. [T]his would permit members of the defendant unions to picket at the place of business or operations [of each individual employer]. The … Project [where the employees are performing contract work] is not the place of business of these three employers. Their head offices are situated elsewhere in Newfoundland and the only business they are carrying on at the project is the performance of their contracts in the construction of various segments of the project.

### 11.3. The meaning of “enterprise”, “business” and “business profits” in Canadian tax law

This section reviews the four main purposes of the concept of business as used in Canadian income tax law: to distinguish non-deductible personal expenses from deductible expenses incurred to earn income; to distinguish non-taxable amounts from taxable amounts that have a source (in business activity); to determine the tax treatment of an amount that has a source in a business activity as opposed to the tax treatment of an amount that has a source in an employment relationship, the ownership or property or a capital gain; and to determine whether there is a sufficient economic nexus between an amount and the jurisdiction of Canada so that the government of Canada can justifiably subject it to tax in Canada (whether a non-resident is carrying on business in Canada).

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11.3.1. Distinguishing non-deductible personal expenses and deductible business expenses

One of the more basic principles underlying all income tax systems is that personal expenses should not be deductible. Often, a taxpayer may carry on an activity that has large personal benefits but at the same time might yield income. These activities include all of those that some taxpayers pursue solely as recreational hobbies but that others pursue in order to earn income, such as e.g. photography, pottery, farming, gambling and horse racing. Consequently, every income tax system must distinguish between so-called hobby activities, in which the expenses are not deductible because the personal benefits are too large, and legitimate business activities, in which the expenses are incurred primarily to earn income and therefore should be deductible. The concept of business is important for this reason.14

As a way of dealing with this problem, some tax systems restrict the deductibility of expenses for certain activities to only the income earned from such activities. Others restrict the number of years that losses can be deducted from such activities unless a profit is generated. In Canada, this problem is dealt with primarily by relying on the concept of business. Canadian courts have developed the so-called “reasonable expectation of profit” test to assist in determining whether there is business in this context. If taxpayers cannot show that they have a reasonable expectation of making a profit from an activity, it is presumed not to be a business but instead a hobby. In these cases, taxpayers cannot deduct expenses associated with the activity. The language for the test was derived from the wording of the definition of personal and living expenses in the Income Tax Act, which are explicitly denied deductibility.15 Personal or living expenses are defined to include “the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or common-law partnership or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit” (emphasis added).16

In deciding whether taxpayers are carrying on an activity with a reasonable expectation of profit the courts examine all of the objective facts and circumstances surrounding the activity, such as the taxpayer’s profit or loss experience in past years, the taxpayer’s training, the taxpayer’s intended course of action and the capability of the venture as capitalized to show a profit.17

One of the most contentious areas in which the distinction must be drawn between a hobby and a business has been in relation to gambling activities. Gambling is tricky since, on the one hand, under Canadian law, if it is not being carried on as a business, any income won is not taxed and of course any losses incurred are not deductible. On the other hand, if it is being carried on as a business, the income is taxed and losses are deductible. One of the early leading cases was Morden,18 in which the taxpayer participated in extensive gambling between 1942 and 1948. Among myriad gaming activities, he owned up to 12 horses and raced them in Canada and the United States. In 1949, he sold his stable, save one horse, and significantly decreased his gambling. The years under review by the court were 1949 and following. The issue was whether in those years the taxpayer had winnings that could be characterized as income from business or whether they were merely a windfall derived from the hobby of gambling.

In Morden, the court articulates the test for distinguishing between non-taxable hobby income and business income as an inquiry into whether the taxpayer intended to conduct himself in an “enterprise of a commercial character” or whether he primarily intended to entertain himself. For the period under review, the court determined that the taxpayer’s activities simply reflect a hobby. He may have spent a fair amount of time gambling, he may have been passionate about it and the stakes may have been high, but these factors do not suffice to determine that he had attempted to profit from the activity.

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15. Income Tax Act, supra, s. 18(1)(h).
16. Id., s. 248(1).
Generally speaking, Canadian courts have been reluctant to hold that gambling wins have been income from business.19 This has been true even where there is significant activity. In Leblanc,20 the taxpayers were brothers who purchased thousands of tickets in sport lotteries and had gross winnings of roughly CAD 55 million. Nevertheless, the court held that their activities did not amount to a business.

In response to concerns over the Canada Revenue Agency’s assessment in Leblanc, at one of its regular round-table meetings the Agency articulated its view on the appropriate test for the finding of a business in the context of gambling activities:

Assessing the taxability of gambling activities is unique in a number of ways. Games of pure chance, like lotteries, lack the badges of trade to which the traditional tests of business activity can be applied. Traditional tests to determine the existence of a “business” normally include an assessment of a taxpayer’s profit-making purpose (that is, “pursuit of profit”) and the commerciality of a taxpayer’s activity.…

Usually the frequency and systematic nature of an activity will be indicative of a “business.” The traditional common-law definition of “business” is “anything which occupies the time and attention and labour of a man for the purpose of profit.”

Such a definition would usually be unexceptionable when one is talking about a commercial activity. If applied literally and mechanically it would include the activities of a person who consistently and regularly placed bets on horses, or played the lotteries or the gaming tables. It would mean that the gambling activities in every case that I have cited would be a business, yet we know that this is not so. Gambling – even regular, frequent and systematic gambling – is something that by its nature is not generally regarded as a commercial activity except under very exceptional circumstances.…

While the “pursuit of profit” test is meaningful in other cases, it is not a meaningful test to apply to a gambling activity. Gambling is anomalous because no one gambles for any reason other than in pursuit of profit. Accordingly, when the first-stage test is applied to gambling cases, one would always conclude that the “pursuit of profit” element was satisfied. Furthermore, the usual indicia of commerciality, such as frequency and systemization, are also not relevant criteria to be applied to a game of chance.21

As mentioned above, in deciding whether an activity is carried on as a personal activity or a business activity, Canadian courts have used as a proxy of this determination an objective reasonable expectation of profit test. Somewhat parenthetically, a few years ago Canada Revenue Agency attempted to use this test in order to disallow the deductibility of certain taxpayers’ interest expenses on the grounds that the taxpayers had no reasonable expectation of making a profit from the business or investment to which the loans related. i.e. the Agency attempted to use the test to deny that the taxpayer was carrying on a business at all. The problem that the Agency was concerned about arises under the Canadian income tax law since taxpayers are able to borrow money and make an investment (or start a business) and deduct the interest expenses even though the current income from the investment or business might be modest (far less than the interest expense); the taxpayer will be counting on realizing most of their investment or business return many years later in the form of a capital gain. In these types of cases the Agency attempted to deny the deductibility of the interest expenses on the grounds that the taxpayer had no reasonable expectation of making a profit from the investment or business. (Under Canadian income tax, capital gains are not considered income from an investment or business.)

The Supreme Court of Canada addressed the issue in Stewart22 in 2002. The taxpayer in Stewart was an experienced real estate investor who entered into an agreement to acquire four condominium units. The acquisition of the units was highly leveraged. In fact, only CAD 1,000 was spent on each unit; the rest of the purchase price was borrowed. The issue was whether the taxpayer could deduct the interest expense. In deciding the matter, the Court decided that a reasonable expectation of profit test could not be used to determine whether the income had a business source. The purpose of the test, it held, was simply to distinguish between personal and business activities and, thus, if the taxpayer’s activities could not yield a personal benefit, the test should not be applied. In permitting the deduction of the losses, the Court held there was no personal element to the purchase and rental of the four properties. Although the case generated considerable comment and in 2003 the Department of Finance proposed amending the income tax legislation to incorporate a broader application of the reasonable expectation of profit test, in fact no amendments were made and the lower courts have followed the...
Stewart case in restricting the reasonable expectation of profit test to distinguishing personal from business activities.23 Thus, an activity that does not yield personal benefits might be a business under Canadian tax law even though the taxpayer does not have an objective reasonable expectation of making a profit.

11.3.2. Distinguishing non-taxable amounts with no source from business income

Canadian courts have traditionally relied upon English precedents in interpreting the concept of income for tax purposes. Under this concept, in order to be taxable, an amount must be recurring and expected, the result of productive economic activity and derived from a source. Hence, income such as gifts, found property and other windfalls, gambling and lottery winnings, and a whole series of one-off receipts are not taxable in Canada unless they can be characterized as business income.

The use of the concept of business in this context can be illustrated by reference to found property. On the one hand, if taxpayers simply stumble on valuable property, even though they are able to claim legal title, the value of the property will not be subject to income tax. On the other hand, if taxpayers organize their affairs in such a way that it can be inferred they are attempting to make a business out of finding property, the value of any found property will be taxed.24

11.3.3. Distinguishing business income from other sources of income

Even though income is a global concept, and taxpayers in many tax systems are taxed on the aggregated amount of their income, almost every tax system has found it necessary both for administrative and policy reasons to distinguish between various common sources of income. Canadian tax legislation distinguishes between employment income, property income, business income and capital gains. Even though these sources of income are basically aggregated in arriving at the taxpayer’s taxable income to which the progressive rates apply, each of these four sources of income are taxed slightly differently and therefore they must be distinguished from one another.

11.3.3.1. Distinguishing employment income from business income

Canadian income tax law distinguishes between employees earning employment income and independent contractors earning business income, largely for three reasons. First, if the payment is employment income, the payer has to withhold an amount for taxes from every payment and remit it to the government. Withholding increases compliance. Since a payer in an employment relationship is likely to be a businessperson and be aware of the employee’s total income, and the payments are likely to be almost exclusively for services rendered, imposing withholding obligations on employers is (relatively) administratively easy. In contrast, with business income it is assumed that the payee is likely doing work for lots of different people and incurring numerous expenses in delivering goods and services and it would therefore be difficult (if not impossible) for the payer to know the correct amount to withhold for taxes owing.

Second, employees are to able account for their yearly income on a cash basis. In contrast, normally, income from business must be accounted for on an accrual basis. The rationale for this differential treatment is that employees are less likely than independent contractors to have control over the timing of the receipt of their earnings. In addition, cash accounting keeps the computation of income simple for the vast majority of taxpayers since all they have to keep track of is their cash flow.

Third, under Canadian tax law, employees generally cannot deduct expenses incurred in earning their employment income, whereas generally all expenses incurred in earning income are deductible from business income. This difference between the two sources of income is based on the assumption that the great majority of taxpayers report only employment income and it would be an impossible task to audit them to verify the validity of their claimed employment expenses; moreover, it is assumed that most employees do not incur many

expenses in earning their employment income and, to the extent that they do, they can either arrange to have their employer bear the expense directly or be reimbursed for it.

From the foregoing, it might be assumed that the test for distinguishing between employment and business income would be based on factors such as whether the payer for services can predict with some accuracy the payee’s annual income, whether the payee has some discretion over the timing of payments and whether the payee is likely to incur few expenses or be able to arrange for the payer to cover the expenses incurred in delivering the services. However, in interpreting the concepts of employment and business in Canadian income tax legislation, the courts based the distinction almost exclusively on the tests developed in labour and tort law for distinguishing between employees and independent contractors, where the tests were developed to condition the application of employment standards and limit vicarious liability, respectively.

Since the consequences are significant, this distinction is frequently litigated in Canadian tax jurisprudence. The legislation provides almost no guidance in making the distinction. Employment is defined as meaning “the position of an individual in the service of some other person...” and business is defined as including “a profession, calling ... an adventure in the nature of a trade.” Basically, in applying the tests developed in labour and tort law, the courts consider all of the facts and circumstances and in particular the degree of control the payer has over the services performed by the payee (control over the method of work, when and where the work is performed, whether it must be performed exclusively by the payee, etc.), whether the payee has to provide his or her own tools and facilities, whether there is a chance that the payee might suffer a loss or realize a profit, whether the payee’s work is integrated into the business of the payer, whether the payee is paid by the hour or for achieving a particular result and whether the employee is in economic reality dependent on the payer. Based upon a consideration of all of these factors, a judgement is made as to whether the payee is earning income from employment or business.25

The leading Canadian case, Wiebe Door,26 illustrates the application of these factors. The taxpayer-payer failed to deduct Canada Pension Plan deductions and unemployment insurance premiums as would be required if the payees were employees. Basically, the taxpayer-payer sold garage doors and hired a number of door installers to install the doors and make required repairs. Canada Revenue Agency argued that the door installers were employees. In holding that the installers were earning income from business, and therefore the taxpayer-payer was not required to withhold income taxes or social insurance premiums, the Court noted that the taxpayer-payer had little control over the way in which the installers did their work, indeed, when requested to install or repair a door the installers could accept or refuse the offer and if they accepted to work they could arrange with the garage owner when the work would be done; the installers provided their own vehicles for delivering the doors and their own tools for installing them; the installers were paid by the job and not by the hour; and the installers accepted the risk that if the door installation was faulty they would undertake the repairs. The work done by the installers therefore had all the earmarks of a business.

11.3.3.2. Distinguishing income from property from business income

Under the Canadian income tax law, income from property and income from business are both basically taxed the same; thus, in most cases it is not necessary to distinguish between them. However, certain specific provisions of the legislation apply only to one or the other and therefore the distinction must be made; for example, if one spouse transfers property to the other, the rules that attribute the income from the property back to the transferor spouse for tax purposes only apply to income from property; rules that restrict the deduction of capital cost allowances to income earned from the property only apply to income from property; and the rules for allocating income to each province for tax purposes apply differently for income from property and business (property income is allocated to the province in which the owner is resident; business income is allocated to the province in which the business has a permanent establishment). Also, like most tax systems, the Canadian tax rules that apply to non-residents distinguish between income from property and business. If a non-resident earns property income in Canada, the familiar flat withholding tax applies to the gross payment; if non-residents are carrying on business in Canada, they are taxed under the normal rules that apply to business income.


Very basically, Canadian jurisprudence distinguishes between income from property and business simply based upon the amount of services the taxpayer performs in earning the income. Conceptually, income from property is income earned from passively renting property; income from business is income earned from a combination of property and services. With residential rental units, for example, if a taxpayer simply rents out one or a small number of units, the income will be classified as income from property; however, if the taxpayer rents out a large number of units and thus must provide a good deal of management services, or if the taxpayer rents out only one unit but provides hotel-like services, the income will be classified as income from business.

The distinction between income from property and business is particularly significant under Canadian tax law in two instances. If a Canadian-controlled private corporation is carrying on a business, it is entitled to claim the small business credit, which effectively reduces its corporate tax rate by 16 percentage points. When this incentive for Canadian-controlled private businesses was first introduced in the early 1970s there was a flurry of cases as taxpayers attempted to claim that their rental buildings or portfolio investments (including in particular mortgage investments) that they transferred into their private corporations were business activities and not passive property investments, and thus qualified for the small business credit. Taxpayers won a series of cases so that finally the legislation was amended to provide a bright-line to distinguish between income from property and income from business for the purpose of the small business credit. Under the present legislation, property investment will not be considered a business activity for this purpose unless the corporation has at least five full-time employees. This same distinction is made in applying Canada’s foreign accrual property income (FAPI) rules. If a corporate taxpayer is earning business income overseas in a country with whom Canada has a tax treaty or a tax information exchange agreement, the income is exempt from Canadian tax. However, if the overseas corporation falls within Canada’s FAPI rules, and it is earning property income, the income is taxed on an accrual basis in Canada. For this purpose, the same bright-line test that is applied in determining eligibility for the small business credit is applied in distinguishing between property and business income.

11.3.3.3. Distinguishing capital gains from business income

Capital gains income in Canada receives preferential treatment: the gains are only taxed when they are realized and taxpayers include only half of the gains (or losses) in their income (excluding the other half of the gain altogether). The one half of the gain that is included in the taxpayer’s income is referred to as “taxable capital gain”; it is taxed at the taxpayer’s marginal tax rate. The reasons that are traditionally given in Canada for providing this preferential treatment are the same as those provided in most countries: the partial inclusion rate reduces the lock-in effect (arising from the consequences of the realization principle); it increases investment in risky capital assets; it at least crudely compensates for the effect of inflation (since inflation is not taken into account in calculating the gain); and it compensates for the effect of bunching (since capital gains are subject to the taxpayer’s marginal tax rate in the year of realization even though they might have been accruing over many years).

The courts might have developed tests to distinguish between capital gains and business income based upon these policy reasons for making the distinction. Instead, as they often did, Canadian courts simply relied upon English precedents in making the distinction. Although the distinction is sometimes stated as relying upon a consideration of all the facts and circumstances, one way to make sense of the long line of Canadian cases in this area is to see them as engaged in identifying the taxpayer’s intention in purchasing the property that resulted in the gain. If a taxpayer’s intention in purchasing property is to hold it and earn income from it, then when it is sold the gain (or loss) will be a capital gain (or loss). However, if a taxpayer purchases property intending to resell it, the gain (or loss) will be income (or a loss) from business. In determining the taxpayer’s intention when property is purchased, courts consider a long list of objective factors that surrounded the purchase of the property: the nature of the asset (was it investment-type property); the taxpayer’s related activity (did the taxpayer conduct a related business); how long the taxpayer held the asset (if it was held for only a short period of time it looks like it was purchased as stock-in-trade); how often the taxpayer had bought and sold similar property (the more frequent the purchases the more likely it will be treated as stock-in-trade); how leveraged the purchase (a highly leveraged purchase might be presumed to require a quick sale); and the degree of organization (whether the taxpayer appeared to organize his or her affairs as an investor or trader).

It might be noted that under Canadian legislation (borrowing from the English legislation) a business is defined as including “an adventure in the nature of a trade” so that even though a taxpayer only purchases and sells one item of property, the taxpayer can still be held to be involved in a business.

11.3.3.4. Business income as a measure of geographic nexus

Under domestic Canadian tax law, a non-resident will be subject to tax in Canada if they are carrying on a business in Canada. Hence the concept of business (or at least the carrying on of a business) is used in order to establish the degree of economic nexus required to justifiably impose Canadian tax on non-residents.

A substantial amount of Canadian jurisprudence addresses the issue of when an activity constitutes carrying on business in Canada. The courts look to a long list of factors in deciding whether a business is being carried on in Canada. Those factors include the place of delivery, the place of payment, the place where purchases are made, the place of manufacture or production, the place from which transactions are solicited, the location of an inventory of goods, the location of a bank account, the place where the non-resident’s number and business are listed in a directory, the location of a branch or office, the location of fixed assets and the place where agents or employees of the non-resident are located.

The Income Tax Act also includes an extended definition of “carrying on business.” That section deems some activities of non-residents to be carrying on business in Canada. It includes, for example:
- producing, growing, mining, creating, manufacturing, fabricating, improving, packing, preserving or constructing, in whole or in part, anything in Canada whether or not exported;
- soliciting orders or offering anything for sale in Canada through an agent or servant regardless of where the contract is concluded; or
- disposing of property with a particularly strong connection to Canada (e.g. real property).

There has been relatively little case law interpreting the various clauses in this extended meaning of carrying on business in Canada. One issue that arises from time to time is whether a company is carrying on business in Canada because it was “soliciting orders or offering anything for sale in Canada.” As an illustration of these cases, in Sudden Valley, the taxpayer was an American company that claimed it was not carrying on business in Canada. The company was trying to sell recreational land in the state of Washington, near Seattle. It leased office space in Vancouver and hired telephone operators to offer sales pitches about the land to local people. The telephone operators invited Canadians to come to Washington to look at the real estate. No contracts were ever concluded in Canada. The advertising also did not state that there was land for sale; instead, it focused on inviting Canadians to come and visit Sudden Valley. In this case, the Court held that the taxpayer merely extended to Canadian buyers an “invitation to treat”, which is something less than soliciting an order. The company was therefore held not to be carrying on business in Canada.

One somewhat interesting issue that has arisen under the definition of carrying on business is whether a non-resident that buys and sells a property just once in Canada, i.e. that engages in an adventure in the nature of a trade, can be found to be carrying on business in Canada. This question arises because business is defined in Canadian legislation as including “an adventure in the nature of a trade”. In Tara Exploration, for instance, a company was incorporated in Canada before the federal government enacted a rule in 1965 that deemed any company incorporated in Canada to be resident there. The company nominally had a head office address and a bank account in Canada; however, all of its personnel, along with its entire decision-making capacity, were in Ireland (its business was minerals exploration in southern Ireland). The company undertook one activity in Canada: in the course of raising capital for its Irish operations, it purchased and sold some shares of another operation, incurring some profit in the transaction. The Minister reassessed the company on the value of the gain on the basis that the company carried on business in Canada.

The issues before the court were whether there was a “business”; whether the company was either (a) resident in Canada or (b) carrying on business in Canada; and, if any amounts were subject to tax, whether there was a relieving provision in the tax treaty (Canada–Ireland) that would apply.

29. Income Tax Act, supra, s. 2(3)(b).
34. Income Tax Act, supra, s. 250(4).
On the issue of whether the company was carrying on business, the court noted that “business” includes an adventure in the nature of trade. The judge held that the purchase and sale of the shares was an adventure in the nature of trade and therefore a business. However, the court held that although the company had a “business,” it was not “carrying on a business” in Canada. The court reasoned that as a matter of ordinary usage, an adventure in the nature of trade, that is an isolated transaction, even though it might be a business could not be considered to be “carried on”. The decision was appealed and decided on different grounds. However, the legislation was amended so that non-residents that engage in an adventure in the nature of a trade in respect of property that has a strong connection to Canada, such as real estate or mineral rights, will be deemed to be carrying on business in Canada.35

11.4. Differences between income tax law and other tax legislation

Generally speaking, the considerations for determining whether a non-resident is carrying on business in Canada under the Income Tax Act are the same as the considerations under Canada’s Excise Tax Act (which imposes a national goods and service tax) and under provincial sales tax legislation. There are, however, two notable differences: (i) the definition of business in the Excise Tax Act does not include “an adventure in the nature of trade”36 and (ii) the Excise Tax Act does not include the extended definition of “carrying on business”. As a consequence, decision-makers may come to differing conclusions about whether a taxpayer is carrying on business in Canada for the purposes of income tax and the goods and services tax.

11.5. “Enterprise,” “business” and “business profits” as interpreted for purposes of tax treaties

11.5.1. State tax treaty practice

Canada has concluded 93 tax treaties, 88 of which are in force as of December 2010. Canada’s tax treaties rely on the concepts of business, business profits and enterprise in a number of their articles, deploying these terms broadly in line with their exemplars in the OECD Model. In some cases, Canada has been willing to incorporate the deviations from the OECD Model reflected in the UN Model. This section of the chapter focuses on the use of those concepts in Arts. 3 (definitions), 5 (permanent establishment), 7 (business profits) and 24 (non-discrimination).

Canadian courts, beginning with Crown Forest Industries,37 have held that the OECD Model is highly persuasive and have relied heavily on the Model and supporting Commentary in interpreting Canada’s tax treaties.38 Given the significant role of the OECD Model and supporting Commentary in the interpretation of Canada’s tax treaties generally, in this part of the chapter the OECD position is explicitly contrasted with the position reflected in Canada’s treaties.

11.5.1. Definitions

The OECD Model provides definitions of the terms “company”, “enterprise”, “enterprise of a contracting state” and “business”. “Enterprise” is defined to apply “to the carrying on of any business” and “business” is defined

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35. See the reference to s. 253(c), supra.
36. According to the Excise Tax Act, R.S.C. 1985, c. E-15, s. 123(1), “‘business’ includes a profession, calling, trade, manufacture or undertaking of any kind whatever, whether the activity or undertaking is engaged in for profit, and any activity engaged in on a regular or continuous basis that involves the supply of property by way of lease, licence or similar arrangement, but does not include an office or employment.”
38. This broad endorsement of OECD Commentaries extends also to the organization’s new Commentaries. See, e.g. R. v. Prevost Car Inc., 2009 FCA 57 at para 11, where the court states that later Commentaries can be persuasive “when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered, and when, of course, neither treaty partner has registered an objection to the new Commentaries.” See also TD Securities (USA) LLC v. Canada, 2010 TCC 186, 2010 D.T.C. 1137.
to include “the performance of professional services and of other activities of an independent character.” In the overwhelming majority of its signed tax treaties (i.e. in 83 of the 93 agreements), Canada has only included definitions of the terms “company” and “enterprise of a contracting state”. Moreover, five of the treaties – those signed with Bulgaria, Kazakhstan, Russia, South Africa and the US – further forego including any version of the model definition for “enterprise of a contracting state” (of those five, four were signed between the years 1995 and 1999).

Leaving out the model definitions of “enterprise” and “business” requires adjudicators to apply the principle of Art. 3(2) of the OECD Model, according to which

As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

In other words, domestic law will prevail in disputes over what constitutes a business. That said, three of the more recently signed treaties, those concluded with Finland (2006), Mexico (2006) and Columbia (2008), contain all four of the OECD Model definitions referred to above.

Two more of these treaties contain interesting variations in their definitions sections. Canada’s agreement with Kuwait contains a unique “fixed base” definition, which includes “a permanent place for the purpose of performing professional services or other activities of an independent nature”. The agreement with New Zealand includes a definition for “industrial and commercial profits”, which encompasses “income derived by an enterprise from the carrying on of a business, but does not include dividends, interest, royalties (as defined in Article 12), income referred to in Article 6, income referred to in Article 13, rents, profits from operating ships, boats, or aircraft, or remuneration from personal (including professional) services.”

11.5.1.2. Permanent establishment

The permanent establishment (PE) article, very generally speaking, sets the level of activity required for the income associated with that activity to be subject to tax at source. The OECD article that lends some meaning to the concept of permanent establishment has seven sections. In brief, Art. 5:

– defines the term “permanent establishment” to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on (Art. 5.1);
– provides that the term “permanent establishment” includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources (Art. 5.2);
– provides that a building site or construction or installation project constitutes a PE only if it lasts more than 12 months (Art. 5.3);
– excludes some preparatory or auxiliary activities (e.g. the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise) from the definition of “permanent establishment” (Art. 5.4);
– defines a dependent agent who acts on behalf of an enterprise and has, and habitually exercises, the authority to conclude contracts in the name of an enterprise, to be a PE unless the person’s activities of the person are preparatory or auxiliary (Art. 5.5);
– clarifies that carrying on business through a broker, general commission agent or any other agent of independent status does not necessarily result in an enterprise having a PE provided such persons are acting in the ordinary course of their business (Art. 5.6); and
– clarifies that simply because a company that is resident in one country controls or is controlled by a company resident in the other country shall not of itself constitute either company as a PE of the other (Art. 5.7).

In a good number of treaties, Canada has been willing to lower the threshold of activity required before a non-resident is subject to tax in the source state.

39. See OECD Model Tax Convention, ss. 3.1(c), (d), and (h).
In a significant number of its treaties, Canada has agreed to reduce the amount of time required for a building site or construction or assembly project to be considered a PE. For example, the time frame has been reduced to 9 months in the Armenia treaty, 6 months in the treaties with Bulgaria, Ecuador, India, Jordan, Mongolia, Peru, Tanzania, Venezuela, Vietnam and Zimbabwe, 3 months in the treaties with Algeria and Nigeria, and no time at all in the treaty with Senegal. Canada is more likely to grant a reduced period of time before a construction site becomes a PE if the negotiating partner is a middle- or low-income country than it is to deviate from the OECD-suggested period of time for high-income countries.

Canada has also been willing to lower the threshold for the concept of PE where an enterprise furnishes services, including consultancy services, through employees or other personnel where the activities continue for the same or a connected project within the country for more than 6 months, or a lesser period, within any 12-month period. Under the OECD Model, such activities alone would not necessarily constitute a PE. Canada has added this expanded provision in a good number of treaties, including those with Algeria, Armenia, Ecuador, India, Jordan, Kazakhstan, Mongolia, Peru, Senegal, Tanzania, Vietnam, and Zimbabwe.

The OECD Model lists six circumstances in which an enterprise has a fixed place of business but it is not a PE since its activities are preparatory or ancillary in nature; the UN Model eliminates the “delivery of goods” from this exclusion list. It has been relatively unusual for Canada to agree to remove the mere delivery of goods or merchandise from the rule that deems such activities not to be the work of a PE. However, it has followed this UN-proposed change in treaties with Algeria, Armenia, India, Oman, Senegal, Vietnam and Zimbabwe.

Under the OECD Model, if an enterprise has a dependent agent who is able to habitually exercise the authority to conclude contracts in the name of the enterprise, that agent’s premises will constitute a PE. In some Canadian treaties, the UN Model is followed: wording includes agents who habitually maintain in the state a stock of goods or merchandise from which they regularly delivers goods or merchandise on behalf of the enterprise. Canada has followed the UN expansion in its treaties with Armenia, India, Kuwait, Lithuania, Nigeria, Senegal, Trinidad and Tobago, Vietnam and Zimbabwe.

The UN Model expands the definition of PE to include insurance activities. Canada has included this provision in several treaties, including those with Argentina, Armenia, Azerbaijan, Belgium, Chile, Mexico, Moldova, Peru, Senegal, Tanzania and Vietnam.

11.5.1.3. Business profits

The OECD Model provides the basis on which the a PE’s activities will taxed. Generally speaking, the OECD Model suggests that an enterprise should only be taxable in the source jurisdiction on the profits it earns that relate to its PE and that those profits should be calculated in the same way they would be for domestic business activities, i.e. income tax should be applied to the PE’s net profits.

Canada’s treaties deviate in a number of ways from the OECD Model. The UN Model suggests two modifications that have been adopted in limited circumstances in Canada’s treaties. First, in some cases, once an enterprise has a PE in a jurisdiction, all the income it derives in that jurisdiction may be taxed there. This expanded scope of attraction rule includes profits attributable to (i) sales of goods or merchandise of the same or similar kind as those sold through the PE and (ii) other business activities carried on of the same or similar kind as those carried on through that PE. Canada’s tax treaties with Argentina, Armenia, India, Jordan, Kazakhstan, Nigeria, Oman, Tanzania and Zimbabwe include this expansion.

Second, both the OECD and the UN Models allow generally for the deduction from business profits of head office expenses incurred by a PE, including executive and general administrative expenses, even if they are incurred in the non-source state; however, the UN Model denies a deduction for head office expenses where

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41. Canada’s treaty with Kuwait also (and unusually) includes two additional provisions: one that deems a dependent agent to be a PE if the person secures orders exclusively or almost exclusively for the enterprise itself or for such enterprise and other enterprises which are controlled by it or have a controlling interest in it; or if the person manufactures goods or merchandise belonging to the enterprise.

42. In R. v. American Income Life Insurance Company, 2008 D.T.C. 3631 and R. v. Knights of Columbus, 2008 D.T.C. 3684, the Tax Court of Canada held that the absence of an insurance clause like that found in the UN Model means that the drafters of the Canada–US treaty meant to exclude that clause.
those expenses are payments for royalties, fees, interest and commissions for specific management services. The UN Model therefore provides for a significant expansion of the taxation of business profits earned at source. Canada has been quite willing to grant this kind of expansion in its treaties, having done so with Armenia, Algeria, Chile, India, Jordan, Kazakhstan, Kuwait, Mexico, Moldova, Nigeria, Ukraine, Uzbekistan, Venezuela and Vietnam.

In addition to these UN-suggested deviations, Canada’s tax treaties contain additional departures from the OECD Model. For example, some of Canada’s treaties clarify that the profits referred to in the business profits article are indeed business profits. So, while the OECD Model provides that the profits of an enterprise shall be taxable, some Canadian treaties (specifically those concluded with Australia, Estonia, Latvia, Lithuania and Mexico) add the word “business” (i.e. “the business profits of an enterprise”). Canadian treaties also include reference to prior activities. Instead of noting that profits shall be taxable at source if the enterprise carries on business, these Canadian treaties add “or has carried on” business. Finally, in some treaties Canada does not include the clause from the OECD Model that enables the use of formulary apportionment of total profits.43

A number of Canadian decisions have considered the application of the business profits article.44 The best known of these decisions is likely Cudd Pressure.45 In Cudd Pressure, a US-resident company engaged in providing technical services to the oil industry entered into an agreement with a Canadian company, stipulating that it would provide certain services to the latter at one of its Canadian locations. Two pieces of snubbing equipment were sent from the United States to the site of performance in eastern Canada. The equipment was unique and costly. The equipment was determined to constitute a PE.

The question before the court was whether the US company could factor into the calculation of the profits of its PE in Canada an amount representing a “notional rent” that its head office in the United States charged for the use of the two pieces of equipment required to perform the services.

Cudd Pressure does not provide clarity about whether it would ever be appropriate to deduct notional amounts when computing the industrial and commercial profits attributable to a PE. The trial judge reasoned that notional amounts should never be deducted because they are never actually “incurred”; in contrast, a dissenting opinion at the Federal Court of Appeal reasoned that, in certain circumstances, notional amounts may be deducted based on the rationale that both the OECD Model and the Canada–US tax treaty provide that the profits of a PE are to be computed as if the PE was an “independent enterprise” interacting at arm’s length with its head office. Despite this guidance, the majority of the Federal Court of Appeal concluded it was not necessary to determine whether notional amounts could be deducted, thus leaving this key question unanswered. Instead, the decision in Cudd Pressure is based on the factual finding that the US-resident company would not have rented the equipment from its head office if the rental would have been to an independent enterprise operating at arm’s length.46

In addition to the provisions reflected in its tax treaties, Canada has enacted rules that address the attribution of profits in the Income Tax Conventions Interpretation Act.47 This legislation provides that,

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[F]or the purposes of the application of the convention, the profits from a business activity, including an industrial or commercial activity, attributable or allocable to a permanent establishment in Canada are to be determined for any period,
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(a) there shall, except where the convention expressly otherwise provides, be included in the determination of those profits all amounts with respect to that activity that are attributable or allocable to the permanent establishment and that would be required to be included under the Income Tax Act, as amended from time to time by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period; and

43. See, in particular, the treaties concluded with Argentina, Australia, Bangladesh, Barbados, Belgium, Brazil, Bulgaria, Chile, Colombia, Croatia, the Dominican Republic, Ecuador, Finland, France, Gabon, Greece, Hungary, Israel, Jamaica, Kazakhstan, Korea, Luxembourg, Malaysia, Mexico, Moldova, Mongolia, Morocco, the Netherlands, New Zealand, Namibia, Nigeria, Norway, Oman, Papua New Guinea, Peru, the Philippines, Portugal, Russia, Singapore, Spain, Sweden, Thailand, Trinidad and Tobago, Tunisia, Turkey, the United Arab Emirates, the US, Venezuela and Zimbabwe.
46. Canada Revenue Agency has confirmed that it will not accept the deduction of notional expenses on a number of occasions. See, e.g. Report of Proceedings of the Fifty-First Tax Conference, 1999 Conference Report, Toronto: Canadian Tax Foundation, 2000, p. 47:15.
(b) there shall, except to the extent that an agreement between the competent authorities of the parties to the
convention expressly otherwise provides, not be deducted in the determination of those profits any amount
with respect to that activity that is attributable or allocable to the permanent establishment and that would
not be deductible under the Income Tax Act, as amended from time to time, by a person resident in Canada
carrying on the activity in Canada in the computation of his income from a business for that period.48

This provision responded to a Supreme Court decision, Melford Developments,49 which held that Canadian
legislation enacted after a given treaty was signed did not affect the treaty’s interpretation.

A last issue is whether individual independent agents determine their tax treatment under the treaty pursuant to
the business profits article or the independent personal services article. Canada has been removing the
independent personal services article in some of its treaties. In the 33 treaties it has concluded or renewed since
2000, five omit the independent personal services article, instead subsuming the tax treatment of independent
personal services under the business profits article.

11.5.1.4. Non-discrimination

Canada has a general reservation on the OECD Model’s non-discrimination article. Despite this reservation,
most of Canada’s tax treaties include an article that addresses non-discrimination, although its application is
quite limited. For example, while Canada generally includes a clause that provides that a PE of an enterprise
shall not be taxed less favourably than enterprises of the other state carrying on the same activities, Canada
generally includes a right to impose a branch tax.

11.6. Compatibility of Canadian tax law with Canada’s tax treaties

Generally speaking, although Canadian domestic law does not include the concept of an enterprise, there seem
to have been no major issues with the integration of Canada’s tax law on the treatment of what constitutes a
business, how business profits are calculated and where a business is geographically located. This report has
highlighted some of the specific instances where courts have grappled with ambiguities in the interpretation of
Canada’s treaties, but generally those decisions have not arisen because of a disconnection between Canada’s
domestic law and its tax treaties’ provisions.

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48. Id., s. 4.