

News Analysis: Withholding Decision Creates Windfall for Revenue Agency

by Steve Suarez and David Gaskell

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COUNTRY DIGEST

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Canada's Federal Court of Appeal on June 24 upheld the July 2008 decision of the Federal Court in *FMC Technologies Company v. The Queen*.¹ (For prior coverage of the decision, see *Tax Notes Int'l*, Nov. 24, 2008, p. 657, *Doc 2008-23768*, or *2008 WTD 230-7*.)

The case is noteworthy because it highlights the broad scope of section 105 of the Income Tax Regulations (Canada) (Regulation 105) applicable to payments to nonresidents of Canada for services rendered in Canada. It also illustrates the importance of the legal form of a taxpayer's contractual agreements under Canadian tax law and the statutory and practical difficulties of recovering an overpayment of Canadian taxes.

Regulation 105 Withholding

Under Regulation 105, any person who pays a fee, commission, or other amount to a nonresident for services rendered in Canada must deduct or withhold 15 percent of the payment and remit that amount to the Canada Revenue Agency as part of the nonresident's Canadian income tax liability. If the nonresident's Canadian income tax liability as ultimately determined exceeds the amount withheld and remitted, the nonresident can claim a refund of the difference when it files its tax return. If the nonresident's Canadian tax liability exceeds the amount withheld, the withheld amount is credited toward that liability, and the nonresident owes the remainder when tax payable for the year is determined. When the nonresident can satisfy the CRA in advance of the payment that the normal withholding required under Regulation 105 will exceed the nonresident's Canadian income tax liability (for example, if the nonresident is exempted from payment by a tax treaty), a waiver may be obtained from the CRA relieving the payer from the obligation to withhold or reducing the amount to be withheld.

¹*FMC Technologies Company v. MNR* (2009 FCA 217), *aff'd* (2008 FC 871).

FMC Technologies Co.

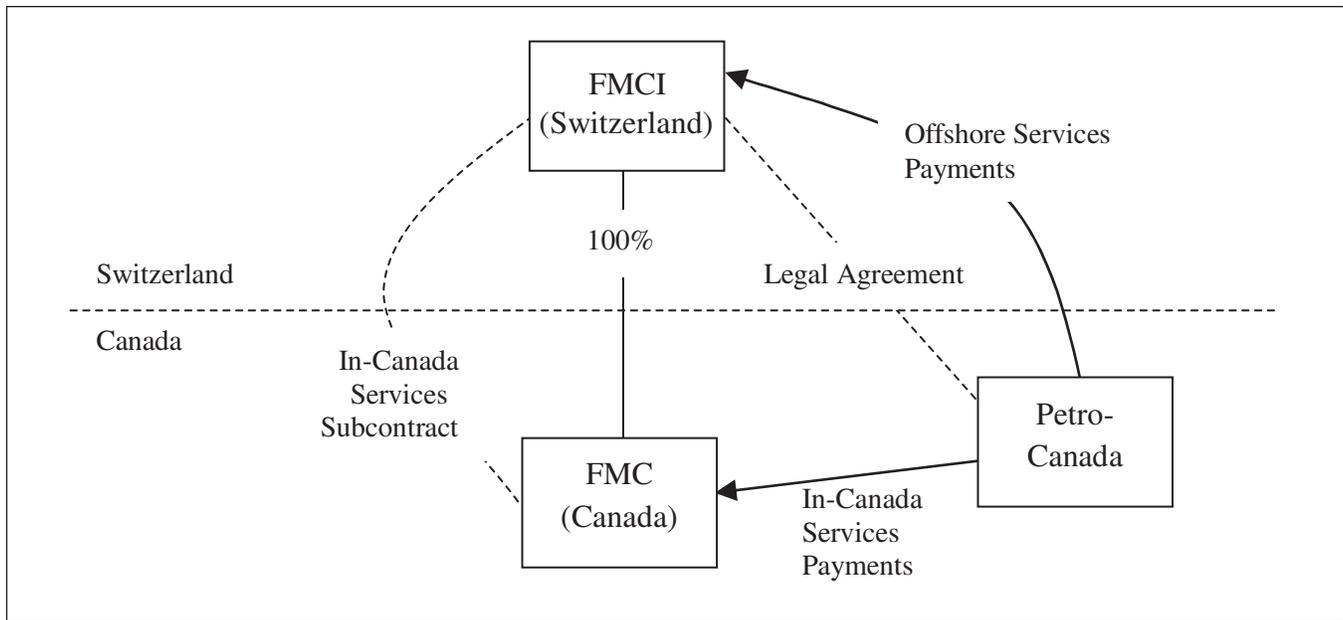
FMC Technologies Co. (FMC) is a Canadian resident company that in the relevant years was a wholly owned subsidiary of a nonresident Swiss company, FMC International A.G. (FMCI). In 1997 FMC entered into an agreement to provide project management services both in Canada and outside Canada to a consortium of companies seeking to develop petroleum resources in the province of Newfoundland. The agent and operator of the consortium was Petro-Canada. Shortly after entering into the agreement, and with the consent of Petro-Canada, FMC assigned all its rights and obligations under the agreement to FMCI.

Because FMCI lacked the capacity to perform the in-Canada services required by the agreement, FMCI entered into a subcontract under which FMC would provide these services to the consortium (the subcontract). Under the subcontract, FMC invoiced Petro-Canada directly for the in-Canada services it performed. In consideration, FMCI assigned to FMC the portion of the monies due under the agreement for in-Canada services. However, because the agreement was between FMCI and Petro-Canada and Petro-Canada was not a party to the subcontract (although it did consent to the subcontract), only FMCI could sue Petro-Canada if payments to FMC were not made. (See figure.)

In accordance with the subcontract, from 1999 to 2002 FMC performed the in-Canada services under the agreement and invoiced Petro-Canada for amounts totaling approximately C \$18.8 million. FMC included those amounts in the calculation of its income under Part I of the Income Tax Act and paid income tax on those amounts received.

Assessments and Objections

In 2004 the CRA issued assessments to Petro-Canada for 15 percent of the C \$18.8 million invoiced to it by FMC, plus interest and penalties, on the basis that Petro-Canada had failed to comply with Regulation 105. According to the CRA, Petro-Canada had an obligation under Regulation 105 to withhold and remit 15 percent of the amounts it paid for the in-Canada services because the legal payee for those amounts was



a nonresident (FMCI), even though the payments were made for and related to work actually performed by a resident of Canada (FMC). The CRA held that because FMCI was the only party with whom Petro-Canada had an agreement to provide services, the payments made by Petro-Canada for the in-Canada services should be considered to have been made to FMCI, even if received by a Canadian resident on the direction of FMCI.

Petro-Canada filed an objection to the Regulation 105 assessments. The CRA confirmed the assessments and the application of Regulation 105. Petro-Canada paid the assessed amounts and decided not to appeal the assessment further.² The CRA credited the taxes paid by Petro-Canada to the Canadian tax account of FMCI (the nonresident), the party the CRA considered the payee. At this point, the payments for the in-Canada services had given rise to two separate taxes: the Part I income tax paid by FMC on the payments as reported in its tax returns and the 15 percent Regulation 105 withholding (plus interest and penalties) paid by Petro-Canada and credited to FMCI's Canadian tax account.

As noted, Petro-Canada (the taxpayer that had been assessed) did not file an appeal to the courts over the CRA's refusal of its objection, presumably because it had been indemnified by FMC. FMC tried to appeal the assessment issued to Petro-Canada, but the appeal was quashed on the grounds that FMC was not the

²Petro-Canada was ultimately indemnified by FMC for the amounts paid to the CRA.

taxpayer subject to the assessments and so had no standing to appeal those assessments.

FMCI, as the taxpayer to whose account the 15 percent tax paid under Regulation 105 had been credited, could have been in a position to request a refund of this tax on the basis that its Canadian taxes had been overpaid.³ FMCI ultimately did request such a refund but was denied, presumably because it did not file Canadian income tax returns within the three-year period specified in the refund provision in subsection 164(1) ITA.

Federal Court

FMC (which had filed Canadian tax returns) requested a refund under subsection 164(1) ITA on the basis that it was legally the payee under the agreement and amounts withheld under Regulation 105 should have been credited to its account. The CRA rejected FMC's request, leading FMC to seek judicial review of the decision. The Federal Court denied FMC's request for judicial review on two grounds. First, the court stated that it did not have jurisdiction to hear the appeal because FMC was using judicial review to indirectly challenge the assessments issued to Petro-Canada. Second, the Federal Court found that even if

³This might have been the case either because FMCI was not subject to tax on its business profits in Canada in the absence of a Canadian permanent establishment under the Canada-Switzerland tax treaty or because concerning the portion of the Petro-Canada payments for services rendered in Canada, FMCI's net income was nil after deducting the amount it owed to FMC under the subcontract.

it did have jurisdiction, the minister was correct to deny the refund because FMCI, not FMC, was legally the payee of amounts under the agreement. The court made the following findings in support of its decision:

- Petro-Canada's contractual obligations were with FMCI, not FMC, and the creation of the subcontract between FMCI and FMC did not change that;
- the agreement did not allow FMCI to assign only a portion of its rights and obligations (that is, the portion relating to in-Canada services) to another party, such as FMC; and
- any assignment by FMCI to FMC of its revenues relating to the in-Canada services did not create contractual rights between FMC and Petro-Canada because under the agreement, only FMCI, and not FMC, had the right to sue Petro-Canada if Petro-Canada failed to pay FMC for the work done in Canada. (FMC's remedy for nonpayment would be against FMCI under the subcontract, not Petro-Canada under the agreement.)

Federal Court of Appeal

On June 24 the Federal Court of Appeal dismissed FMC's appeal, holding that FMC was not entitled to a refund because there had been no overpayment of its tax. Under subsection 164(7) of the ITA, an overpayment exists when amounts paid to a taxpayer's account exceed the taxpayer's liability. Because the CRA had credited the amount paid by Petro-Canada under the Regulation 105 assessment to FMCI's tax account, there was no overpayment of FMC's tax. According to the Federal Court of Appeal, the definition of overpayment "does not ask how the amounts in question *should* have been credited, rather it asks how they were, in fact, credited."⁴ Therefore, FMC could not claim a refund, even if the subcontract had, as FMC claimed, made FMC the legal payee of amounts under the agreement.

Conclusions

Regulation 105 withholding would normally not be applicable to payments made to a Canadian resident for services it renders in Canada. That such withholding was found to be applicable under the circumstances of the FMC case demonstrates that Regulation 105 withholding does not depend on who actually performs the in-Canada services or who receives the payment, but on the underlying legal rights of the parties.

Because Petro-Canada did not appeal the Regulation 105 assessments to the Tax Court of Canada, the merits of those assessments were not fully tested; however,

based on the findings of the Federal Court, the CRA's position seems supportable under a strict reading of the law.

That Regulation 105 withholding could apply to amounts paid to a Canadian resident (FMC) shows how important it is to carefully consider the legal rights between the parties and the legal capacity in which parties are making and receiving payments. A subtle change in the structure of the legal arrangements can make a big difference in the tax consequences of a payment, and when the payments are being made to a Canadian resident for services rendered by that Canadian resident, it will not be obvious that a nonresident withholding tax applies. In Canadian tax matters, the legal form of the transactions generally determines the tax consequences, so it is important that the documentation reflect the legal rights that the parties are intended to have.

The application of Regulation 105 and the statutory and practical limitations on the ability of FMC or FMCI to recover amounts paid as excess tax produced a harsh result for the taxpayers and a windfall for the CRA, as the government effectively received tax on the same amount twice. Petro-Canada was the only person entitled to appeal the Regulation 105 assessments. Because Petro-Canada had an indemnity from FMC, however, it apparently had little incentive to challenge the assessments, although the terms of the indemnity and the indemnification procedure followed by the parties are not clear from the judgment. In any case, it is clearly advisable for an indemnifying party to ensure that the indemnified party is obligated to notify it promptly in the event of any assessment or other claim for tax and for the indemnifying party to be allowed to take charge (at its own expense) of any appeal of such assessments.

The amounts Petro-Canada paid under the assessments were credited to FMCI's account based on the CRA's conclusion that FMCI was the legal payee of the amounts. FMCI may have claimed a refund of those amounts but for an apparent lack of awareness that Regulation 105 could apply. To the extent that FMCI would have been entitled to the refund had the time to claim it not elapsed, the CRA received a windfall.

The FMC case appears to illustrate that there is no equitable rule in Canadian tax law to the effect that a windfall for the CRA is per se an objectionable result requiring judicial intervention. Rather, the Federal Court considered the rules governing Regulation 105 withholding and remitting and claiming overpayments and concluded that the taxpayers had not met the strict requirements necessary to create a statutory basis for requiring the CRA to make a refund. The result is harsh, and the lesson seems to be that the courts will not fill in the gaps in statutes that lead to unfair results. ♦

⁴Para. 12 of the decision (emphasis added).