Docket: 2015-2514(IT)I

BETWEEN:

HERMAN KORFAGE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeal heard on January 14, 2016, at Montreal, Quebec.

Before: The Honourable Lucie Lamarre, Associate Chief Justice

Appearances:

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|---|---|
| For the Appellant: | The Appellant himself |
| Counsel for the Respondent: | Valerie Messore |

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**JUDGMENT**

The appeal from the assessment made under the *Income Tax Act* for the 2010 taxation year is dismissed.

Signed at Ottawa, Canada, this 22nd day of March 2016.

"Lucie Lamarre"

Lamarre A.C.J.

Citation: 2016 TCC 69
Date: 20160322
Docket: 2015-2514(IT)I

BETWEEN:

HERMAN KORFAGE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

## REASONS FOR JUDGMENT

Lamarre A.C.J.

### Introduction

[1] This appeal arises out of a dispute between the Minister and the Appellant regarding the Canadian dollar amount of a deduction claimed by the Appellant for the 2010 taxation year in respect of his pension income, which arises in the United States. The deduction claimed by the Appellant represents the amount of pension income that is exempt from Canadian tax pursuant to the *Canada-United States Convention with Respect to Taxes on Income and on Capital*[1] (**Treaty**). The Minister recalculated the deduction claimed by the Appellant from $17,677 CAD to $12,701 CAD. Specifically, the Minister and the Appellant disagree on the exchange rate that should be used in converting the deductible amount from US dollars to Canadian dollars. The Minister used an exchange rate of 1.0562, being the annual average exchange rate for 2010. The Appellant used an exchange rate of 1.47 for the reasons that will be explained below.

[2] For the reasons that follow, I find that the Minister correctly used the annual average exchange rate for 2010 to convert the deductible amount to $12,701 CAD.

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1 *Canada-United States Convention with Respect to Taxes on Income and on Capital*, 26 September 1980, Can TS 1984 No. 15 (entered into force 16 August 1984).

Factual Background

[3] The Appellant is a retired former employee of the International Civil Aviation Organization (**ICAO**), which is an agency of the United Nations (**UN**). He has been receiving a monthly pension amount from the United Nations Joint Staff Pension Fund (**Plan**) since his retirement from the ICAO in September 2000. The income from the Plan arises in the United States. The Appellant was a Canadian resident at all relevant times.

[4] Under the terms of the Plan, the Appellant was entitled to opt into the "local track".[2] By choosing this option, the Appellant's pension amount was converted from US dollars into Canadian dollars as at the date of his retirement using the average exchange rate over the 36 months preceding and including his last month of employment.[3] Therefore, the Appellant's pension amount was converted into Canadian dollars as at September 2000 using an exchange rate of 1.47, which was the average exchange rate over the 36 months preceding and including September 2000.[4]

[5] In 2010, the Appellant received $59,753 CAD from the Plan.[5] Under subparagraph 110(1)(*f*)(i) of the *Income Tax Act* (Canada) (**ITA**), in each taxation year the Appellant may deduct an amount that is exempt from Canadian tax pursuant to the Treaty. The portion of the Appellant's pension that was exempt from Canadian tax in 2010 was $12,024 USD.[6] In order to claim the deduction, the Appellant was required to convert the amount of $12,024 USD into Canadian dollars using an appropriate exchange rate. The Appellant and the Respondent disagree on what the appropriate exchange rate should be for this purpose.

[6] For his 2001 to 2008 taxation years, the Appellant had been converting the $12,024 USD to Canadian dollars by applying the Bank of Canada annual average exchange rate for each of those years, a method that is accepted by the Minister.[7] However, on July 8, 2009, the Appellant wrote a letter to the Canada Revenue Agency (**CRA**) requesting that the deductible amounts for his 2001 to 2008

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2 Transcript at p. 20, lines 26-27.

3 Transcript at p. 19, lines 4-5; Transcript at p. 20, lines 12-21; see also CRA memorandum, Exhibit R-1, Tab 6, pages 1-2, and United Nations Joint Staff Pension Fund, Practical Steps, Exhibit R-1, Tab 6, p. 35.

4 Exhibit A-1, 4th page (Appendix B) and CRA Memorandum, Exhibit R-1, Tab 6, p. 2.

5 Reply at par. 5(e); Exhibit R-1, Tab 6, second to last page.

6 Reply at par. 5(g); Exhibit R-1, Tab 6, third to last page.

7 Transcript at p. 30, lines 17-19.

taxation years be adjusted to reflect the exchange rate of 1.47 that was used to convert his pension amount from US dollars into Canadian dollars under the "local track" option.[8] The CRA did not make the requested adjustment due to a lack of supporting documentation.[9] For the 2010 taxation year, the Appellant appealed his assessment, claiming a deduction of $17,677 CAD using the exchange rate of 1.47.[10] The Minister issued for the 2010 taxation year a notice of assessment recalculating the deductible amount using an annual average exchange rate of 1.0562, which reduced the deduction claimed to $12,701 CAD.[11]

[7] The Appellant's position is that the appropriate exchange rate to use in converting the $12,024 USD to Canadian dollars is the 1.47 rate that was used to convert his pension amount as at September 2000.

[8] The Respondent's position is that the appropriate exchange rate is the annual average exchange rate for the taxation year for which the deductible amount is claimed. The Respondent points out that the amount that is exempt from Canadian tax arises once the Appellant receives the pension income.[12] It is therefore more appropriate to use the annual average exchange rate for the taxation year for which the deduction is claimed.

Issue

[9] The issue in this appeal is the appropriate exchange rate to be used in determining the Canadian dollar amount of the pension income that is deductible under subparagraph 110(1)(*f*)(i) of the ITA. This issue is inextricably linked to the question of when the amount that is exempt from Canadian tax arises.

Analysis

[10] The crux of the dispute between the Appellant and the Respondent is the date on which the tax-exempt amount arose. As will be seen, the determination of that date will dictate which exchange rate should be used to convert that amount from US dollars into Canadian dollars. The Appellant argues that the tax-exempt amount arose on the date of his retirement, in September 2000, when the amount of his investment in the Plan was fixed. The Respondent argues that the tax-exempt

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8 Transcript at p. 32, lines 6-9; Transcript at p. 33, lines 23-27.
9 Exhibit R-1, Tab 1.
10 Reply at par. 5(h); Transcript at p. 74, lines 10-14; Exhibit R-1, Tab 4, last page.
11 Reply at par. 2 and 5(i).
12 Transcript at p. 88, lines 6-14.

amount arises on a monthly basis, when each benefit payment is received by the Appellant.

[11] The operative provision with respect to the deduction claimed by the Appellant is subparagraph 110(1)(*f*)(i) of the ITA, which provides:

> **(1) Deductions permitted.** For the purpose of computing the taxable income of a taxpayer for a taxation year, there may be deducted such of the following amounts as are applicable:
>
> > . . .
> > (*f*) any social assistance payment made on the basis of a means, needs or income test and included because of clause 56(1)(*a*)(i)(A) or paragraph 56(1)(*u*) in computing the taxpayer's income for the year or any amount that is
> >
> > (i) an amount exempt from income tax in Canada because of a provision contained in a tax convention or agreement with another country that has the force of law in Canada,
> >
> > . . .
>
> [Emphasis added.]

Therefore, in calculating his taxable income for the 2010 taxation year, the Appellant was permitted to deduct an amount that was exempt from tax in Canada pursuant to the Treaty.

[12] The amount that is exempt from Canadian tax under paragraph 1 of Article XVIII of the Treaty is the portion of the Appellant's pension income that would be excluded from taxable income in the United States. Paragraph 1 of that Article provides:

> 1 Pensions and annuities arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State, but the amount of any such pension that would be excluded from taxable income in the first-mentioned State if the recipient were a resident thereof shall be exempt from taxation in that other State.

[13] In *Coblentz v. Canada*, [1997] 1 F.C. 368, 96 DTC 6531, [1996] 3 C.T.C. 295, the Federal Court of Appeal considered the deductibility of a lump sum payment received by a Canadian resident taxpayer on the winding up of a pension fund operated by his former US employer. Robertson J.A. made the following comments on the purpose of paragraph 1 of Article XVIII of the Treaty:

> As discussed earlier the purpose underlying Paragraph 1 of Article XVIII is to ensure that any portion of a lump sum payment which is exempt from taxation in the U.S. remains exempt in Canada. Thus, the question to be addressed is whether any part of the lump sum received by the taxpayer *would* under U.S. law be excluded from taxable income had he been a resident thereof during the 1989 taxation year. That is to say, for example, does any portion of the pension represent a return of capital? . . .[13]
>
> [Emphasis added.]

Although the Federal Court of Appeal refers to the purpose of paragraph 1 of Article XVIII as regards lump sum payments, the same underlying principle would apply to periodic pension payments such as those in the instant appeal. In light of the Federal Court of Appeal's comments and the language of the Treaty itself, the tax-exempt amount is to be determined by reference to US law.

[14] The United States Internal Revenue Service (**IRS**) made a determination that the Plan is a "qualified" employees' trust under section 401(a) of the Internal Revenue Code (IRC).[14] Section 402(a) of the IRC provides:

> **402 (a)** Except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).[15]

Thus, the recipient of an amount distributed by the Plan is taxable on that amount under section 72 of the IRC in the taxable year in which the amount is distributed.

[15] Section 72(a)(1) of the IRC provides:

> **72(a)(1)** Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or

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13 *Coblentz, supra*, at par. 30 (DTC p. 6536; C.T.C. p. 305).

14 UNJSPF, *National Taxation: Guide to national taxation of United Nations Joint Staff Pension Fund benefits, with special reference to United States income taxation* (2010), online: UNJSPF <www.unjspf.org/UNJSPF_Web/pdf/National%20Taxation_Guide_2010.pdf>, Exhibit R-1, Tab 7, p. 7, at par. 11.

15 26 U.S.C. § 402(a).

> during one or more lives) under an annuity, endowment, or life insurance contract.[16]

The recipient must therefore include in his or her gross income the pension benefit payments received in the taxable year. However, the IRC excludes from gross income the amount that is the investment in the Plan. Section 72(b)(1) of the IRC provides:

> **72(b)(1)** Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).[17]

Therefore, a certain proportion of each benefit payment that is received is excluded from gross income because it represents part of the cost of the Plan. This excluded amount is exempt from tax in Canada, and the Canadian taxpayer claims it as a deduction under subparagraph 110(1)(*f*)(i) of the ITA.

[16] The Plan publishes a guide entitled *National Taxation: Guide to national taxation of United Nations Joint Staff Pension Fund benefits, with special reference to United States income taxation* (**Taxation Guide**), which was filed in evidence by the Respondent (Exhibit R-1, Tab 7). The Taxation Guide provides information on the US taxation of benefits under the Plan. It confirms that a participant in the Plan is entitled to recover his or her investment in the Plan "tax-free".[18] Each benefit payment includes a portion that is taxable and a portion that is non-taxable, the amount of those portions depending on how the investment in the Plan is calculated and allocated to each benefit payment.[19] The method for calculating the portion of a benefit payment that is considered a return of investment is referred to as the "Simplified General Rule" [20] or "Simplified Method". Under the Simplified General Rule, the investment in the Plan is allocated over the number of months that the beneficiary and his qualifying surviving spouse are expected to live.[21] The Taxation Guide states that "the tax-

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16 26 U.S.C. § 72(a)(1).
17 26 U.S.C. § 72(b)(1).
18 Taxation Guide, *supra*, note 14 at par. 13.
19 *Ibid*. at par. 14.
20 *Ibid*. at par. 27.
21 *Ibid*. at par. 28(a).

free portion of a periodic retirement benefit is the total investment . . . divided by the number of months of life expectancy determined under the IRC".[22]

[17] Another resource presented by the Respondent was the IRS guide to assist taxpayers with reporting pension or annuity income: Publication 575 entitled *Pension and Annuity Income* (Publication 575), produced as Exhibit R-1, Tab 10. Publication 575 advises that if a taxpayer has a cost to recover in his or her pension or annuity plan, a part of each benefit payment may be excluded from income as a recovery of that cost.[23] Publication 575 states that the tax-free portion is calculated when the annuity begins, and remains the same each year, regardless of whether the amount of the benefit payment changes.[24] The fact that the tax-free portion remains the same each year appears to be a matter of administrative practice. Like the Taxation Guide, Publication 575 advises taxpayers to calculate the tax-free portion of benefit payments using the Simplified Method, whereby the taxpayer's cost is divided by the total number of anticipated monthly payments to determine the monthly tax-exempt amount.[25] The monthly amount is then multiplied by 12 (the number of months in a calendar year) to determine the yearly amount. Therefore, under the Simplified Method, the excluded amount would be expressed in US dollars and would remain the same each taxation year until the cost is fully recovered. This US dollar amount would be the amount that is tax-exempt in Canada under subparagraph 110(1)(*f*)(i) of the ITA, and it must be converted into Canadian dollars for Canadian tax purposes.

[18] Subsection 261(2) of the ITA requires any amount that is expressed in another currency to be converted into Canadian dollars for Canadian tax purposes; it reads as follows:

> **261(2)** In determining the Canadian tax results of a taxpayer for a particular taxation year,
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> (*a*) subject to this section, other than this subsection, Canadian currency is to be used; and
>
> (*b*) subject to this section, other than this subsection, subsection 79(7) and paragraphs 80(2)(*k*) and 142.7(8)(*b*), <u>if a particular amount that is relevant in computing those Canadian tax results is expressed in a currency other than Canadian currency, the particular amount is to be</u>

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22 *Ibid*. at par. 28(d).
23 Publication 575 at p. 9.
24 *Ibid*. at p. 11.
25 *Ibid*. at p. 12.

converted to an amount expressed in Canadian currency using the relevant spot rate for the day on which the particular amount arose.

[Emphasis added.]

[19] Subsection 261(1) of the ITA provides the following relevant definitions:

**"Canadian tax results"** of a taxpayer for a taxation year means

(*a*) the amount of the income, taxable income or taxable income earned in Canada of the taxpayer for the taxation year;

(*b*) the amount (other than an amount payable on behalf of another person under subsection 153(1) or section 215) of tax or other amount payable under this Act by the taxpayer in respect of the taxation year;

(*c*) the amount (other than an amount refundable on behalf of another person in respect of amounts payable on behalf of that person under subsection 153(1) or section 215) of tax or other amount refundable under this Act to the taxpayer in respect of the taxation year; and

(*d*) any amount that is relevant in determining the amounts described in respect of the taxpayer under paragraphs (*a*) to (*c*).

. . .

**"relevant spot rate"** for a particular day means, in respect of a conversion of an amount from a particular currency to another currency,

(*a*) if the particular currency or the other currency is Canadian currency, the rate quoted by the Bank of Canada for noon on the particular day (or, if there is no such rate quoted for the particular day, the closest preceding day for which such a rate is quoted) for the exchange of the particular currency for the other currency, or, in applying paragraphs 2(*b*) and 5(*c*), another rate of exchange that is acceptable to the Minister . . .

[Emphasis added.]

[20] The deduction under subparagraph 110(1)(*f*)(i) of the ITA is a "Canadian tax result" under paragraphs (*a*) and (*d*) of the above definition, since it is an amount that is relevant in computing the Appellant's taxable income for the 2010 taxation year. The "particular amount" referred to in paragraph 261(2)(*b*) of the ITA is the amount that is exempt from Canadian taxation pursuant to paragraph 1 of Article XVIII of the Treaty, which is also the amount that would be excluded from income in the United States if the Appellant were a resident of that country. That

amount is therefore expressed in US dollars. Paragraph 261(2)(*b*) of the ITA requires that the exempt amount be converted into Canadian currency using the relevant spot rate for the day on which that amount (the particular amount) arose. Thus, the day on which the exempt amount arose determines the appropriate exchange rate that should be used to convert the US dollar amount into Canadian dollars.

[21] On the basis of what is stated in the IRC, the Taxation Guide and Publication 575, I agree with the Respondent's position. Although the Appellant's cost in the Plan is fixed as at the time of his retirement, a review of US law and administrative practices indicates that the exempt amount arises each month, when the benefit payment is received by the Appellant. This conclusion is supported in particular by the language of section 72(b)(1) of the IRC. That provision indicates that a portion of each benefit payment that is *received* by the Appellant is excluded from income. It is this excluded portion that constitutes the amount that would be exempt from tax in Canada. Specifically, the provision states that gross income does not include "that part of any amount *received* . . . which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)". Thus, although the cost or investment in the Plan is measured as of the retirement date, the excluded amount is determined as of the date of receipt.

[22] Having determined that the exempt amount arises on the date of receipt of each benefit payment, I conclude that the Minister's use of the annual average exchange rate for 2010 was appropriate for converting the deductible amount. The relevant spot rate for a particular day is either the rate quoted by the Bank of Canada for noon on the particular day or another rate of exchange that is acceptable to the Minister. The Minister has discretion in the application of an appropriate exchange rate to convert the US dollar amount to Canadian dollars, and chose to use the annual average exchange rate for 2010 of 1.0562.

[23] The Appellant's appeal is accordingly dismissed.

Signed at Ottawa, Canada, this 22nd day of March 2016.

"Lucie Lamarre"

Lamarre A.C.J.

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| CITATION: | 2016 TCC 69 |
| COURT FILE NO.: | 2015-2514(IT)I |
| STYLE OF CAUSE: | HERMAN KORFAGE v.<br>HER MAJESTY THE QUEEN |
| PLACE OF HEARING: | Montreal, Quebec |
| DATE OF HEARING: | January 14, 2016 |
| REASONS FOR JUDGMENT BY: | The Honourable Lucie Lamarre,<br>Associate Chief Justice |
| DATE OF JUDGMENT: | March 22, 2016 |

APPEARANCES:

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| Counsel for the Respondent: | Valerie Messore |

COUNSEL OF RECORD:

For the Appellant:

Name:

Firm:

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