Docket: 2008-2967(IT)G

BETWEEN:

FLSMIDTH LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on September 30, 2010, at Montreal, Quebec,

Before: The Honourable Justice B. Paris

Appearances:

Counsel for the Appellant:	Pierre Martel Pierre-Louis Le Saunier
Counsel for the Respondent:	Michel Lamarre

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2002 taxation year is dismissed with costs to the respondent in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 3rd day of January 2012.

"B.Paris"

Paris J.

Citation: 2012 TCC 3
Date: 20120103
Docket: 2008-2967(IT)G

BETWEEN:

FLSMIDTH LTD.,

Appellant,

and

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Respondent.

REASONS FOR JUDGMENT

Paris J.

[1] The issue in this appeal is whether GL&V/Dorr-Oliver Canada Inc. ("Dorr-Oliver"), a predecessor corporation of the Appellant, is entitled to a deduction under subsection 20(12) of the *Income Tax Act*[1] for its share of U.S. income tax paid by a limited partnership of which it was a member. The appeal relates to Dorr-Oliver's taxation year ending March 31, 2002.

[2] Subsection 20(12) allows a deduction for non-business income tax paid to a government of a country other than Canada. The deduction is available in computing a taxpayer's income from a business or property.

[3] Subsection 20(12) sets out a number of conditions for the deduction. The relevant conditions for the purposes of this appeal are that the foreign tax be paid in respect of the taxpayer's income from a business or property and that, in the case of a

[1] R.S.C., 1985 c.1 (5th Supp.)

corporation, the tax cannot reasonably be regarded as having been paid in respect of income from the share of the capital stock of a foreign affiliate of the corporation.

[4] Subsection 20(12) reads as follows:

> In computing a taxpayer's income for a taxation year from a business or property, there may be deducted such amount as the taxpayer claims not exceeding the non-business income tax paid by the taxpayer for the year to the government of a country other than Canada (within the meaning assigned by subsection 126(7) read without reference to paragraphs (*c*) and (*e*) of the definition "non-business-income tax" in that subsection) in respect of that income, other than such tax, or part thereof, that can reasonably be regarded as having been paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation.

[5] The questions raised in this appeal are:

i) whether the limited partnership, of which Dorr-Oliver was a member, paid the U.S. income tax in respect of a property source of income under the *Act* and, if so,

ii) whether the U.S tax could reasonably be regarded as having been paid in respect of income from the share of the capital stock of a foreign affiliate of Dorr-Oliver.

Overview

[6] Dorr-Oliver was incorporated in Ontario in 1990 as a wholly owned subsidiary of Groupe Laperrière & Verrault ("GL&V"), a Quebec corporation.

[7] In 1998, GL&V set up a cross-border structure to finance the acquisition of companies in the U.S. The kind of structure set up by GL&V is known as a "tower structure." Generally speaking, a tower structure is a chain of holding entities (corporations or partnerships) set up by a corporation to allow it to fund U.S. subsidiaries in a tax-efficient manner.[2] This tax efficiency is achieved by using entities that are classified differently under Canadian and U.S. tax law. Such entities are referred to as "hybrid entities" because, for tax purposes, one country treats the

[2] The tax efficiency is achieved generally at least in part by giving rise to what is referred to as a "double-dip" deduction for interest on money borrowed by the parent to fund the U.S. subsidiaries.

entity as a flow-through vehicle like a partnership while the other country treats it as a corporation, which is taxable in its own right.[3]

[8] As a result of the different treatment of the hybrid entities in the GL&V structure, the income of the limited partnership was calculated in a different manner for Canadian tax purposes than for U.S. tax purposes. Under U.S. tax law, the income that was earned by the limited partnership consisted of interest income earned from a U.S. corporation. For Canadian tax purposes, it earned dividend income from a Canadian corporation. This difference in treatment leads to the first issue in this appeal: whether the U.S. tax paid on the interest income was paid in respect of a property source of income under the *Act*.

[9] With respect to the second issue, the entity in the GL&V structure that paid the interest income on which the limited partnership was taxed in the U.S. was a foreign affiliate of Dorr-Oliver. The question, therefore, is whether the U.S. tax can reasonably be regarded as having been paid by the limited partnership in respect of income from a share of a foreign affiliate.

Facts

[10] The following entities were part of the GL&V structure:

> GL&V and Peg Limited Partnership – the U.S. limited partnership of which Dorr-Oliver was a member. It was constituted under the laws of the state of Delaware.[4] Dorr-Oliver had a 98.9% interest in the limited partnership, and GL&V had a 1% interest. The general partner (another wholly owned subsidiary of GL&V) held a 0.1% interest.[5] The limited partnership filed an election with the U.S. Internal Revenue Service to be treated as a U.S. resident corporation. Under Canadian tax law, the limited partnership was treated as a transparent entity.

> GL&V Company: a Nova Scotia unlimited liability company ("NSULC"), all of the shares of which were owned by the limited

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[3] Brad Gordica and Sara McCracken, "*Interest Deductibility and Other International Tax Proposals in the 2007 Federal Budget*," 2007 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2007) 13A:1-22.

[4] *Delaware Revised Uniform Limited Partnership Act*, 6 Del C. c. 17.

[5] The General Partner until March 1, 2002 was GL&V and Peg Management Ltd., at which time it transferred its interest to GL&V Acquisition Inc. which became the general partner. Both corporations were wholly owned subsidiaries of GL&V.

> partnership. The sole activity of the limited partnership was holding the shares of NSULC. NSULC was a disregarded entity under U.S. tax law. It was treated as a corporation under Canadian tax law and therefore subject to tax as a separate person.
>
> <u>GL&V Finance Inc.</u>: a U.S. limited liability company ("LLC") all of the shares of which were owned by NSULC. LLC was a disregarded entity under U.S. tax law. Under Canadian tax law, LLC was treated as a separate person subject to tax.

[11] GL&V used the cross-border structure to finance the its acquisition of U.S. companies in the following manner:

> - the limited partnership subscribed for shares of NSULC using, in part, borrowed funds;
>
> - NSULC used the funds from the subscriptions made by the limited partnership to subscribe for shares of LLC;
>
> - LLC used the proceeds from the subscriptions to make interest-bearing loans (the "LLC loans") to GL&V Holdings ("Holdings"), a U.S. subsidiary of GL&V, and
>
> - Holdings used the proceeds of the LLC loans to provide capital and loans to indirectly wholly-owned subsidiaries of GL&V to purchase U.S. companies.

[12] For the year ended March 31, 2002, LLC earned interest income from Holdings on the LLC loans and used this income as well as interest income it earned in the previous year to pay dividends to NSULC. NSULC used the proceeds of the dividends from LLC to pay dividends to the limited partnership.

[13] During that year, the limited partnership paid interest on money it borrowed to subscribe for the NSULC shares.

[14] These transactions gave rise to different tax results under U.S. and Canadian tax law.

[15] For U.S. tax purposes NSULC and LLC were treated as disregarded entities, and it was considered that:

-the limited partnership made the LLC loans to Holdings directly,

-the interest earned on those loans was earned directly by the limited partnership, and the LLC dividends and the NSULC dividends were disregarded, and

-the interest paid by the limited partnership on the money used to acquire the NSULC shares and ultimately fund the LLC loans was incurred to earn the interest income on the LLC loans.

The limited partnership filed an election with the U.S. Internal Revenue Service to be treated as a U.S. resident corporation. In computing its net income, it included the interest income from Holdings, and it deducted the interest it paid on the money it borrowed to purchase the NSULC shares. The limited partnership paid tax to the U.S. government on the resulting net income.

[16] For Canadian tax purposes:

-LLC was treated as a foreign affiliate of NSULC, and the interest income earned by LLC from Holdings was recharacterized as active business income and was included in LLC's exempt surplus.[6]

-The LLC dividends paid to NSULC were paid out of LLC's exempt surplus. Since the dividends were paid out of exempt surplus, NSULC was able to deduct the amount of those dividends in computing its taxable income pursuant to paragraph 113(1)(*a*) of the *Act* and did not pay tax on them.

-The limited partnership included the NSULC dividends in its income and deducted the interest paid on the money it borrowed to subscribe for the NSULC shares. It also deducted the U.S. tax it paid during the year, which is the deduction that is disputed in this case.

-Dorr-Oliver included its share of the limited partnership's income in computing its income. The amount included in income by Dorr-Oliver was net of its proportionate share of disputed deduction taken by the limited partnership under subsection 20(12).

[6] By paragraph 95(2)(*a*) of the *Act* and section 5907, *Income Tax Regulations*, CRC c. 945.

> -In computing its taxable income, Dorr-Oliver deducted its share of the NSULC dividends received by the limited partnership under subsection 112(1). Therefore, Dorr-Oliver did not pay any tax on its proportionate share of the NSULC dividends.
>
> -LLC was a foreign affiliate of Dorr-Oliver.

It is admitted by the parties that the U.S. tax that was paid by the limited partnership was paid by it on interest income from the LLC loans and was non-business income tax as defined in subsection 126(7) of the *Act*. It is also admitted that the limited partnership's only source of income under the *Act* was its shares in NSULC and that the only income it received in the year in issue was the NSULC dividends.

First Question: Was the U.S. tax paid by the limited partnership in respect of income from a business or property under the *Act*?

[17] For the purposes of the first issue, it is helpful to repeat the relevant portions of subsection 20(12), which read as follows:

> In computing a taxpayer's income . . . from a business or property, there may be deducted . . . the . . . income tax paid by the taxpayer . . . to a government of a country other than Canada . . . in respect of that income . . .

Respondent's position

[18] The respondent submits that a deduction under subsection 20(12) of the *Act* is only available for tax paid to a foreign government in respect of income that arises from the same business or property source as the income which is being computed by the taxpayer under the *Act*. In this case, the limited partnership's only source of income from a Canadian tax perspective was its shares in NSULC. However, there was no amount that could be deducted by the limited partnership under subsection 20(12) in computing the limited partnership's income from that source because the U.S. tax was not paid by the limited partnership in respect of income from that source. The respondent says that the U.S. tax was paid on interest income from the LLC loans, which were not recognized as a source of income to the limited partnership under the *Act*.

[19] Since the income on which the U.S. tax was paid was not considered to be income under the *Act*, there was no source of income to the limited partnership against which the subsection 20(12) deduction could be taken.

[20] The respondent says that there must be a "direct link" between the U.S. tax paid by the limited partnership and the dividend income it received from NSULC and no direct link exists here. It is not enough that interest income and dividends are both income from property under the *Act*. The appellant cannot take deductions in respect of the interest income attributed to the limited partnership under U.S. tax law, because that source did not exist under the *Act*. Furthermore, since income from property is computed under the *Act* on a property by property basis, only deductions that relate to the NSULC shares can be taken in computing income from those shares.

[21] The respondent also says that this interpretation of the phrase "tax paid ….in respect of that income" is consistent with the purpose of subsection 20(12), which is to ensure that Canadian residents are not subject to international double taxation. There is no double taxation of the limited partnership's dividend income from NSULC because those dividends were deductible by it under subsection 112(1) of the *Act*, and therefore were not taxed under the *Act*. The only tax paid by the limited partnership on the LLC interest income that flowed through to the limited partnership was the U.S. tax.

Appellant's position

[22] The appellant argues that the phrase "tax paid … in respect of that income" in subsection 20(12) does not require a causal or direct link between the U.S. tax and the dividend income from NSULC. It only requires that the U.S. tax be paid *in relation to* the income which is being computed under the *Act* or *in connection with* that income.

[23] The appellant says that in economic terms the limited partnership's profit from its shares in NSULC was reduced by the U.S. tax that it paid and therefore that the U.S. tax was paid in respect of the dividend income from NSULC. The appellant says that the U.S. tax "reduced the profit from the sole and only undertaking of the limited partnership, its investment in the NSULC shares."

[24] The appellant contends that the words "In computing a taxpayer's income from a business or property" and "tax paid . . .in respect of that income" were added to subsection 20(12) simply for the purpose of clarifying that the deduction was not available in respect of foreign taxes paid on income from sources other than business

or property and not for the purpose of requiring that the foreign tax be paid on income from the same source as that which is being computed under the *Act*. Since the U.S. taxes in this case were paid in respect of a property source of income, the deduction would fall within the intent of subsection 20(12).

[25] In the alternative, the appellant submits that the reference in subsection 20(12) to "income from a business or property" is in fact a reference to a single unified source of income, again because this wording is only intended to limit the deduction to foreign tax paid in respect of income from business or property as opposed to other sources of income. Therefore, the distinction made by the respondent between dividend income earned by the limited partnership for Canadian tax purposes, and interest income earned by it for U.S. tax purposes is irrelevant for the purposes of subsection 20(12) since both types of income fall within the category of "income from a business or property."

[26] In addition, the appellant says that the interpretation proposed by the respondent is contrary to administrative positions taken by the Minister in a number of CRA technical interpretations. In those interpretations, the Minister has accepted that a subsection 20(12) deduction was available in situations that were analogous to that of Dorr-Oliver in this case.

[27] The appellant also says that the respondent's interpretation of the phrase "in respect of that income" introduces a territorial sourcing rule to subsection 20(12) that would deny a deduction where income earned by a taxpayer is sourced in Canada under Canadian tax rules. The appellant submits that nothing in subsection 20(12) suggests that the characterization of income under Canadian and foreign tax law must be the same. The language of subsection 20(12) does not refer to foreign source income on which the foreign tax is paid.

Analysis

[28] In order to determine whether the limited partnership paid the U.S. tax in respect of income from a business or property under the *Act*, it is necessary to determine the meaning of the phrases "income . . . from a business or property" and "tax paid . . . in respect of that income" found in subsection 20(12).

[29] Firstly, I agree with the respondent that the words "that income" in subsection 20(12) refer back to "income from a business or property" found in the opening words of the provision. The appellant did not challenge this point, and the language used is unambiguous.

[30] Secondly, it is clear that the phrase "income . . . from a business or property" is intended to refer to income arising from each individual business or individual property of the taxpayer, rather than income from all of a taxpayer's business sources combined or property sources combined or the combined business and property income of a taxpayer. The phrase is used as part of the expression "in computing a taxpayer's income for a taxation year from a business or property" which has been held to require a computation of income for each separate business or property. In *Hickman Motors Limited v. The Queen*[7] Iacobucci J. wrote:

> 133 . . . for tax purposes, when calculating income from business, a taxpayer may not lump together the revenues and expenses from all of that person's various business enterprises. Rather, the taxpayer must compute, separately, his or her income or loss from each individual business. This provides the appropriate figure which the taxpayer then "plugs in" to the s. 3 formula for computing income for the taxation year.
>
> 134 This requirement to treat each business as a separate source arises from the wording of the applicable statutory provisions. For example, s. 3(*a*) states that a taxpayer must "determine the aggregate of amounts each of which is the taxpayer's income for the year . . . from <u>each</u> office, employment, business and property" (emphasis added). Similarly, s. 4(1)(*a*) provides:
>
>> . . . a taxpayer's income or loss for a taxation year from <u>an</u> office, employment, business, property or other source, . . . is the taxpayer's income or loss . . . computed in accordance with this Act on the assumption that he had during the taxation year no income or loss except from that source.... [Emphasis added.]

[7] [1997] 2 S.C.R. 336, at paragraphs 133 to 135.

> Section 9(1) contains similar wording, as does s. 20(1), which lists a number of deductions permitted from a taxpayer's income "from <u>a</u> business or property" (emphasis added).
>
> 135 This need to segregate business income according to its various "sub-sources" has been discussed in both academic writings and the jurisprudence. In *Canadian Income Taxation* (4th ed. 1986), Edwin C. Harris says at p. 99:
>
> > . . . the Act provides that a taxpayer's income for a taxation year is his income from all sources, including but not limited to his income from <u>each</u> office or employment, <u>each</u> business, and <u>each</u> property. His income from each source-type is to be computed separately. [Emphasis added.]

[31] At paragraph 138 of that decision, Iacobucci J. went on to say:

> The requirement to calculate income from each "sub-source" separately is fundamental to the entire taxing scheme set up by Parliament. To suggest otherwise, as my colleague does, is to ignore the plain words of the Act.

[32] These comments apply equally to the calculation of property income under the *Act.* For this reason, I reject the appellant's arguments that the phrase "income . . . from a business or property" in subsection 20(12) refers to a single unified source of income, or to income from business or property generally. I find that the wording of subsection 20(12) contemplates a calculation of income from a specific business or property source of a taxpayer, and that the foreign tax must be paid in respect of income from that source.

[33] This interpretation, in my view, accords with Parliament's purpose in adding the phrases "from a business or property" and "in respect of that income" to subsection 20(12) in 1992. Prior to that time, subsection 20(12) did not contain any express restriction as to the source of income against which foreign tax could be deducted and read as follows:

> Foreign non-business income tax – <u>In computing the income of a taxpayer for a taxation year,</u> there may be deducted such amount as the taxpayer [may] claim not exceeding the non-business income tax paid by the taxpayer for the year to the government of a country other than Canada (within the meaning assigned [by the definition "non-business-income tax"] in subsection 126(7) [if that definition] read without reference to paragraphs (c) and (e) [thereof] other than any such tax, or part thereof, that [may] reasonably be regarded as having been paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation.

(Emphasis added.)

[34] The argument was made in the case of *Kaiser v. The Minister of National Revenue*[8] that subsection 20(12) permitted the taxpayer to deduct foreign tax paid on employment income. Although the Court in *Kaiser* held that a deduction under subsection 20(12) was only available for the purposes of computing income from a business or property, Parliament chose to amend the section in order to ensure that this limitation was clear. However, Parliament also wanted to clarify that any amount claimed under subsection 20(12) was to be deducted in computing income from the source to which the foreign tax related. The Department of Finance Technical Notes set out this purpose:

> Subsection 20(12) permits non-business income tax paid to a foreign government to be deducted in computing a taxpayer's income, as an alternative to claiming that tax as a foreign tax credit under section 126. This amendment, which applies to 1992 and subsequent taxation years, provides that a deduction under subsection 20(12) is available only with respect to foreign taxes paid in respect of income from a business or property, and also clarifies that any amount claimed under that subsection is to be deducted in computing income from the source to which that tax relates.[9]

[35] Therefore, there is a clear requirement in subsection 20(12) that the foreign tax be paid in respect of income of a taxpayer from a particular business or property and that the tax is only deductible in respect of that source.

[36] In this case, the limited partnership's only source of income under the *Act* was its NSULC shares and the only computation of income done by the limited partnership under the *Act* was for that source. The requirement in subsection 20(12) that the foreign tax be paid "in respect of that income" must be read as a requirement that the U.S tax be paid in respect of the dividend income from NSULC.

[37] The respondent's position is that since the U.S. tax was paid on interest income, it could not have been paid in respect of the limited partnership's NSULC dividend income. The respondent is in effect arguing that the phrase "tax paid . . . in respect of that income" should be read as "tax paid . . . on that income."

[38] This interpretation is too narrow.

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[8] 1991 2 C.T.C.2168 (T.C.C.)

[9] *2009 Department of Finance Technical Notes* – Income Tax – 21st Edition, consolidated to October 22, 2009, page 202, June 1992 technical note - subsection 20(12).

[39] In *Nowegijick v. The Queen*[10] the Supreme Court of Canada held that the words "in respect of" were "words of the widest possible scope" and went on to say:

> They import such [meanings] as "in relation to", "with reference to" or "in connection with." The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters.

[40] This statement has been quoted frequently in Canadian tax cases, and I am not aware of any instance in which the conclusion reached by the Supreme Court has not been followed. Therefore the phrase "in respect of that income" in subsection 20(12) must be taken to require some relationship or connection between the foreign tax and the income being computed under the *Act*.

[41] The respondent's position that there must be a direct link between the payment of the foreign tax and the Canadian income also contradicts the position taken by the Canada Revenue Agency (the "CRA") in a number of its technical interpretations.

[42] The first technical interpretation involved an individual residing in Canada who owned all the shares of a Nova Scotia unlimited liability corporation (ULC) which in turn owns all the shares of a U.S. limited liability corporation (LLC). That individual paid U.S. tax on the business or property income of LLC because both ULC and LLC were disregarded under U.S. tax law. The CRA stated that the individual was entitled to a deduction under subsection 20(12) for the U.S. tax paid even if he or she did not receive any dividend from ULC. The material part of the technical interpretation reads:

> . . . Although what the taxpayer owns is the shares of ULC which is a Canadian corporation, the U.S. taxes paid can be considered to be in respect of such shares such that the deduction under subsection 20(12) . . . would not be denied . . . In this situation the property is the shares of ULC. If the taxpayer did not own such shares he would not have to pay the U.S. taxes and there is nothing in subsection 20(12) of the *Act* which precludes the deduction from creating a loss.[11]

[43] A similar example, from a 2008 technical interpretation, dealt with U.S. tax paid by a Canadian resident taxpayer on his or her share of the income of a U.S. "S" corporation. An "S" Corporation is disregarded for U.S. tax purposes and the income of the corporation is attributed to its shareholders. Under Canadian tax law, the corporation is treated as a separate person subject to tax. Therefore, the shareholder

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[10] [1983] 1 S.C.R. 29, at page 39.
[11] CRA Technical Interpretation 1999-0010295 (February 21, 2000).

would pay U.S. tax on income from the corporation's activities, whereas in Canada he or she would pay tax on dividends distributed by the corporation. The CRA stated that a subsection 20(12) deduction was available for the U.S. tax paid by the shareholder even where ULC did not pay a dividend to the taxpayer. In other words, the CRA accepted that the 20(12) deduction was available where the U.S. tax was paid on income from a source that is different from the taxpayer's source of income under the *Act*. Presumably, the CRA accepted that the U.S tax was paid *in respect of* the shareholder's income from property under the *Act* because the corporation's income is paid out to the shareholder eventually and taxed as income from property. The technical interpretation states the view of the CRA that:

> . . . a deduction in a taxation year under subsection 20(12) of the Act for U.S. tax paid by the taxpayer for the year in respect of his share of the income of an S Corporation is not to be denied even though the taxpayer does not receive a distribution from the S Corporation in the year. It should be noted that the above view is not just an administrative position, as you indicated on your memorandum, ignoring the words of the provision of subsection 20(12) but it is a correct interpretation of that provision and is supported by the Department of Finance.[12]

[44] While these interpretations are not binding, they can be taken into account in cases of doubt. In *Nowegijick*, the Supreme Court said that:

> Administrative policy and interpretation are not determinative but are entitled to weight and can be an "important factor" in case of doubt about the meaning of legislation: *per* de Grandpré, J *Harel* v *The Deputy Minister of Revenue of the Province of Quebec*, [1978] 1 S.C.R. 851 at 859.[13]

[45] For these reasons, I find that there is no requirement in subsection 20(12) that the foreign tax be paid *on* the taxpayer's income from a business or property, but that it is sufficient that the payment of the tax be connected with or related to that income. It seems to me, that, had Parliament intended to restrict the availability of a deduction under subsection 20(12) to situations where the foreign tax was paid on income from the same source as that which was being calculated it would have simply used the words "paid on that income" rather than "paid in respect of that income. "

[46] I accept the appellant's contention that the payment of the U.S. tax was related to or connected with the dividend income received by the limited partnership from NSULC because the indirect source of the dividend income received by the limited

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[12] CRA Technical Interpretation 2008-028435117 (July 22, 2008)

[13] *Supra*, note 10, at page 37.

partnership was the interest income received by LLC from Holdings and the payment of the tax reduced the amount available to NSULC that could be paid out to the limited partnership as dividends. Furthermore, as stated in the first CRA technical interpretation cited above, if the appellant had not owned the NSULC shares, it would not have had to pay the U.S. tax. This, in my view, is also sufficient to link the payment of the U.S. tax and the dividend income received by the limited partnership from NSULC for the purposes of subsection 20(12).

Second question: Can Dorr-Oliver's share of the U.S. tax paid by the limited partnership reasonably be regarded as having been paid by Dorr-Oliver in respect of income from a share of the capital stock of a foreign affiliate of Dorr-Oliver?

[47] The parties agree that LLC was a foreign affiliate of Dorr-Oliver during the period in issue. This is because subsection 93.1(1) of the *Act* deemed Dorr-Oliver to own a proportionate share of the NSULC shares owned by the limited partnership equal to its proportionate interest in the limited partnership, with the result that Dorr-Oliver had an equity percentage in LLC equal to 98.7%.

[48] The appellant and respondent disagree whether Dorr-Oliver's share of the U.S. tax paid by the limited partnership can reasonably be regarded as having been paid with respect to income from the shares of LLC.

Appellant's position

[49] The appellant says that the U.S. tax cannot be reasonably regarded as having been paid by Dorr-Oliver in respect of income from the shares of LLC because the shares of LLC was not a source of income to Dorr-Oliver. The only potential source of dividend income for Dorr-Oliver was the shares of NSULC owned by the limited partnership. Dividends from those shares could not be considered income from the share of a foreign affiliate, since NSULC was a Canadian corporation and not a foreign affiliate of Dorr-Oliver.

[50] The appellant also argued that the phrase "may reasonably be regarded" does not authorize the Minister to ignore the existence of NSULC and consider that the limited partnership received the LLC dividends. Counsel stated that, absent a provision of the *Act* to the contrary, or a sham, a taxpayer's legal relationships must be respected.

[51] The appellant also said that a reasonable person could not conclude that the U.S. tax was paid in respect of dividend income from LLC because the tax was

payable even if LLC did not declare a dividend. The limited partnership paid the U.S. tax on the interest income from Holdings that flowed through to it because LLC and NSULC were disregarded entities for U.S. tax purposes.

[52] The appellant's final argument was that the respondent's interpretation of the limitation in subsection 20(12) is inconsistent with Canada's obligation under the *Convention between Canada and the United States of America with respect to Tax on Income and on Capital*[14] (the "*Treaty*"). The appellant says that Canada is obligated under Paragraphs XXIV (2) and (3) of the *Treaty* to provide relief from the U.S. tax paid by the limited partnership in this case.

<u>Respondent's position</u>

[53] The respondent submitted that the words "other than any such tax, or part thereof, that can reasonably be regarded as having been paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation" are intended to prevent a taxpayer from taking advantage of the foreign tax credit and deduction regime under the *Act* if the taxpayer already benefits from the foreign affiliate regime.

[54] Counsel also said that since dividends paid out of the exempt surplus of a foreign affiliate are not taxed in Canada, it is only logical that foreign tax paid in respect of the income giving rise to such dividends are not deductible under subsection 20(12).

[14] S.C. 1984, c. 20.

Analysis

[55] The appellant's argument that Dorr-Oliver could not have earned dividends from LLC and therefore that its share of the U.S. tax paid by the limited partnership could not reasonably be regarded as having been paid in respect of income from a share of LLC fails, in my view, to take into account that Parliament has again used the words "tax that can reasonably be regarded as having been paid . . . *in respect of* income from a share of a foreign affiliate" rather than "tax paid *on*" such income.

[56] As set out above, the phrase "in respect of" is a broad expression intended to convey a connection between two related matters. Here, the test would be whether it can reasonably be regarded that the U.S. tax was paid in relation to, or in connection with, income from the share of the foreign affiliate.

[57] In this case, the tax was connected with or related to the dividend income paid by LLC to NSULC because it was paid on income that funded the payment of the dividends. It was admitted that the dividends paid by LLC to NSULC were paid out of the interest paid to LLC by Holdings, and that the LLC dividends in turn funded the dividends paid by NSULC to the limited partnership.

[58] The appellant argued, and I accepted, on the first question in this appeal that the U.S. tax was paid by the Partnership *in respect of* the dividend income received by the Partnership from NSULC, although it was not paid *on* that income. The appellant maintained that "when taxes affect a flow of income from a source, with the result that the economic profit from that source is reduced, it is reasonable to conclude that those taxes are paid 'in respect of' that source." I agree with this logic, and find that it also applies in relation to the dividend income paid by LLC to NSULC. The U.S. tax paid by the Partnership on the interest income paid by Holdings to LLC reduced the economic profit from that source that could then be paid out to NSULC, and by extension reduced the amount that could be paid by NSULC to the Partnership. The payment of taxes thereby affected the flow of income at each step, from LLC through NSULC to the Partnership. Therefore, I find that the U.S. tax was related to or connected with the dividend income received by NSULC from LLC since both were part of the flow of funds that originated with Holdings and ended up with the Partnership.

[59] The appellant also argued that the phrases "can reasonably be regarded" and "in respect of" in subsection 20(12) do not allow the Minister to look through NSULC to conclude that the Partnership paid the U.S. tax in respect of dividends

from LLC. The Minister is not entitled under that provision to disregard the existence of NSULC. The appellant relies on the holding by the Supreme Court of Canada in *Shell Canada Ltd. v. R.*[15] that, absent a specific provision of the *Act* to the contrary, or a sham, a taxpayer's *bona fide* legal relationships must be respected by the Minister.

[60] Counsel referred to sections 16 and 68 of the *Act* which specifically recharacterize certain agreements entered into by a taxpayer.

[61] Subsection 16(1), for example, deems payments that can reasonably be regarded as interest or as another amount of an income nature payable to a taxpayer to be income of the taxpayer regardless of the legal form or effect of the agreement under which the payment was made to the taxpayer. It reads:

> Where, under a contract or other arrangement, an amount can reasonably be regarded as being in part interest or other amount of an income nature and in part an amount of a capital nature, the following rules apply:
>
> > (a) the part of the amount that can reasonably be regarded as interest shall, irrespective of when the contract or arrangement was made or the form or legal effect thereof, be deemed to be interest on a debt obligation held by the person to whom the amount is paid or payable: and
> >
> > (b) the part of the amount that can reasonably be regarded as an amount of an income nature, other than interest, shall, irrespective of when the contract or arrangement was made or the form or legal effect thereof, be included in the income of the taxpayer to whom the amount is paid or payable for the taxation year in which the amount was received or became due to the extent it has not otherwise been included in the taxpayer's income.

[62] Pursuant to section 68, where a taxpayer receives an amount that can reasonably be regarded as part consideration for the disposition of property and part consideration for services, the former amount is deemed to be proceeds of disposition of property and the latter amount to be an amount receivable in respect of those services, irrespective of the legal form or effect of the contract under which the amounts were payable. It reads:

> Where an amount received or receivable from a person can reasonably be regarded as being in part the consideration for the disposition of a particular property of a

[15] [1997] 3 S.C.R. 622.

> taxpayer or as being in part consideration for the provision of particular services by a taxpayer,
>
> > (a) the part of the amount that can reasonably be regarded as being the consideration for the disposition shall be deemed to be proceeds of disposition of the particular property irrespective of the form or legal effect of the contract or agreement and the person to whom the property was disposed of shall be deemed to have acquired it for an amount equal to that part; and
> >
> > (b) the part of the amount that can reasonably be regarded as being consideration for the provision of particular services shall be deemed to be an amount received or receivable by the taxpayer in respect of those services irrespective of the form or legal effect of the contract or agreement and that part shall be deemed to be an amount paid or payable to the taxpayer by the person to whom the services were rendered in respect of those services.

[63] I disagree with the appellant’s position that the words “can reasonably be regarded” in subsection 20(12) do not enable the Minister to look through NSULC. It seems to me that this phrase, on its own, is a specific provision enabling the Minister to evaluate the economic substance of a transaction regardless of its legal form. The words “irrespective of . . . the form or legal effect thereof” found in subsection 16(1) and “irrespective of the form or legal effect of the contract or agreement” found in section 68 do not modify the phrase “can reasonably be regarded” but instead relate to the deeming provision which follows in each case which deems certain types of income to have been received by the taxpayer. There is no such deeming provision in subsection 20(12).

[64] The appellant also submitted that the words “can reasonably be regarded” were inserted into subsection 20(12) as an objective test to apportion the foreign tax paid by the taxpayer among various sources of income rather than to recharacterize the basis of the tax. Counsel for the appellant drew a parallel in this regard between subsection 20(12), subsection 16(1) and section 68. However, both subsection 16(1) and section 68 are aimed at amounts that contain more than one type of payment: subsection 16(1) refers to “an amount . . . in part interest or other amount of an income nature and in part an amount of a capital nature” and section 68 refers to an amount part of which is consideration for the disposition of property and in part consideration for the provision of services. There is no similar wording in subsection 20(12) that would indicate an apportionment purpose.

[65] For these reasons, I conclude that the language of subsection 20(12) supports the respondent's position that the U.S. tax paid by the limited partnership were paid in respect of income from the shares of LLC and that the tax could therefore reasonably be regarded as having been so paid.

[66] It is also necessary to consider whether this result accords with the purpose of subsection 20(12), which is to provide relief from foreign taxes paid in respect of income which is included in a taxpayer's income under the *Act*.

[67] I agree with the proposition of the respondent that the restriction in subsection 20(12) relating to foreign tax paid in respect of income from the shares of a foreign affiliate of the taxpayer is included because relief from foreign taxation on dividends from foreign affiliates is dealt with comprehensively elsewhere in the *Act*.

[68] The *Act* provides in subsection 113(1) for relief from double taxation on dividends received from a foreign affiliate: paragraph 113(1)(*a*) exempts dividends from tax when the dividends are paid out of exempt surplus, and paragraphs 113(1)(*b*) and (*c*) allow a deduction for the underlying foreign tax attributable to the amount of the dividend when the dividends are paid out of taxable surplus. (Add 113(*a*)(*b*)+(*c*)) It is reasonable to conclude that in enacting these specific rules relating to foreign tax paid on dividends received from foreign affiliates, Parliament intended to deal fully with the relief from foreign tax for such dividends and that no further deduction under 20(12) is intended.

[69] In this case, the dividend paid by LLC to NSULC was deducted under paragraph 113(1)(*a*) and was thereby exempt from tax in Canada. The dividends paid to the limited partnership by NSULC were funded by the LLC dividends which had borne no Canadian tax.

[70] The appellant also argues that the respondent's interpretation of the limitation in subsection 20(12) is inconsistent with Canada's obligation under the *Treaty*.

[71] Paragraphs XXIV (2) and (3) of the *Treaty* provide rules for reciprocal credits and exemptions with respect to foreign tax in order to avoid double taxation on income that is taxable by both Canada and the U.S.

[72] Paragraphs XXIV (2) and (3) read as follows:

> (2) In the case of Canada, subject to the provisions of paragraphs 4, 5 and 6, double taxation shall be avoided as follows:

(a) subject to the provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions (which shall not affect the general principle hereof)

(i) income tax paid or accrued to the United States on profits, income or gains arising in the United States, and

(ii) in the case of an individual, any social security taxes paid to the United States (other than taxes relating to unemployment insurance benefits) by the individual on such profits, income or gains

shall be deducted from any Canadian tax payable in respect of such profits, income or gains;

(b) subject to the existing provisions of the law of Canada regarding the taxation of income from a foreign affiliate and to any subsequent modification of those provisions - which shall not affect the general principle hereof - for the purpose of computing Canadian tax, a company which is a resident of Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate which is a resident of the United States; and

(c) notwithstanding the provisions of subparagraph (a), where Canada imposes a tax on gains from the alienation of property that, but for the provisions of paragraph 5 of Article XIII (Gains), would not be taxable in Canada, income tax paid or accrued to the United States on such gains shall be deducted from any Canadian tax payable in respect of such gains.

(3) For the purposes of this Article:

(a) profits, income or gains (other than gains to which paragraph 5 of Article XIII (Gains) applies) of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules)) shall be deemed to arise in that other State; and

(b) profits, income or gains of a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention (without regard to paragraph 2 of Article XXIX (Miscellaneous Rules)) or to which paragraph 5 of Article XIII (Gains) applies shall be deemed to arise in the first-mentioned State.

[73] The appellant says that Canada is obligated under Paragraphs XXIV(2) and (3) to provide relief from the U.S. tax paid by the limited partnership in this case. Counsel says that paragraph XXIV(2) of the *Treaty* applies in this case because the limited partnership paid income tax in the U.S. on U.S. source income which is subject to Canada's taxing power. The U.S. has taxed the limited partnership as its

resident, which it is allowed to do under the *Treaty*, and since Canada flows through the income of the limited partnership to the partners, who are resident in Canada, the foreign tax paid by the partnership should be allocated to the partners and they should be entitled to foreign tax relief.

[74] In arriving at this interpretation of Paragraphs XXIV (2) and (3), the appellant relies on Articles 23A and 23B of the *OECD Model Treaty*,[16] as well as the OECD Commentary on those provisions[17] and the 1999 OECD report entitled *The Application of the OECD Model Tax Convention to Partnerships*.[18]

[75] In this respect, the appellant's counsel cited the following excerpt from the 1999 OECD report (at para. 139):

> The issue is therefore whether State R (Canada), which taxes partner A on his share in the partnership profits, is obliged, under the Convention to give credit for the source tax that is levied in State P (United States) on partnership P, which State P (United States) treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R (Canada) flows-through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership [to the partners] for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P (United States) is ignored for the purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit,

[76] The appellant argues that in this case, "consistent with the OECD flow-through approach for partnerships, Canada must provide relief from U.S. tax as a result of the fact that the limited partnership's U.S. source income is taxed in the United States." The appellant says that subsection 20(12) is one of the measures adopted by Canada to provide relief from double taxation, and therefore it should be interpreted in a manner that provides relief to taxpayers in accordance with Canada's treaty obligations.

<u>Analysis</u>

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[16] *Supra*, note 14.

[17] *Commentary on Articles 23A and 23B Concerning the Methods for Elimination of Double Taxation*, OECD, (2000).

[18] *The Application of the OECD Model Tax Convention to Partnerships,* OECD, No. 6, (1999).

[77] Firstly, I am not satisfied that the appellant has shown that subsection XXIV(2) of the *Treaty* imposes an obligation on Canada to provide a deduction in the form of paragraph 20(12) of the *Act*.

[78] Under paragraph XXIV(2) of the *Treaty*, Canada undertakes to avoid double taxation on profits, income or gains arising in the U.S. by allowing specific types of relief, namely:

> i) a deduction for any income tax paid or accrued to the U.S. on U.S. source income from any Canadian tax payable in respect of that income (subparagraph XXIV(2) (*a*)(i))
>
> ii) a deduction for social security tax paid by an individual to the U.S. (with certain limitations) on U.S. source income from any Canadian tax payable in respect of that income. (subparagraph XXIV(2) (*a*)(ii))
>
> iii) a deduction from taxable income for dividends received by a Canadian resident company out of exempt surplus of a foreign affiliate which is resident in the U.S. (paragraph XXIV(2)(*b*))
>
> and
>
> iv) a deduction for income tax paid or accrued to the U.S. tax on certain gains from the alienation of property from Canadian tax payable in respect of the gains (paragraph XXIV(2)(*c*)).

[79] Paragraph XXIV(2) is made subject to paragraphs XXIV(4), (5) and (6) which deal with U.S. citizens resident in Canada. Those provisions are not relevant to the present discussion.

[80] It is apparent from paragraph XXIV(2) that Canada is not required to allow a deduction for all U.S. tax paid on income arising in the U.S., and that Canada's obligation does not extend beyond relief from double taxation. This is because in categories (i) (ii) and (iv) above, the deduction is limited to the Canadian tax payable in respect of that income. This obligation is met by the foreign tax credit provisions

in subsection 126 of the *Act* which makes available a credit up to the amount of Canadian tax payable in respect of that income.

[81] Thus it seems to me that the *Treaty* is not intended to provide for any relief for U.S. tax on U.S. source income that is not taxed in Canada. In the present case, neither the U.S. source income of the limited partnership that was taxed in the U.S. (and which is not recognized as income of the limited partnership under Canadian law) nor the dividend income which was received by the limited partnership from NSULC, and which flowed through to the partners including the appellant, was taxed in Canada. Furthermore, the LLC dividends received by NSULC (which were the source of the dividends paid by NSULC to the Partnership) were not taxed in Canada because they were paid out of the exempt surplus of LLC. On this basis, it seems clear that no Canadian tax was payable "in respect of" the dividends received by the limited partnership from NSULC.

[82] Therefore, in my view, the appellant's contention that the Canada's obligations under the *Treaty* require that subsection 20(12) be interpreted to allow the appellant a deduction for its share of the U.S. tax paid by the limited partnership is ill-founded.

[83] With respect to the comments cited by the Appellant from the OECD Partnership Report, it seems to me that the position taken in that report (which would require the state in which the partners are resident to flow through the tax paid in the state of source) is predicated on the income on which the tax was paid being flowed through to the partners. The report states:

> <u>To the extent that State R (Canada) flows-through the income of the partnership to the partners for the purpose of taxing them</u>, it should be consistent and flow-through the tax paid by the partnership to the partners for the purposes of eliminating double taxation arising from its taxation of the partners.

(Emphasis added.)

[84] In the case at bar, however, the income on which U.S. tax was paid by the limited partnership was not flowed through to the partners. That income was not recognized by Canada.

[85] Furthermore, since no Canadian tax was paid on income derived from the income on which the U.S. tax was paid by the limited partnership, there is no double taxation of the income that was earned by the limited partnership in the U.S.

[86] Therefore, I find that the interpretation of subsection 20(12) which precludes the deduction taken by Dorr-Oliver is not inconsistent with Canada's obligations under the *Treaty*.

[87] For these reasons, the appeal is dismissed, with costs to the respondent.

Signed at Ottawa, Canada, this 3rd day of January 2012.

"B.Paris"

Paris J.

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