

Docket: 2003-3999(IT)G

BETWEEN:

TEMBEC INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on common evidence with the appeals of *Cascades Inc.*
(2004-1916(IT)G) and *Provigo Inc.* (2003-4340(IT)G)
on May 28, 2007, at Montréal, Quebec.

Before: The Honourable Justice Louise Lamarre Proulx

Appearances:

Counsel for the Appellant: Wilfrid Lefebvre
Counsel for the Respondent: Marie Bélanger
Natalie Goulard

JUDGMENT

The appeal from the assessment under the *Income Tax Act* for the 1997 taxation year is dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 11th day of July 2007.

"Louise Lamarre Proulx"

Lamarre Proulx J.

Translation certified true
on this 4th day of September 2007.
Monica F. Chamberlain, Revisor

Docket: 2004-1916(IT)G

BETWEEN:

CASCADES INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on common evidence with the appeals of *Tembec Inc.*
(2003-3999(IT)G) and *Provigo Inc.* (2003-4340(IT)G)
on May 28, 2007, at Montréal, Quebec.

Before: The Honourable Justice Louise Lamarre Proulx

Appearances:

Counsel for the Appellant: Wilfrid Lefebvre
Counsel for the Respondent: Marie Bélanger
Natalie Goulard

JUDGMENT

The appeal from the assessment under the *Income Tax Act* for the 1997 taxation year is dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 11th day of July 2007.

"Louise Lamarre Proulx"

Lamarre Proulx J.

Translation certified true
on this 4th day of September 2007.
Monica F. Chamberlain, Revisor

Docket: 2003-4340(IT)G

BETWEEN:

PROVIGO INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on common evidence with the appeals of *Cascades Inc.*
(2004-1916(IT)G) and *Tembec Inc.* (2003-3999(IT)G)
on May 28, 2007, at Montréal, Quebec.

Before: The Honourable Justice Louise Lamarre Proulx

Appearances:

Counsel for the Appellant: Wilfrid Lefebvre
Counsel for the Respondent: Marie Bélanger
Natalie Goulard

JUDGMENT

The appeal from the assessment under the *Income Tax Act* for the 1998 taxation year is dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 11th day of July 2007.

"Louise Lamarre Proulx"

Lamarre Proulx J.

Translation certified true
on this 4th day of September 2007.
Monica F. Chamberlain, Revisor

Citation: 2007TCC395
Date: 20070711
Dockets: 2003-3999(IT)G
2004-1916(IT)G
2003-4340(IT)G

BETWEEN:

TEMBEC INC.
CASCADES INC.
PROVIGO INC.,

Appellants,

and

HER MAJESTY THE QUEEN

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Lamarre Proulx J.

[1] In each of these appeals, agreements as to the facts were filed before the hearing. The facts are not completely identical, but the question of law is the same in each case. It involves the interpretation of subparagraph 20(1)(f)(ii) of the *Income Tax Act* (the Act). The taxation years at issue are 1997 for Tembec Inc. and Cascades Inc. and 1998 for Provigo Inc.

[2] Paragraph 20(1)(f) of the Act read as follows during the relevant period:

20(1) Deductions permitted in computing income from business or property.
Notwithstanding paragraphs 18(1)(a), 18(1)(b) and 18(1)(h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

...

(f) **Discount on certain obligations**-an amount paid in the year in satisfaction of the principal amount of any bond, debenture, bill, note, mortgage or similar obligation issued by the taxpayer after June 18, 1971 on which interest was stipulated to be payable, to the extent that the amount so paid does not exceed,

- (i) in any case where the obligation was issued for an amount not less than 97% of its principal amount, and the yield from the obligation, expressed in terms of an annual rate on the amount for which the obligation was issued (which annual rate shall, if the terms of the obligation or any agreement relating thereto conferred on its holder a right to demand payment of the principal amount of the obligation or the amount outstanding as or on account of its principal amount, as the case may be, before the maturity of the obligation, be calculated on the basis of the yield that produces the highest annual rate obtainable either on the maturity of the obligation or conditional on the exercise of any such right) does not exceed $\frac{4}{3}$ of the interest stipulated to be payable on the obligation, expressed in terms of an annual rate on
 - (A) the principal amount of the obligation, if no amount is payable on account of the principal amount before the maturity of the obligation, or
 - (B) the amount outstanding from time to time as or on account of the principal amount of the obligation, in any other case,

the amount by which the lesser of the principal amount of the obligation and all amounts paid in the year or in any preceding year in satisfaction of its principal amount exceeds the amount for which the obligation was issued, and

- (ii) in any other case, $\frac{3}{4}$ of the lesser of the amount so paid and the amount by which the lesser of the principal amount of the obligation and all amounts paid in the year or in any preceding taxation year in satisfaction of its principal amount exceeds the amount for which the obligation was issued;

[3] Subparagraph 20(1)(f)(ii) was amended in 2001 by replacing the reference to the fraction " $\frac{3}{4}$ " with a reference to the fraction " $\frac{1}{2}$ ", in order to reflect the amendment made to the capital gains inclusion rate, which was changed from $\frac{3}{4}$ to $\frac{1}{2}$.

[4] The definition of "principal amount" in subsection 248(1) of the Act reads as follows:

"principal amount", in relation to any obligation, means the amount that, under the terms of the obligation or any agreement relating thereto, is the maximum amount or maximum total amount, as the case may be, payable on account of the obligation by the issuer thereof, otherwise than as or on account of interest or as or on account of any premium payable by the issuer conditional on the exercise by the issuer of a right to redeem the obligation before the maturity thereof;

[5] In these cases, there are two issues. The first is whether the principal amount can fluctuate between the year the obligation is issued and the year it is redeemed. The second issue involves determining the maximum amount paid in satisfaction of the principal amount in the case of redemption in shares. Is it the share price agreed upon by the parties in the trust indenture, or is it the fair market value (FMV) of the shares at the time they are issued in satisfaction of the obligations?

[6] Since the agreements as to the facts are relatively long, I shall reproduce the version submitted by the Appellant Tembec Inc.:

[TRANSLATION]

1. The Appellant is a corporation that was incorporated in 1972 under Part I of the *Companies Act* (QCA) and continued under Part IA of the QCA in 1983. The Appellant's fiscal year ends on September 30 of each year.
2. The Appellant operates primarily in the field of pulp and paper.
3. The Appellant's authorized capital stock includes, *inter alia*, an unlimited number of Class A shares.
4. The taxation year in dispute for the Appellant ended on September 30, 1997.

THE DEBENTURES

(a) Issuance

5. Throughout 1993 and in accordance with the terms of a trust indenture dated July 28, 1993, the Appellant issued \$70,000 in convertible unsecured subordinated debentures (the Debentures) maturing on August 1, 2003. The Debentures were issued in \$1,000 denominations.

Short-form prospectus of July 15, 1993 – Tab 1
Trust Indenture of July 28, 1993 – Tab 2

6. The Debentures were issued with no original discount.
7. A portion of the net proceeds from the issuance was used to refinance the Appellant's operations and a portion was added to its working capital.

(b) Interest

8. The Debentures bore interest at the rate of 7.5% per year, payable semi-annually on February 1 and August 1. The interest on the Debentures was deductible under paragraph 20(1)(c) of the Act.

(c) Conversion privilege

9. The Debentures were convertible at the holders' option into the Appellant's Class A shares at any time prior to the close of business on the last business day preceding August 1, 2003, or, if they were called for early redemption, the last business day prior to the redemption date.
10. The conversion price was \$10 per Class A share, or 100 shares per \$1,000 of principal amount of Debentures.

(d) Early redemption

11. The Appellant could call the Debentures for early redemption at any time on or after August 1, 1996, at a price equal to the Debenture capital (\$1,000) plus any accrued interest. However, in order for the transaction to take place, the weighted average price of the Appellant's Class A shares on the Montreal and Toronto Stock Exchanges for the 20 consecutive trading days ending five trading days preceding the date on which the notice of redemption was given shall not be less than the following:

- i. if called during the 12 months ending August 1

1997	\$14.00
1998	\$13.00
1999	\$12.00
2000	\$11.50
2001	\$11.00
2002	\$10.50
2003	\$10.00

12. Unless in default, the Appellant also had the option, with at least 30 days' and at most 60 days' notice, of redeeming the principal amount of the Debenture by issuing a certain number of Class A shares. The number of Class A shares to issue was calculated by dividing \$1,000 by 95% of the weighted average price at which the Appellant's Class A shares were traded on the Montreal and Toronto Stock Exchanges during the 20 consecutive trading days ending five trading days preceding the call date. This calculation resulted in the holder receiving shares with an approximate value of \$1,050 per \$1,000 of principal amount of Debentures.

(e) Buyback of Debentures for cancellation

13. The Appellant could purchase the Debentures on the market or by private contract or offer for a price not higher than 105% of their principal amount for purchases until August 1, 1997, and, for purchases after that date, for a price not higher than the principal amount (\$1,000 per Debenture), plus accrued and unpaid interest and acquisition fees.

(f) Payment upon maturity

14. Upon maturity, the Appellant had to pay \$1,000 per Debenture plus accrued and unpaid interest. However, unless in default, the Appellant had the option, with at least 30 days' and at most 60 days' notice, of redeeming the principal amount of the Debenture by issuing a certain number of Class A shares. The number of shares was calculated in the same way as in paragraph 12 above.

CONVERSION

15. Between August 6 and 29, 1997, following a Notice from the Appellant that it would call the Debentures as soon as the weighted average price exceeded \$13.00, the holders converted 64,485 Debentures having a face value of \$64,485,000 into 6,448,500 of the Appellant's Class A shares.
16. At the time the Debentures were converted, the stock market value of the Appellant's Class A shares was fluctuating between \$13 and \$14 a share.

Stock prices – Tabs 3 and 4

ACCOUNTING AND TAX TREATMENT

17. For accounting purposes, the Appellant raised the value of its capital stock by \$64,485,000, the face value of the converted Debentures.
18. In June 2000, the Appellant submitted an adjustment request for its income tax return for its 1997 taxation year. The request focused on, *inter alia*, the claim for a \$16,553,987 deduction under paragraph 20(1)(f). The amount of \$16,553,987 represents 75% of the difference between the stock market value of the 6,448,500 of the Appellant's Class A shares (\$86,556,983) and the amount initially received when the converted Debentures were issued (\$64,485,000).
19. In its Notice of Determination of a Loss dated October 15, 2001, the CRA disallowed the \$16,553,987 deduction claimed by the Appellant.
20. The Appellant duly and in a timely manner filed a notice of objection to the Notice of Determination and the CRA confirmed its determination in a notice dated August 6, 2003.

[7] Cascades Inc. used unsecured convertible debentures as the financial instrument for the purpose of borrowing from its subscribers, while Provigo Inc. used unsecured convertible promissory notes.

[8] As the provisions concerning the right to convert securities into shares are important, I shall also reproduce paragraphs 8 and 9 of the agreement as to the facts from Cascades Inc. and paragraph 12 of the agreement as to the facts from Provigo Inc.:

[TRANSLATION]

Cascades Inc.

(c) Conversion privilege

8. Subject to adjustments in certain cases, holders of common shares had the option of converting them into Debentures at any time prior to the close of business on August 19, 1998, at a conversion price ("initial conversion price") of \$6.50 per common share of the Appellant's company, i.e. a rate of 153,846 common shares per \$1,000 of principal amount of Debentures.
9. Holders then had the option of converting the Debentures into common shares at a conversion price ("subsequent conversion price"), subject to

adjustments in certain cases, of \$7.25 per common share, i.e. a rate of 137,931 common shares per \$1,000 of principal amount of Debentures.

Provigo

(d) Conversion privilege

12. The promissory notes were convertible into the Appellant's common shares without par value on the following basis:
 - (i) if the conversion took place after June 29, 1994, and before June 29, 1999, one common share for every \$4.93 (face value) of the promissory note.
 - (ii) notwithstanding the above, if the conversion took place on June 29, 1999, or if a call notice was issued with respect to the promissory note or if the holder of the note was in a position, according to the note's terms, to declare due and payable the principle amount of the promissory note, one common share for every \$4.475 (face value) of the promissory note.

[9] Here is how the conversion right is described in Tembec Inc.'s trust indenture:

[TRANSLATION]

Conversion Privilege

Each Debenture is convertible at the option of the holder at all times prior to the close of business on the on the last business day preceding whichever is the earlier of the date of maturity or the specified early redemption date, into Class A shares, at a conversion price of \$10.00 per Class A share, i.e. 100 Class A shares per \$1,000 in Debentures. . . .

. . .

The issued and outstanding Class A shares are traded on the Montreal and Toronto Stock Exchanges. There is currently no market through which the Debentures may be sold. On July 14, 1993, the closing price of the Class A shares was \$8.125 on the Montreal Stock Exchange and \$8.00 on the Toronto Stock Exchange. The Montreal and Toronto Stock Exchanges have conditionally agreed to list the Debentures and Class A shares issued upon the conversion of the Debentures. Listing is conditional upon the Company fulfilling all the requirements of those stock exchanges no later than October 15, 1993.

[10] The obligations issued give the holder a right of conversion into shares of the borrowing company, in accordance with the provisions of the trust indentures under which they were issued. The holder was entitled to redeem the amount paid for the debenture or promissory note, i.e. the obligation's face value, or to convert the obligation into company shares.

[11] In the case of Tembec Inc., obligations in the amount of \$70,000,000 were issued in 1993, in the case of Provigo Inc., \$20,000,000 in 1994, and Cascades Inc., \$82,500,000 in 1993.

[12] In 1997, the holders of obligations from Tembec Inc. (the company used as an example in the submissions) converted 64,485 debentures having a face value of \$64,485,000 into 6,448,500 of the Appellant's Class A shares. At that time, the shares' stock market price was fluctuating between \$13 and \$14, as opposed to the \$10 set out in the agreement. The claim, pursuant to subparagraph 20(1)(f)(ii) of the Act, is for 75% of the difference between the stock market value of the 6,448,500 Class A shares, which was \$86,556,983, and the amount initially received when the Debentures were purchased. See paragraphs 15, 16 and 18 of the agreement as to the facts.

[13] Before moving on to the parties' arguments, it may be helpful to reproduce paragraphs 32 and 33 of the Supreme Court of Canada's decision in *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, [2006] 2 S.C.R. 447, hereinafter *Imperial Oil*. In that decision, the scope of paragraph 20(1)(f) of the Act was analyzed in depth and the formula set out.

32 . . . The instant cases turn on the proper interpretation of the deduction encompassed by s. 20(1)(f). Specifically, the question is whether the deduction provided for in par. (f) is exclusively one for original issue discounts or whether it is instead a broader deduction that applies more generally to the capital cost of borrowing.

33 The formula described in s. 20(1)(f) is as follows:

$$X = [\text{lesser of A or B}] - [C]$$

where

X is the amount of the *deduction*;

A is the *principal amount* of the obligation;

- B** is *all amounts paid* in the year or in any preceding year in satisfaction of the principal amount; and
- C** is the amount for which the obligation was *issued*.

[14] In this case, the dispute concerns the amounts in variables A and B of the formula. There is no dispute as to variable C. The Appellants must satisfy the Court that both the amount corresponding to variable A of the formula (the principle amount) and the amount corresponding to variable B (all amounts paid) exceed the amount for which the obligation was issued. Nor is there any dispute as to the applicability of subparagraph 20(1)(f)(ii).

Appellants' arguments

[15] It is common ground in the agreements as to the facts that the obligations—debentures and promissory notes—were issued with no original issue discount: see paragraph 6 of the agreement reproduced above.

[16] However, according to counsel for the Appellants, the Supreme Court decision does not make a final determination as to whether only the original issue discount may be taken into consideration. Despite the fact that in the last sentence of paragraph 32 of the decision, the Supreme Court says that the issue is whether the deduction provided for in paragraph (f) is exclusively one for original issue discounts or whether it is instead a broader deduction that applies more generally to the capital cost of borrowing, counsel argues that the decision makes a final determination only with respect to foreign exchange losses. The issue of other potential borrowing costs, such as redemption costs, was not decided.

[17] In support of this argument, counsel refers to paragraphs 64 and 67 of the decision:

64 . . . This does not dispose of the matter, however, because if the "principal amount" can fluctuate with the cost of repayment in Canadian dollars, then the "discount amount" can be ascertained in relation to the value of the principal in Canadian dollars *at the time of repayment*, rather than in relation to the face value of the obligation (i.e., the term "discount" may not be limited to "original issue discounts" but may encompass discounts that arise out of fluctuations of commodity or currency prices over time). To resolve this issue, it is necessary to determine whether Parliament intended foreign exchange losses to be covered by s. 20(1)(f) in the same way as discounts.

...

67 In my view, s. 20(1)(f) was never intended to apply to foreign exchange losses. As we have seen above, a number of factors, which generally relate to the wording of the provision, are determinative in this respect. This interpretation best reflects the structure of the *ITA* and the intent of Parliament. The purpose of the provision is to address a specific class of financing costs arising out of the issuance of debt instruments at a discount. The interpretation advanced by the respondents in these appeals, on the other hand, turns s. 20(1)(f) into a broad provision allowing for the deductibility of a wide range of costs attendant upon financing in foreign currency, in the absence of any mention of such costs in the text of the *ITA*, and despite the fact that such costs are usually regarded as being on capital account.

[18] Counsel makes two proposals in light of his view that the Supreme Court settled only the issue of foreign exchange losses: (1) in some circumstances, the principal amount can fluctuate, and (2) the fair market value (FMV) of the shares must be taken into account in calculating the total amounts paid in satisfaction of the principal amount.

[19] According to counsel, the term "principal amount" is not an amount fixed upon issuance, but can fluctuate according to the market value of the product payable upon maturity. For example, if a \$100,000 debenture were issued and redeemable at 1,000 ounces of gold that, at the time of the loan, were worth \$100,000, the principal amount of that debenture would be, according to counsel, the FMV of the gold at the time of redemption.

[20] Counsel points out that these cases are distinguishable from *Imperial Oil*. In that case, uncertainty as to the maximum repayment was not dealt with in the lending agreement. In this case, on the other hand, under the terms of the agreement a potential discount is possible, since the market value of the shares at the time of their conversion is unknown, but the conversion right is included regardless.

[21] Hence, in the case of Tembec Inc., the conversion price set out in the agreement was \$10 per Class A share, or 100 shares per \$1,000 of principal amount of the Debentures: see paragraph 15 of the agreement as to the facts. According to counsel, it is not the expected price that is important but rather the proportion of shares obtained. It is this proportion that remains stable. Therefore,

according to the very terms of the agreement, the total amount payable in satisfaction of the principal amount may vary.

[22] In *Imperial Oil*, borrowing and redemption were performed in US dollars. At the time of redemption, there had been a fluctuation in the value of the US dollar, expressed in Canadian dollars. According to counsel for the Appellant, the conversion into Canadian dollars was not addressed in the agreement, which was not the case for the right to convert into shares. Therefore, counsel argues, the principal amount is subject to fluctuation; it is not necessarily the initial amount, but rather the cost of redemption to the extent that that cost is covered by the lending agreement.

[23] The second proposal by counsel for the Appellants is that the amounts paid in satisfaction of the obligation pursuant to subparagraph 20(1)(f)(ii) of the Act and the definition of "principal amount" in subsection 248(1) of the Act must be calculated by taking the FMV of the shares at the time of conversion or redemption and not the price agreed upon in the trust indenture.

[24] Counsel maintains that the price mentioned in the trust indentures is nothing more than an item or tool for calculating the proportion of shares to be issued in satisfaction of the obligations. The intention of the parties must be considered. He maintains that the agreement between the parties is to fix a total number of shares to be obtained. It is therefore at the time of payment that the maximum amount payable in satisfaction of the principal amount can be determined; the cost incurred by the Appellants for this purpose is the FMV of the shares and not the agreed upon price. In support of this, he refers to the decision of this Court in *Alcatel Canada Inc. v. Canada*, 2005 TCC 149 at paragraph 31:

31 Black's Law Dictionary, Eighth Edition, defines "expenditure" as follows:

1. The act of process of paying out; disbursement.
2. A sum paid out.

I take that to be the ordinary meaning of the word. Expenditure is not confined to outlays of cash. Nothing in the definition excludes the disbursement of assets by mechanisms adopted for that purpose which do not involve payouts of cash. The Respondent's argument fails to recognize that a very real expenditure is accomplished when shares having an established market value are sold for less than that value in the context of a scheme for the compensation of the employees who buy them. The benefit realized by the employees is real. It is not conjured up by magic. It flows from the Appellant to the employees by the mechanism of the

stock option. The expenditure consists of the consideration which the Appellant foregoes when it issues its shares for less than market value. The encouragement of scientific research which is the object of the legislation would be greatly diminished by the adoption of the narrow construction for which the Respondent contends.

[25] According to this decision, a company makes a real expenditure when it issues shares for less than their FMV. The expenditure consists of the consideration that the Appellant foregoes when it issues its shares for less than their market value.

[26] I should also note that counsel, in response to a question from the Court, expressed the opinion that the cost of acquiring the shares upon conversion by the holders of the obligations is the issue price of the obligation.

Respondent's arguments

[27] Counsel for the Respondent maintains that the Supreme Court in *Imperial Oil* made a final determination not only on foreign exchange losses, but also on the issue of whether the deduction referred to in paragraph 20(1)(f) is exclusively one for original issue discounts or whether it should be deemed to cover a broader array of financing costs. If, at the end of the decision, the Supreme Court focused primarily on foreign exchange losses, it is because they represented, in that case, the additional cost of borrowing at the time of redemption. There is no reason the same reasoning cannot be applied to other additional borrowing costs at the time of redemption.

[28] According to her, the paragraph 20(1)(f) deduction is designed to cover one-time expenses incurred when the debt is repaid but not to cover the depreciation or appreciation of the principal amount over time, apart from that related to the original issue discount.

[29] The Supreme Court held at paragraph 67 of the decision that paragraph 20(1)(f) was never intended to apply to foreign exchange losses. The provision was meant to apply to a specific category of financing costs flowing from the issuance of discounted debt securities.

[30] In this case, when the obligations were issued, the principal amount of the obligations was equal to the amount in which they were issued. It is common

ground that there was no original issue discount. According to counsel, the principal amount could therefore not fluctuate as a function of redemption costs.

[31] With respect to the second argument raised by the Appellants, to the effect that the amounts paid in satisfaction of the obligations must be calculated based on the FMV of the shares, counsel maintains that the case law is clear that what is paid is the share price agreed upon by the parties in the trust indentures.

[32] When there is an agreement between the parties establishing the cost to the company of issuing the shares, whether in exchange for property or in payment of a debt, it is the terms of the obligation that apply. It is the agreed upon price and not the FMV of the shares at the time of issue that constitutes the cost or the consideration for the issuing company.

[33] She refers to the decision in *Teleglobe Canada Inc. v. R.*, 2002 DTC 7517, and paragraph 32 in particular:

32 It follows from this that the cost to the appellant of issuing shares as part consideration for the assets of Old Teleglobe is the amount agreed between the parties, as evidenced by the stated capital of the common shares in the appellant. . . .

[34] Under the agreements, the Appellants undertook, in the case of conversion, to issue shares at a certain price. At the time of issuance, they renounced the possibility of receiving more for the shares.

[35] Counsel also refers to the decision in *King Rentals Ltd. v. Canada*, [1995] T.C.J. No. 790 (QL), and paragraph 14 in particular:

14 I conclude from this jurisprudence that, provided there is no abuse, the amount agreed upon between the subscriber and the corporation and added to the paid-up capital of the shares is conclusive of the amount paid by the corporate debtor to retire the debt.

[36] To summarize, counsel argues that the principal amount of the obligations, variable "A", could not fluctuate after the obligations had been issued and that, in any case, the maximum amount payable in satisfaction of the obligations issued, variable "B", was equal to the amount for which the obligations were issued.

Conclusion

[37] I am of the opinion that the Court must accept the arguments of counsel for the Respondent.

[38] It is at the time the obligations are issued that it must be determined whether or not they are issued at a discount. The deduction can only be realized when the debt is repaid, but it is the contractual terms related to the issuance that are determinant.

[39] This is what was found by the Supreme Court of Canada. The principal amount cannot fluctuate. The following passage is from the summary of the Supreme Court's decision: " . . . *The text, scheme and context of s. 20(1)(f) indicate that the deduction is limited to original issue discounts—shallow discounts in par. (f)(i) and deep discounts in para. (f)(ii). . . .* "

[40] However, to calculate the principal amount, the amount of the redemption agreed upon at the time the obligations are issued is essential. We must therefore look at the subscription agreement. In the agreement, there is no reference made to redemptions greater than the amount loaned. What is contemplated is a redemption equal to the amount loaned, whether the amount loaned is redeemed in cash or by conversion of shares.

[41] Counsel for the Appellants submits that the parties intended that the redemption be at the FMV of the shares. No subscriber testified on this point. Moreover, counsel himself believes that the cost of acquiring the shares would be equivalent to the amount of the claim. It is also common ground that for accounting reasons, the Appellants raised the value of their capital stock by the face value of the converted debentures or promissory notes. See page 17 of the agreement as to the facts.

[42] In the trust indentures, two items were referred to that related to the satisfaction of the debt through the conversion of shares, namely the agreed upon price and the proportion of shares. Counsel for the Appellants argues that the price is nothing more than a tool for calculating the proportion of shares. I disagree: if the price can fluctuate, there is no reason that the proportion of shares cannot fluctuate accordingly.

[43] The proportion of shares did not fluctuate. The agreed upon price did not fluctuate either. The redemption agreed to upon the conversion of shares was equal

to the amount for which the obligation was issued and is the amount that was paid in satisfaction of the obligations issued. This is the interpretation of the case law cited by counsel for the Respondent. It was also the intention of the parties.

[44] Nevertheless, as a result of this Court's decision in *Alcatel*, the Appellants must be considered to have made as a real expenditure the FMV of the shares that they issued when the subscribers exercised their conversion rights. The difference between the price agreed upon in satisfaction of the obligations and the FMV of the shares issued can be considered an expenditure made by the Appellants, but there is no need for me to decide that issue, nor the tax treatment of that expenditure, as those issues are secondary to the legal debate in this case. Only the deduction under paragraph 20(1)(f) of the Act is in dispute, and I am of the opinion that the Respondent's position is the correct one.

[45] Accordingly, the appeals are dismissed, with costs.

Signed at Ottawa, Canada, this 11th day of July 2007.

"Louise Lamarre Proulx"

Lamarre Proulx J.

Translation certified true
on this 4th day of September 2007.
Monica F. Chamberlain, Revisor

CITATION: 2007TCC395

COURT FILE NOS.: 2003-3999(IT)G, 2004-1916(IT)G and
2003-4340(IT)G

STYLES OF CAUSE: TEMBEC INC. v. HER MAJESTY THE
QUEEN, CASCADES INC. v. HER MAJESTY
THE QUEEN, and PROVIGO INC. v. HER
MAJESTY THE QUEEN

PLACE OF HEARING: Montréal, Quebec

DATE OF HEARING: May 28, 2007

REASONS FOR JUDGMENT BY: The Honourable Justice Louise Lamarre Proulx

DATE OF JUDGMENT: July 11, 2007

APPEARANCES:

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