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Docket: 2009-845(IT)G
2011-2326(IT)G

BETWEEN:

LEHIGH CEMENT LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Docket: 2009-847(IT)G

CBR ALBERTA LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Paris J.

[1] The appellants are appealing reassessments by which the Minister of National Revenue disallowed the deduction of dividends they received from a non-resident corporation in the 1996 and 1997 taxation years. The reassessments were based on paragraph 95(6)(*b*) of the of *Income Tax Act*, an anti-avoidance rule which forms part of the foreign affiliate provisions in the *Act*.

[2] The issue in these appeals is whether paragraph 95(6)(*b*) applies to the acquisition of shares by the appellants in the non-resident corporation.

[3] In reassessing the appellants, the Minister also relied on the General Anti-Avoidance Rule (the GAAR) in section 245 of the *Act*, but that position has now been abandoned.

[4] Another issue raised by the pleadings, but which is now conceded by the respondent, has to do with the disallowance of a deduction taken by CBR Canada under section 112(1) of the *Act* for certain other dividends totaling $4,463,041 which it received in its 1997 taxation year. The respondent now concedes that CBR Canada is entitled to deduct those dividends.

<u>Statutory scheme</u>

[5] Paragraph 95(6)(*b*) is found in subdivision i of Division B of Part I of the *Act*, which deals with income from non-resident corporations.

[6] The taxation of income received by a Canadian taxpayer from a non-resident corporation depends in part on the degree of ownership that the Canadian taxpayer holds in the non-resident corporation and in part on the type of income earned by the non-resident corporation.

[7] The degree of ownership determines whether or not the non-resident corporation is a "foreign affiliate" or a "controlled foreign affiliate" of the Canadian taxpayer.

[8] Where a Canadian taxpayer holds at least a one per cent interest of any class of shares in a non-resident corporation and the taxpayer's holdings, when combined with the holdings of any related person, total 10 percent or more of the class, the non-resident corporation is a "foreign affiliate" of the Canadian taxpayer.

[9] Generally, a "controlled foreign affiliate" is a foreign affiliate of a Canadian taxpayer that is controlled by the Canadian taxpayer or would be controlled by the Canadian taxpayer if the taxpayer held the shares of certain other persons (including certain arm's length persons): subsection 95(1) of the *Act*. Control in this instance refers to *de jure* control, and therefore is determined on the basis of shareholdings.

[10] Pursuant to section 90 of the *Act*, dividends received by a Canadian taxpayer from a non-resident corporation must be included in income when received by the

taxpayer. However, dividends received from a foreign affiliate that are paid out of the foreign affiliate's exempt surplus are exempted from tax for the Canadian taxpayer by virtue of paragraph 113(1)(*a*) of the *Act*, which permits the deduction of those dividends from the taxpayer's taxable income. Exempt surplus of a foreign affiliate is, in general terms, active business income earned by the foreign affiliate in a country with which Canada has a tax treaty.

[11] It is apparent, then, that foreign affiliate status in relation to a Canadian taxpayer can be advantageous for the Canadian taxpayer.

[12] On the other hand, it can be disadvantageous for a Canadian taxpayer if a non-resident corporation is its "controlled foreign affiliate", since this can result in certain passive income earned by the non-resident corporation (i.e. foreign accrual property income, or FAPI) being imputed to the Canadian taxpayer even if has not been received by the Canadian taxpayer.

[13] Thus, as noted by Professor Vern Krishna in *The Fundamentals of Canadian Income Tax* (9th ed. 2006) at page 1327, "taxpayers jockey to get on the right side of the distinctions to take advantage of the rules."

[14] This provides a context for paragraph 95(6)(*b*) which, in general terms, provides that where a person acquires or disposes of shares of a corporation and it can reasonably be considered that the principal purpose of the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax, the acquisition or disposition is deemed not to have occurred. It applies for the purposes of subdivision i of Division B of Part I of the *Act* except section 90**.**

[15] 95(6)(*b*) reads as follows:

> For the purposes of this subdivision (other than section 90),
>
> …
>
> (b) where a person or partnership acquires or disposes of shares of the capital stock of a corporation or interests in a partnership, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, that acquisition or disposition is deemed not to have taken place, and where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests, as the case may be, are deemed not to have been issued.

[16] Since foreign affiliate status under the *Act* is determined on the basis of the Canadian taxpayer's shareholding in the non-resident corporation, if paragraph 95(6)(*b*) applied to an acquisition or disposition of shares that would otherwise cause a foreign corporation to be a foreign affiliate of the Canadian taxpayer, and that acquisition or disposition of shares is disregarded, foreign affiliate status for the non-resident corporation would be lost.

[17] One of the consequences of the denial of foreign affiliate status would be that any dividends received by the Canadian taxpayer out of the exempt surplus of the non-resident corporation that are included in the taxpayer's income under section 90 of the *Act* would no longer be deductible under paragraph 113(1)(*a*) in computing the taxable income of the Canadian taxpayer.

Facts

Overview

[18] In this case, in the course of a corporate refinancing, the appellants set up a U.S. limited liability company (the LLC) as their foreign affiliate. The LLC loaned money to a U.S. corporation that was related to both the LLC and to the appellants. The U.S. corporation paid interest income to the LLC which was deemed by the *Act* to be active business income of LLC. In 1996 and 1997, the LLC paid dividends to the appellants out of the interest income it received. The appellants included the dividends in their income as required by section 90 of the *Act* and then deducted them in the calculation of their taxable income according to paragraph 113(1)(*a*).

[19] The Minister reassessed the appellants to disallow the deductions of the LLC dividends on the basis that the appellants acquired the shares of the LLC principally to avoid tax and therefore that paragraph 95(6)(*b*) applied to deem the shares not to have been acquired. In the absence of the acquisition of the LLC shares, LLC did not qualify as a foreign affiliate of the appellants and the dividends it paid to them would not be considered to have been paid out of exempt surplus.

Background

[20] The appellants are members of a corporate group (the CBR Group) that has operations in Europe, North America and Asia. The parent of the CBR Group, Cimenteries CBR SA (CBR SA), is a Belgian company.

[21] The first appellant, Lehigh Cement Limited, is a Canadian company. It carries on the business of manufacturing and selling cement and related building products in Canada.

[22] Lehigh was incorporated in 1986 as “CBR Cement Canada Limited”. On October 1, 1998, the company changed its name to “Lehigh Portland Cement Limited” and on February 1, 2002 to “Lehigh Cement Limited”. In these reasons, I will refer to the appellant, Lehigh, as “CBR Canada”.

[23] The second appellant, CBR Alberta Limited (CBR Alberta), is a wholly-owned subsidiary of CBR Canada. It was incorporated in 1995 in the course of the corporate refinancing that will be described in detail below.

[24] CBR Cement Corporation (CBR US) is a sister corporation of CBR Canada and was incorporated in the United States in 1986. It carries on the business of manufacturing and selling cement and related products in the U.S.

[25] The sole shareholder of CBR US is CBR Investment Corporation of America (CBR ICA), another U.S. corporation.

[26] Between 1987 and 1991 CBR US made a series of acquisitions. It began incurring operating losses in 1991 and by the end of 1994 its book losses totaled US$94.8 million. The acquisitions and operating losses were financed in part by debt and in part by infusions of equity, including the following amounts:

- US$44.3 million borrowed from CBR SA;

- US$14 million borrowed from CBR Asset Management Luxembourg (CBR AM), a Luxembourg company wholly owned by CBR SA.

- US$40 million of capital contributed by CBR ICA, which CBR ICA raised from the sale of preferred shares to CBR Canada in 1991.

<u>The refinancing</u>

[27] In 1995, the CBR Group decided to refinance the inter-company debt and equity of CBR US set out above with US$100 million borrowed by CBR Canada to be invested in a U.S. LLC and loaned by the LLC to CBR US.

[28] The refinancing was carried out in two parts. The CBR SA and CBR AM loans were replaced in a series of transactions carried out in mid-1995. The preferred shares in CBR ICA held by CBR Canada were redeemed as part of another series of transactions carried out in December 1995.

[29] The first series of transactions took place as follows:

In March 1995, CBR Alberta was incorporated to act as the second requisite member in the LLC.

On June 27, 1995 the appellants set up a Delaware limited liability company under the name CBR Developments NAM LLC (NAM LLC). It was structured as a foreign affiliate of the appellants with CBR Canada holding a 99% interest and CBR Alberta holding a 1% interest.

On July 10, 1995:

- CBR Canada borrowed US$60 million from Citibank Canada Inc. at an annual interest rate of 6.7% in exchange for a promissory note.

- Citibank sold the right to receive future interest payments under the note to Brussels Bank Lambert (BBL) and sold the right to receive the principal to CBR International Services SA (CBR IS), a Belgian company ultimately owned by CBR SA. CBR IS acted as the treasury centre for the CBR Group. It obtained the capital required for the purchase through an increase in capital from CBR SA.

- CBR Canada used part of the borrowed funds to subscribe for preferred shares in CBR Alberta, bringing the total capital invested by CBR Canada in CBR Alberta to US$600,000.

- CBR Canada contributed US$59.4 million (i.e. the remainder of the borrowed funds) to NAM LLC, and CBR Alberta contributed US$600,000.

- NAM LLC lent US$60 million to CBR US at an annual interest rate of 8.25%.

- CBR US used these funds to pay off the CBR SA and CBR AM loans.

[30] The second series of transactions took place as follows:

On December 22, 1995, CBR Canada borrowed US$40 million from BBL at an annual interest rate of 6.84%, or at a fluctuating rate depending on the circumstances;

On December 27, 1995, CBR Canada subscribed for preferred shares of CBR Alberta for US$400,000;

CBR Canada and CBR Alberta made additional capital contributions of US$39.6 million and US$400,000, respectively, to NAM LLC;

On or before December 31, 1995, NAM LLC loaned an additional US$40 million to CBR US at an annual interest rate of 8.25%;

CBR US paid a dividend of US$40 million to CBR ICA;

CBR ICA used the proceeds of the dividend to redeem the preferred shares held by CBR Canada;

As of December 31, 1995, CBR Canada and CBR Alberta had made total contributions of capital to NAM LLC of US$99 million and US$1 million, respectively.

Anticipated tax results

[31] The refinancing was expected to produce tax savings of US$1.92 million per year in Canada for CBR Canada and US$1.19 million per year for CBR SA in Belgium.

[32] For the appellants, the tax savings were expected to result from the deduction for interest paid on the money borrowed by CBR Canada to purchase the shares of NAM LLC and from the fact that the dividends received by the appellants from NAM LLC would be tax exempt.

[33] For CBR SA, the tax savings were expected to originate from an exemption under Belgian tax law on dividends to be received from CBR IS.

[34] CBR US was not expected to have any net income until 1997. Therefore, while it was not expected that CBR US would obtain a tax benefit in the years 1995 to 1997 for the interest it paid to NAM LLC, it was anticipated that its interest

expense would increase its net operating losses to be carried forward for U.S. federal tax purposes.

[35] In addition to the tax benefits already mentioned, the refinancing also addressed other tax concerns raised by the financial services division of the CBR Group. It was noted that proposed changes to Canadian tax law regarding interest deductibility put the interest deduction on the money borrowed by CBR Canada to purchase the preferred shares in CBR ICA at risk, since CBR ICA had not paid dividends to CBR Canada on those shares. It was also felt that potential changes to the U.S.-Luxembourg tax treaty might increase the tax cost of the existing financing. Finally, the U.S. withholding tax on interest payments from CBR US to CBR SA was not fully tax credited in Belgium.

<u>Interest and Dividends Paid</u>

[36] In 1995, 1996 and 1997 CBR US paid a total of US$15,279,452 of interest to NAM LLC. NAM LLC paid the interest received from CBR US to the appellants as dividends in the 1996 and 1997 taxation years.

[37] For U.S. tax purposes, CBR US deducted the interest it paid to NAM LLC. NAM LLC was treated as a pass-through entity and was not subject to tax on the interest received from CBR US. The interest paid by CBR US to NAM LLC was considered to be income of the appellants and was subject to U.S. withholding tax of 10%.

[38] For Canadian tax purposes, the appellants deducted the dividends received from NAM LLC in computing their taxable income pursuant to paragraph 113(1)(*a*) of the *Act* on the basis that:

- CBR US carried on an active business and the interest it paid to NAM LLC was deductible in computing its income for U.S. tax purposes;

- NAM LLC was a foreign affiliate of both of the appellants;

- CBR US was related to both NAM LLC and the appellants; and

- the dividends were paid to the appellants out of the exempt surplus of NAM LLC.

[39] In certain circumstances, clause 95(2)(*a*)(ii)(A) of the *Act* applies to deem interest income received by a foreign affiliate of a Canadian taxpayer to be active business income. Clause 95(2)(*a*)(ii)(A) applies if the interest is paid to the foreign affiliate by another non-resident corporation that was related to both the foreign affiliate and the Canadian taxpayer and is paid on borrowed money used by the non-resident corporation in an active business. Since the "exempt surplus" of a foreign affiliate is computed with reference to the "active business income" of the affiliate, the application of clause 95(2)(*a*)(ii)(A) generally results in such interest income being considered to be "exempt surplus" of the foreign affiliate.

[40] CBR Canada paid a total of US$12,496,833 in interest for 1996 and 1997 on the US$100 million it borrowed for the refinancing. The commercial profit to the appellants on the investment in NAM LLC, excluding Canadian tax considerations, was US$1,254,674. This represents the total dividends paid by NAM LLC to the appellants less the US withholding tax and less the Canadian interest expense incurred by CBR Canada.

[41] The parties agree that if paragraph 95(6)(*b*) is found not to apply, the tax benefit that would be received by CBR Canada under the *Act* from its investment in NAM LLC for the 1996 and 1997 taxation years is US$3,624,081, resulting from the deductibility of interest paid on the borrowed money and the exemption for dividend income received from NAM LLC.

<u>Subsequent events</u>

[42] The loan structure put in place in the 1995 refinancing was replaced in late 1997, principally as a result of a change in Belgian tax law that occurred in December 1996. In the course of the 1997 refinancing, CBR US repaid the US$100 million it had borrowed from NAM LLC. NAM LLC returned the appellants' investment of US$100 million to them and was subsequently dissolved. CBR Canada invested the funds that were returned to it by NAM LLC in CBR Alberta, who used them (along with the funds returned to it from NAM LLC) to purchase preferred shares in CBR US, thus replacing the previous loans from NAM LLC to CBR US.

<u>Appellants' position</u>

[43] The appellants maintain that, on a textual contextual and purposive reading, paragraph 95(6)(*b*) is only intended to prevent the avoidance of Canadian tax in the case of an acquisition or disposition of shares of a foreign corporation carried out to

manipulate its status as a foreign affiliate and it only applies where the purpose of the share acquisition or disposition itself, not the purpose of the series of transactions of which the acquisition or disposition may form a part, is to avoid or reduce tax.

[44] The appellants submit that, because of the bright-line, formulaic nature of the tests in the *Act* for foreign affiliate and controlled foreign affiliate status, which are dependent on the number of shares held, and because of the significant advantages and disadvantages that can result from such status, it would be relatively easy to acquire or dispose of shares in order to manipulate the rules to obtain foreign affiliate status, or avoid controlled foreign affiliate status, for a non-resident subsidiary. Thus, subsection 95(6) is specifically directed at preventing the manipulation of the status of non-resident corporations, whether by obtaining options (paragraph 95(6)(*a*)) or by acquiring or disposing of shares (paragraph 95(6)(*b*)).

[45] The appellants argue that the text of paragraph 95(6)(*b*) raises only a specific and narrow question: "What was the principle purpose of the acquisition or disposition of the shares?" The paragraph does not ask a broader question referential to the series of transactions of which the acquisition or disposition of shares was a part. *Singleton v Canada*, 2001 SCC 61, [2001] 2 SCR 1046, mandates that, when a provision of the *Act* refers to a "transaction" as opposed to a "series of transactions", the transactions must be viewed independently. The appellants submit that paragraph 95(6)(*b*) is unconcerned with whether tax was avoided by virtue of paragraph 20(1)(*c*) of the *Act* or subsection 113(1), since, for those provisions to apply, there must have been a series of transactions (i.e. paragraph 20(1)(*c*) applies if there was a borrowing, an acquisition of shares and a payment of interest and similarly subsection 113(1) applies if there was the payment of a dividend). Paragraph 95(6)(*b*) refers only to the principal purpose of the acquisition or disposition of shares.

[46] The appellants also submit that, contextually, paragraph 95(6)(*b*) must be interpreted in light of the fact that it refers to a disposition of shares as well as to an acquisition of shares. It is difficult to conceive of how the purpose of a disposition of shares could be to avoid tax other than by manipulating the status of a corporation, and this suggests that the provision as a whole is concerned only with such manipulation.

[47] In addition, they say that paragraph 95(6)(*b*) should be read in the context of paragraph 95(6)(*a*), which deals with the acquisition of options. The fact that these paragraphs are companion provisions suggests that each paragraph should be interpreted so as to apply to transactions with the purpose of masking or manipulating the true economic ownership of shares of a foreign corporation.

[48] The appellants argue that, on a purposive interpretation, paragraph 95(6)(*b*) was intended by Parliament to prevent the avoidance of Canadian tax only through the manipulation of foreign affiliate and controlled foreign affiliate status. The GAAR applies only if there was a misuse or abuse, whereas paragraph 95(6)(*b*) has no such relieving provision. Parliament cannot have intended for paragraph 95(6)(*b*) to apply without discretion or arbitrarily, as this would violate the principles of fairness and certainty.

[49] In addition, the appellants argue that the limited purpose of paragraph 95(6)(*b*) is evident in the limited consequences that result if the provisions applies, which is that the acquisition or disposition of shares is ignored. If Parliament intended paragraph 95(6)(*b*) to apply more broadly, one would expect other consequences to be attendant on its application – such as those found in subsection 245(5) on the application of the GAAR.

[50] The appellants concede that the main benefits from the implementation of the new structure result from improved tax efficiency. However, they submit that the principal purpose of the acquisition of the shares of NAM LLC was not to avoid or reduce Canadian tax payable, but instead was to permit CBR US to have an interest deduction in computing U.S. income and that the purpose of avoiding U.S. tax is irrelevant to the application of paragraph 95(6)(*b*).

[51] Furthermore, the appellants argue that no taxes otherwise payable were avoided as a result of the acquisition of the NAM LLC shares. CBR Canada could have obtained the deductions afforded by paragraph 20(1)(*c*) and subsection 113(1) by investing directly in the shares of CBR US. Therefore, there was no Canadian tax avoidance purpose to the acquisition of the LLC shares.

<u>Respondent's position</u>

[52] Briefly stated, the respondent's position is that, when the words of a provision are clear and unambiguous, the textual interpretation of that provision is to be emphasized: *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 54, [2005] 2 SCR 601.

[53] Given the similarity in the language used in paragraph 95(6)(*b*) and the GAAR, the respondent argues that paragraph 95(6)(*b*) should be interpreted using the same approach that is used to interpret the GAAR. As with the GAAR,

paragraph 95(6)(*b*) contemplates an objective assessment of the relative importance of the driving forces of the transaction.

[54] In the respondent's view, the principle from *Singleton* is that paragraph 20(1)(*c*) requires a transaction-by-transaction approach, but this principle is derived from the words of paragraph 20(1)(*c*) and is not relevant to the interpretation of paragraph 95(6)(*b*).

[55] The respondent argues that *Byram v The Queen*, 99 DTC 5117, [1999] 2 CTC 149 (FCA) suggests that the Court should take a case-by-case, common sense approach to the determination of whether a particular tax or non-tax objective can be said to be the principal purpose of the transaction. The Court should consider whether there is a sufficient nexus between the acquisition of shares and the tax or non-tax objective, or whether the objective is too remote to be considered a principal purpose.

[56] The respondent submits that comparing the potential tax benefit with the expected non-tax returns can assist in determining the principal purpose of an acquisition of shares. The significant disparity between the Canadian tax benefit to CBR Canada and the expected returns from the investment in NAM LLC establishes that the appellants' acquisitions of shares in NAM LLC was made primarily for the purpose of reducing CBR Canada's tax liability, not for the inherent commercial value of the transaction.

[57] In this case, the respondent submits that the principal purpose for the acquisitions of the shares of NAM LLC was to earn income that was tax-exempt by virtue of subsection 113(1) while obtaining a deduction for the interest paid on the loan obtained to make the investment under paragraph 20(1)(*c*). The resulting "tax asymmetry" was the principal purpose for the acquisitions.

[58] The respondent also suggests that a direct investment by CBR Canada in shares of CBR US would not have been possible during the years in issue because it would have violated a bank covenant that was in place between CBR Canada, CBR US and The R-M Trust Company. In addition, as CBR US had net operating losses and accumulated book losses, a direct investment in the capital stock of CBR US would not have allowed the appellants to receive dividends.

Analysis

[59] It is well established that the interpretation of a provision of the *Income Tax Act* requires a textual, contextual and purposive analysis to find a meaning that is

harmonious with the *Act* as a whole and that achieves consistency, predictability and fairness so that taxpayers may manage their affairs intelligently. It is also well established that "when the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process: *Canada Trustco,* at paragraphs 10 to 12, *Gunn v Canada*, 2006 FCA 281, [2007] 3 FCR 57 at paragraph 15.

<u>Text</u>

[60] The appellants submit that the text of paragraph 95(6)(*b*) does not support the view that the purpose of the series of transactions of which the share acquisition or disposition is a part may be considered in determining whether the purpose test in that provision is met. They say that in order to take the purpose of a series into account, words to that effect would be required, and they note the absence of such wording in paragraph 95(6)(*b*). They say that the word "purpose" in paragraph 95(6)(*b*) refers strictly to the purpose of the acquisition or disposition itself.

[61] I agree that the text of paragraph 95(6)(*b*) is clear that it is only the purpose of the acquisition or disposition of shares that is material in determining whether that provision applies. The words "principal purpose of the acquisition or disposition" are unambiguous in this regard.

[62] However, the purpose of a transaction is a question of fact, and one to be made on a consideration of all of the circumstances surrounding the transaction. The fact that the transaction is part of a series of transactions and the overall purpose of the series of transactions may be relevant factors in determining the purpose of the specific transaction under scrutiny. The question in such a case would be whether the specific transaction was arranged for a purpose that differed from the overall purpose of the series.

[63] This was the approach taken by this Court in *Canadian Pacific Limited v Canada*, 2000 DTC 2428, [2001] 1 CTC 2190, in determining whether a borrowing in Australian dollars by the taxpayer had a primary commercial purpose. The borrowing was found to be part of a series of transaction. At paragraph 15 of that decision, Bonner J. stated:

> The transactions which the Respondent says constitute the series were, when viewed objectively, inextricably linked as elements of a process primarily intended to produce the borrowed capital which the Appellant required for business purposes.

> The capital was produced and it was so used. No transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series. . .

[64] While the decision of the Tax Court was appealed, it was not alleged in that appeal that the Tax Court judge applied the wrong legal test to determine the primary purpose of the borrowing in Australian currency: *Canada v Canadian Pacific Limited*, 2001 FCA 398, [2002] 3 FC 170 at paragraph 28. In *Mackay v Canada*, 2008 FCA 105, [2008] 4 FCR 616, the Federal Court of Appeal held that in a GAAR analysis involving a series of transactions, the primary purpose of the series should not automatically be ascribed to each transaction in the series. Sharlow J.A. wrote at paragraph 21 of that decision:

> In my view, the conclusion that a series of transactions was undertaken primarily for *bona fide* non-tax purposes does not preclude a finding that the primary purpose of one or more steps within the series was to obtain a tax benefit.

[65] With respect to the appellants' submission concerning the Supreme Court decision in *Singleton*, I agree with the respondent that the difference in wording between paragraph 20(1)(*c*) of the *Act* which was in issue in *Singleton* and paragraph 95(6)(*b*) is material. Paragraph 20(1)(*c*) refers to "borrowed money *used* for the purpose of earning income". Paragraph 95(6)(*b*) refers only to the purpose of an acquisition or disposition of shares. In *Singleton*, Major J., writing for the majority, stated at paragraph 26:

> Only the third element is at issue in this appeal: the borrowed money must be used for the purpose of earning non-exempt income from a business. The *Shell* case confirmed that <u>the focus of the inquiry is not on the purpose of the borrowing per se</u>, but is on the taxpayer's purpose in <u>using</u> the money. McLachlin J. agreed with Dickson C.J. in *Bronfman Trust* that <u>the inquiry must be centred on the use to which the taxpayer put the borrowed funds. McLachlin J. made it clear that the deduction is not available where the link between the borrowed money and the eligible use is indirect. However, she made it equally clear that "[i]f a direct link can be drawn between the borrowed money and an eligible use" this third element is satisfied</u> (para. 33).
>
> (My emphasis)

[66] It is in this context that the Supreme Court held that only the direct <u>use</u> of the borrowed money in *Singleton* could be taken into account and not the ultimate use of the funds resulting from the entire series of transactions. Focusing as it does on <u>use</u> rather than <u>purpose</u>, I do not believe that the legal test adopted by the Supreme Court in *Singleton* in respect of paragraph 20(1)(*c*) can be transposed to paragraph 95(6)(*b*).

Context

[67] The appellants suggest that a contextual analysis also demonstrates that the sole focus of the purpose test in paragraph 95(6)(*b*) is the acquisition or disposition of shares in question and not the series of transactions of which the acquisition or disposition formed a part. They also say that the context shows that paragraph 95(6)(*b*) is directed at share acquisitions or dispositions carried out by a taxpayer in order to put itself in technical compliance with the share ownership rules either to create a foreign affiliate relationship or to avoid a controlled foreign affiliate relationship which is not in fact reflective of the true economic ownership of shares of a non-resident corporation.

[68] The appellants refer to the definitions of “foreign affiliate” and “controlled foreign affiliate” found in subsection 95(1) of the *Act* which provide bright-line, formulaic tests based on the number of shares of the non-resident corporation held by the taxpayer, and which they maintain would make it easy to manipulate the status of the non-resident corporation.

[69] The appellants also refer to the inclusion of share dispositions in paragraph 95(6)(*b*) and say that it is difficult to conceive of how the purpose of a disposition of shares could be to avoid tax other than by manipulating the status of a corporation, and this suggests that the provision as a whole is concerned only with such manipulation.

[70] The appellants also point to the location of paragraph 95(6)(*b*) at the end of subdivision i as an indication that it is a “concluding anti-avoidance provision” for the purpose of preventing manipulation of status by means of an acquisition or disposition of shares.

[71] Finally, the appellants refer to paragraph 95(6)(*a*) which deals with rights to acquire shares for the purpose of avoiding or reducing tax. The appellants submit that this is another indication that the purpose of paragraph 95(6)(*b*) is to prevent “the masking of or manipulating the true economic ownership” of shares of a non-resident corporation.

[72] It does not appear to me, however, that the contextual factors referred to by the appellants necessarily weigh in favour of a narrow reading of paragraph 95(6)(*b*) that would limit its application to situations where there has been what the appellants describe as a manipulation of true economic share ownership. In my view, the

context of paragraph 95(6)(*b*) is equally consonant with a broader reading that would include any share acquisition or disposition carried out principally to avoid tax.

[73] Each of the elements listed by the appellants supports the conclusion that paragraph 95(6)(*b*) acts as a limit on a taxpayer's ability to arrange the shareholdings of a non-resident corporation to fall within the definition of foreign affiliate or to skirt the definition of controlled foreign affiliate. However, these elements do not, even when taken together, demonstrate a sufficient basis for inferring that paragraph 95(6)(*b*) contains an unwritten requirement that, in addition to being carried out principally to avoid defer or reduce tax, the share acquisition or disposition must be transitory or artificial or amount to a manipulation of the ownership of the shares of the non-resident corporation that masks the "true economic ownership" of the shares.

[74] The broader context of paragraph 95(6)(*b*) is the entirety of the foreign affiliate rules in the *Act*. As already noted, certain advantages to a Canadian taxpayer can result from a foreign corporation being a "foreign affiliate" of the taxpayer and certain disadvantages can result from a foreign corporation being a "controlled foreign affiliate". Those rules provide tax relief in certain situations for foreign taxes paid on foreign affiliate income that is distributed or imputed to a Canadian taxpayer. They also require a taxpayer to include the FAPI of a controlled foreign affiliate on an accrual basis.

[75] It is likely in this context that when the new foreign affiliate regime was introduced in 1974 Parliament intended that the benefits of foreign affiliate status should be available only where there was a non-tax purpose behind the creation of the foreign affiliate status of the non-resident corporation and that foreign affiliates should not be used principally for tax planning or tax avoidance purposes. Similarly, where a disposition of shares was carried out to avoid controlled foreign affiliate status principally for tax reasons, the disposition would be disregarded.

[76] It appears to be the appellants' position that Parliament did not intend paragraph 95(6)(*b*) to apply to non-abusive tax-motivated reorganizations that rely upon the rules contained in subdivision i. However, in my view, it would introduce uncertainty and unpredictability in the application of such anti-avoidance provisions if Courts were to second guess Parliament as to what tax-driven transactions should or should not be caught by those provisions on the basis of what the Court perceives to be the abuse the anti-avoidance provision is directed at. While the GAAR explicitly requires a consideration of whether there has been an abuse or misuse, the absence of similar wording in paragraph 95(6)(*b*) leads me to conclude that such an interpretation should be avoided in the present case. In *65302 British Columbia Ltd v*

Canada, [1999] 3 SCR 804, [2000] 1 CTC 57 Iacobucci J., writing for the majority, quoted with approval the following passage from P. W. Hogg and J. E. Magee, *Principles of Canadian Income Tax Law* (2nd ed. 1997), at pages 475-476,

> It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision.

This passage was also cited with approval by McLachlin C.J. and Major J., writing for the Court in *Canada Trustco* (at paragraph 12.)

[77] I also disagree with the appellants' contention that a contextual reading favours a finding that the purpose test in paragraph 95(6)(*b*) is focused solely on the purpose of the share acquisition or disposition, to the exclusion of any consideration of the overall purpose of a series of transactions of which the acquisition or disposition forms a part. As I indicated earlier in these reasons, the purpose of a transaction is a question of fact, and one to be determined on a consideration of all relevant circumstances. Whether the overall purpose of a series of transactions is relevant to establishing the purpose of a particular transaction in the series is also a question of fact to be decided in each case. I see nothing in the context of paragraph 95(6)(*b*) that would justify a departure from this approach in determining the purpose of an acquisition or disposition of shares.

<u>Purpose</u>

[78] In attempting to determine the purpose of a provision it can be helpful to consider its legislative evolution and any statements of legislative intent.

[79] Subsection 95(6) was added to the *Act* as part of the comprehensive reform of the treatment of foreign source income that was introduced in 1974. At the time it first appeared in the *Act*, paragraph 95(6)(*b*) read as follows:

> (6) For the purposes of this subdivision,
>
>> (*a*) where any person has right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares of the capital stock of a corporation, those shares shall, if one of the main reasons for the existence of the right may reasonably be considered to be the reduction or postponement of the amount of taxes that would otherwise be payable under this Act, be deemed to be owned by that person; and

> (*b*) where any foreign affiliate of a taxpayer or any non-resident corporation controlled, directly or indirectly in any manner whatever, by the taxpayer or by a related group of which the taxpayer was a member has issued shares of a class of its capital stock and one of the main reasons for the existence or issuance of one or more of the shares of that class may reasonably be considered to be the reduction or postponement of the amount of taxes that would otherwise be payable under this Act, those shares shall be deemed not to have been issued.

[80] There do not appear to be any statements of legislative intent concerning paragraph 95(6)(*b*) at the time of its enactment in 1974.

[81] Subsection 95(6) was amended in 1995 to read as follows:

> (6) For the purposes of this subdivision (other than section 90),
>
> (*a*) where any person or partnership has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, to, or to acquire, shares of the capital stock of a corporation and
>
> (i) it can reasonably be considered that the principal purpose for the existence of the right is to cause 2 or more corporations to be related for the purpose of paragraph 2(a), those corporations shall be deemed not to be related for that purpose, or
>
> (ii) it can reasonably be considered that the principal purpose for the existence of the right is to permit any person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed to be owned by that person or partnership; and
>
> (*b*) where a person or partnership acquires or disposes of shares of the capital stock of a corporation, either directly or indirectly, and it can reasonably be considered that the principal purpose for the acquisition or disposition of the shares is to permit a person to avoid, reduce or defer the payment of tax or any other amount that would otherwise be payable under this Act, those shares shall be deemed not to have been acquired or disposed of, as the case may be, and where the shares were unissued by the corporation immediately prior to the acquisition, those shares shall be deemed not to have been issued.

[82] These changes applied to the taxation years of a foreign affiliate of a taxpayer that began after 1994.

[83] When the amendments were brought in, the Department of Finance issued a Technical Note that explained the changes to subsection 95(6). The portion of the Technical Note dealing with paragraph 95(6)(*b*) reads as follows:

> The amendment to the preamble of subsection 95(6) provides that the rule does not apply for the purposes of section 90 of the *Act*. Section 90 simply includes in the income of a taxpayer resident in Canada a dividend received by the taxpayer on a share of a non-resident corporation owned by the taxpayer.
>
> Paragraph 95(6)(*a*) has been amended in a number of ways. First, the "one of the main reasons test" is replaced by a "principal purpose" test consistent with the test in new paragraph (*b*). Second, it has been made to apply to persons and partnerships. Finally, it has been made to apply where the principal purpose for the existence of any right is to make two or more corporations related for the purposes of paragraph 95(2)(*a*) or to avoid, defer or reduce any amounts payable under the *Act*. In the first case, the corporations are deemed not to be related for the purposes of paragraph 95(2)(*a*) and, in any other case, the shares that could be acquired under the right are deemed to be owned.
>
> Paragraph 95(6)(*b*) has been rewritten and applies to an acquisition or disposition of shares where the principal purposes for such acquisition or disposition was the avoidance, reduction or deferral of amounts payable under the *Act*. If the principal purpose exists, the shares are deemed not to have been acquired or disposed of and previously unissued shares are deemed not to have been issued.

[84] The 1995 Technical Note also contained the following example:

> *Facts*
>
> Canco is a corporation resident in Canada that has a wholly owned foreign subsidiary (FC) which carries on an active business in a designated treaty country. Only one class of shares of FC are outstanding.
>
> XCo is another corporation resident in Canada that is not related to Canco that is to lend money to FC for use in its foreign business. XCo forms a wholly-owned subsidiary (FX) in a designated treaty country for the purpose of making the loan to FC. FX does not carry on a business.
>
> To take advantage of the rules in paragraph 95(2)(*a*) (which would permit FX to include its income from property derived from the loan in its active business income), XCo acquires a 11% interest in the outstanding shares of FC from Canco which are to be sold back to Canco when the loan is repaid. Canco has a right of first refusal at an agreed price in the event that XCo is to sell the shares.

> FX includes the income derived from the loan in its active business income under subparagraph 95(2)(*a*)(ii).
>
> *Application of subsection 95(6)*
>
> The shares of FC acquired by XCo shall be deemed not to have been disposed of by Canco or acquired by XCo since the principal purpose for the acquisition was the avoidance of Canadian tax on the foreign accrual property income of FX derived from the loan to FC.
>
> The income of FX derived from the loan to FC will be property income of FX and will be included in its foreign accrual property income (FAPI). XCo will include the FAPI in its income for Canadian income tax purposes.

[85] Clearly, this example deals with a transitory acquisition of shares designed to obtain foreign affiliate status for a foreign corporation in order for the Canadian taxpayer XCo to benefit from the rules in clause 95(2)(*a*)(ii) of the *Act*.

[86] The appellant argues that this example shows that the legislative purpose underlying 95(6)(*b*) is to prevent tax avoidance based on share acquisitions or dispositions that manipulate the bright-line tests for foreign affiliate and controlled foreign affiliate status and that the Technical Note example supports a narrow reading of the purpose test in paragraph 95(6)(*b*).

[87] I do not believe that the example goes that far. It is only one example of the application of paragraph 95(6)(*b*) and it is not suggested in the text of the Technical Note preceding the example that this is the only type of situation to which paragraph 95(6)(*b*) is intended to apply. I am not persuaded that the purpose of paragraph 95(6)(*b*) suggested by the appellants can be extrapolated from the single example included in the Technical Note.

[88] The appellants also assert that parliament did not intend paragraph 95(6)(*b*) to allow the Minister to attack the series of transactions of which the share acquisition was a part, since the GAAR is available for that purpose. The appellants point to the definition of "avoidance transaction" in subsection 245(3) which includes a transaction that is part of a series of transactions. The relevant part of paragraph 245(3)(*b*) reads:

> An avoidance transaction means any transaction
>
> . . .
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, . . .

[89] I cannot agree though that this is indicative that Parliament did not intend paragraph 95(6)(*b*) to apply in the case of an acquisition or disposition of shares that was part of a series of transactions. The reference to a series of transactions in paragraph 245(3)(*b*) does not relate to the purpose test in the GAAR but rather to the tax avoidance results that have been achieved by the taxpayer. As noted by Lebel J. writing for the majority in *Lipson v The Queen*, 2009 SCC 1, [2009] 1 SCR 3 at paragraph 37:

> Section 245(3)(*b*) indicates that an avoidance transaction is not necessarily a transaction that results in a tax benefit on its own, but may instead be one that is part of a series of transactions that result in a tax benefit.

[90] The purpose test in paragraph 245(3)(*b*) however, focuses on the specific alleged tax avoidance transaction rather than on the series of transactions. This is similar to the purpose test in paragraph 95(6)(*b*).

[91] The appellants contend as well that the absence of a misuse or abuse test in paragraph 95(6)(*b*) is another indication that it was intended to have only a limited application to situations involving manipulation of status. They maintain that if it is to have wider application, the absence of a misuse or abuse requirement means either that paragraph 95(6)(*b*) should be applied without discretion or it could be applied arbitrarily. However, in my view, the absence of a misuse or abuse test would tend to show that paragraph 95(6)(*b*) applies to any tax-motivated acquisition or disposition, not just one that involves manipulation of status.

[92] In summary, I am not convinced that Parliament intended that paragraph 95(6)(*b*) only apply to situations in which the shareholdings in a non-resident corporation is manipulated in a manner that masks the true economic ownership of the shares of a non-resident corporation. A textual, contextual and purposive analysis leads to the conclusion that the provision can apply to any acquisition or disposition of shares that is principally tax-motivated.

<u>Appellants' purpose</u>

[93] The next question to be decided is whether paragraph 95(6)(*b*) applies to the appellants' acquisition of the shares of NAM LLC.

[94] There are three stages to this inquiry. The first is to identify the tax otherwise payable under the *Act* that the appellants are alleged to have intended to avoid, the

second is to determine whether the acquisition or disposition of shares permitted this avoidance, reduction or deferral and the third involves an assessment of the appellants' purpose in acquiring the shares.

[95] In general, the first stage relates to whether tax was actually avoided, the second stage relates to the degree of causation between the acquisition or disposition and the avoidance, and the third stage relates to the principal purpose for the acquisition or disposition.

[96] While it is conceivable that the third stage of the inquiry will be satisfied while the first or second stage is not satisfied (in that, for example, the principal purpose of the acquisition was to permit a person to avoid tax, but the acquisition did not actually result in any avoidance), this outcome is unlikely.

[97] With respect to the first stage of the inquiry, the parties disagree on how the "tax…otherwise payable" is determined for the purpose of paragraph 95(6)(*b*).

[98] In the respondent's view, the requirement to show that there was tax otherwise payable is met simply by showing that the appellants claimed deductions related to the acquisition of the NAM LLC shares.

[99] The appellants contend that the determination of whether there was tax otherwise payable should be based on a comparison with an alternative arrangement.

[100] The respondent contends that the notion of "tax . . . that would otherwise be payable" in paragraph 95(6)(*b*) is analogous to the "tax benefit" in the GAAR and that the existence of "tax . . . that would otherwise be payable" may be established in the same manner as a "tax benefit". The relevant portion of the definition of "tax benefit" in subsection 245(1) reads:

> …a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;

[101] In *Canada Trustco*, the Supreme Court considered the definition of "tax benefit" and stated at paragraph 20 that "if a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax." The Court went on to say:

> In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. For example, characterization of an amount as an annuity rather than as a wage, or as a capital

> gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements.

[102] The respondent maintains that given the similarity of the terms used in paragraph 95(6)(*b*) and in the definition of "tax benefit" in subsection 245(1), the "tax …otherwise payable" referred to in paragraph 95(6)(*b*) is equivalent to the "tax benefit" under subsection 245(1): *Univar Canada Ltd v The Queen*, 2005 TCC 723, [2006] 1 CTC 2308 at paragraph 32.

[103] However, this interpretation fails to take into account the difference in wording between paragraph 95(6)(*b*) and the definition of tax benefit in subsection 245(1). The words "that would otherwise be payable" do not appear in the definition of tax benefit and appear to relate both to "tax" and to "any other amount" in paragraph 95(6)(*b*). This difference in wording between paragraph 95(6)(*b*) and the definition of "tax benefit" in subsection 245(1) is material, given that every word found in a statute is presumed to have a meaning: *Winters v Legal Services Society (British Columbia)*, [1999] 3 SCR 160, 177 DLR (4th) 94 at paragraph 48; *Sheldon Inwentash & Lynn Factor Charitable Foundation v The Queen*, 2012 FCA 136, at paragraph 45). For this reason, I respectfully disagree with the conclusion reached by Bell J. in *Univar* that the "tax that would otherwise be payable" referred to in paragraph 95(6)(*b*) and the "tax benefit" under subsection 245(1) are equivalent. It should be noted that this point was not material to the ultimate decision in *Univar* and was not the subject of any analysis.

[104] In my view, the reference to tax "otherwise payable" invites a comparison with an alternative situation, such that the approach described by the Supreme Court in paragraph 20 of *Canada Trustco*, cited above, is more appropriate. The words "tax…otherwise payable" should be read in the context of the consequences that result from the application of paragraph 95(6)(*b*). If paragraph 95(6)(*b*) applies, the acquisition or disposition is deemed not to have occurred. This suggests that the relevant comparator, when determining whether tax would otherwise have been payable, should be an arrangement where the acquisition or disposition has not occurred. This is also consistent with the purpose of paragraph 95(6)(*b*) which is to deny the tax benefits of foreign affiliate status (and to ensure a taxpayer does not escape the tax consequences of controlled foreign affiliate status) by means of an acquisition (or disposition) of shares carried out principally to obtain those benefits (or to avoid those consequences).

[105] In addition, the comparator should be an arrangement that might reasonably have been carried out by the taxpayer. As the Supreme Court noted in *Copthorne Holdings Ltd v Canada*, 2011 SCC 63, [2011] 3 SCR 721, at paragraph 35:

> . . .considering what a corporation would have done if it did not stand to gain from the tax benefit attempts to isolate the effect of the tax benefit from the non-tax purpose of the taxpayer.

[106] In this case, I accept the appellants' contention that the reasonable alternative arrangement for the purpose of assessing tax otherwise payable is one in which CBR Canada subscribes for shares directly in CBR US with borrowed funds. As the appellants' counsel points out, this was in substance the arrangement that existed after 1997 when NAM LLC was dissolved. At that point, CBR Canada used $100 million of borrowed funds to subscribe for additional shares in CBR Alberta, which in turn used the money to subscribe for additional shares in CBR US. The routing of the financing through CBR Alberta was done to get around the bank covenant to which the respondent referred that restricted CBR Canada's right to invest more than 20% of its assets in a corporation (other than a subsidiary) to which it was related.

[107] In the post-1997 scenario, the Canadian tax results are the same as those that flowed from the transactions in issue here. CBR Canada was entitled to deduct dividends received from CBR US under paragraph 113(1)(*a*) since CBR US was already a foreign affiliate. In addition, CBR Canada deducted the interest paid on the money borrowed to purchase the shares of CBR US.

[108] Therefore, I find that the appellants have shown that there is no tax that would have otherwise been payable had they carried out the alternative transaction described above that did not involve the acquisition of the NAM LLC shares. In other words, the tax savings that they obtained as a result of the transactions carried out in 1995 could have been obtained without the acquisition of the NAM LLC shares. Therefore, I find as well that there was no tax avoided by the appellants as a result of the share acquisition.

[109] Having reached these conclusions, it is not necessary to decide whether the appellants' principal purpose in acquiring the shares was to avoid or reduce tax otherwise payable. However, since the tax savings in issue could have been obtained without acquiring the NAM LLC shares, I accept that the principal purpose for the acquisition was to avoid U.S. tax rather than Canadian tax. While I agree with the respondent that one of the main benefits of the overall series of transaction

comprising the refinancing was the Canadian tax savings, those savings could also have been achieved by a direct investment by CBR Canada in CBR US.

[110] It follows that paragraph 95(6)(*b*) is not applicable to the appellants' acquisition of the NAM LLC shares and the dividends received from NAM LLC are deductible to them under paragraph 113(1)(*a*).

[111] For these reasons, the appeals are allowed.

[112] At the end of the hearing of these appeals the respondent's counsel requested the opportunity to make submissions on costs following the release of my reasons. Both parties will have 30 days from the date of these reasons to make written submissions on costs. If no submissions are received, the appellants will be awarded one set of costs for the three appeals 2009-845(IT)G, 2011-2326(IT)G and 2009-847(IT)G.

Signed at Toronto, Ontario, this 29th day of May 2013.

"B.Paris"

Paris J.

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