Docket: 2017-1901(IT)G

BETWEEN:

EMERGIS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on October 16, 2019, at Vancouver, British Columbia

Before: The Honourable Justice Réal Favreau

Appearances:

Counsel for the Appellant:	Ian J. Gamble
Counsel for the Respondent:	Lynn M. Burch Christa Akey

JUDGMENT

The appeal from the reassessments dated February 2, 2012 made under the *Income Tax Act* for the appellant's 2000 and 2001 taxation years is dismissed with costs to the respondent in accordance with the attached reasons for judgment.

Signed at Montréal, Québec, this 19th day of March 2021.

"Réal Favreau"

Favreau J.

Citation: 2021 TCC 23
Date: 20210319
Docket: 2017-1901(IT)G

BETWEEN:

EMERGIS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent,

REASONS FOR JUDGMENT

Favreau J.

[1] The issue in this appeal is whether Emergis Inc. ("Emergis") is entitled to a deduction claimed under subsection 20(12) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (the "*Act*") in each of its taxation years ending on December 31, 2000 and on December 31, 2001 with respect to the U.S. withholding tax paid in the equivalent of $3,808,456 and $5,051,276 Canadian dollars respectively on the interest income received from BCE Emergis General Partnership (the "*USGP*"), a U.S. partnership formed under the laws of Delaware in which Emergis held a 99.9% participation. The Emergis' claims under subsection 20(12) of the *Act* were disallowed by virtue of reassessments dated February 2, 2012 made under the *Act* by the Minister of National Revenue (the "Minister").

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

[4] Subsection 20(12) reads as follows in its version applicable to the years 2000 and 2001:

> **Foreign non-business income tax**
>
> **20(12)** 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 any such taxes, 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] As the parties agree that the U.S. withholding taxes of CAD$3,808,456 and CAD$5,051,276 paid by Emergis in its 2000 and 2001 taxation years, respectively, represented non-business income taxes paid by Emergis to the U.S. government in respect of Emergis's income from the loan to USGP, the first condition of subsection 20(12) is met.

[6] Consequently, the sole issue in this appeal is to determine whether the second condition in subsection 20(12) also applies that is, whether these U.S. withholding taxes of CAD$3,808,456 and CAD$5,051,276 or any part thereof could reasonably be regarded as having been paid by Emergis in respect of income from a share of the capital stock of a foreign affiliate of Emergis. If this second condition is satisfied, Emergis is not entitled to the deduction that is claimed under subsection 20(12) as described above. If, on the other hand, the second condition does not apply, Emergis is entitled to the deduction that it claimed under subsection 20(12) as described above.

General Overview

[7] At all times material to this appeal, Emergis was a Canadian public company owned 65% by BCE Inc., another Canadian public company.

[8] In its 2000 taxation year, Emergis acquired an arm's length U.S. operating company ("*UP & UP*") and for that purpose established a cross-border financing structure known in the tax community as a "tower structure".

[9] Generally speaking, a tower structure is a chain of entities (corporations or partnerships) set up by a corporation to allow it to fund U.S. subsidiaries in a tax efficient manner. The tax efficiency is achieved at least in part by using what is referred to as a "double-dip" deduction for interest on money borrowed by the Canadian parent company to fund the U.S subsidiaries. This tax efficiency is achieved by using entities that are classified differently under Canadian and U.S. tax laws. Such entities are referred to as "hybrid entities" because, for tax purposes, one country treats the 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.

[10] In the structure put in place by Emergis, the income of the USGP consisted, for U.S. tax purposes, of interest income earned from a U.S. corporation, but for Canadian tax purposes, of dividend income from a Canadian corporation. This difference in treatment has no consequence concerning the first condition of subsection 20(12) because clearly the U.S. tax paid on the interest income paid to Emergis was in respect of a property source of income under the *Act* as Emergis lent directly to USGP US$266,670,000 (the "First Loan").

[11] The particular issue in this appeal arose from the fact that the entity that paid the interest income to the USGP was a foreign affiliate of Emergis. This raised the question whether the U.S. tax paid by Emergis can reasonably be regarded as having been paid in respect of income from a share of a foreign affiliate.

[12] The structure used by Emergis is very similar to the structure put in place by the Québec corporation Groupe Laperrière & Verreault Inc. in 1998, which has been described in the decision of the Tax Court of Canada in *FLSmidth Ltd. v. The Queen,* 2012 TCC 3, aff'd 2013 FCA 160*("FLSmidth").*

[13] The appeal proceeded before this Court on the basis of a detailed partial agreed statement of facts and issues to which the parties agreed prior to the trial. The

partial agreed statement of facts and issues is reproduced in it's entirety at the end of this judgement.

Facts

[14] The following entities were part of the Emergis structure:

- BCE Emergis General Partnership (USGP) a partnership formed under the laws of Delaware (U.S.) with Emergis Inc. holding a 99.9% interest and 3701123 Canada Inc. (Cansubco) a new Canadian subsidiary of Emergis, holding a 0.1% interest.
- 3040697 Nova Scotia Unlimited Liability Company (NSULC) was incorporated with USGP as its sole shareholder.
- BCE Emergis LCC (LCC) was organized as a limited liability company under the laws of Delaware (U.S.) by NSULC.
- BCE Emergis US Holdings Inc. (US Holdco), a newly created Delaware corporation in which Emergis subscribed for 100 shares.
- Acquisitionco, a newly created U.S. subsidiary in which U.S Holdco subscribed for 100 shares.
- Jetco Inc. (Jetco), a company incorporated under the laws of Delaware (US) in which Emergis subscribed for 100 shares. The shares of Jetco owned by Emergis were transferred to US Holdco in consideration for 100 common shares of US Holdco and subsequently transferred to Acquisitionco in consideration for 100 common shares of Acquisitionco.

[15] Emergis used the cross-border structure to finance its arm's length acquisition of U.S. operating company (UP&UP) in the following manner:

a. Emergis subscribed for Cansubco shares in the amount of US$34,400;
b. Emergis and Cansubco made capital contributions to USGP, based on their respective partnership percentages, totalling US$33,385,535;
c. Emergis lent USGP US$266,670,000 at an annual interest rate of 12.25% for a ten-year term, which interest rate was reduced to 12.127% after October 1, 2000 due to a change in the interest payment schedule from quarterly to monthly (the "First Loan");

d. USGP used the funds provided by the First Loan and the Appellant's and Cansubco's capital contributions to subscribe for US$300,002,000 of capital stock of NSULC;

e. USGP subscribed for 1 share of LLC for US$100;

f. NSULC subscribed for shares of LLC for US$300,001,000;

g. Emergis subscribed for 2,424,720 shares of US Holdco, for US$242,472,050;

h. US Holdco subscribed for 2,424,710 shares of Acquisitionco, for US$242,471,050;

i. LLC lent Acquisitionco US$300,000,000 at an annual interest rate of 12.5% for a 10-year term, which interest rate was reduced to 12.372% after September 27, 2000 due to a change in the interest payment schedule from quarterly to monthly (the "Second Loan");

j. Jetco and UP&UP merged and thereby formed a new U.S. corporation (US Mergco); and

k. Acquisitionco was merged into US Mergco to form US Amalco and by virtue of this merger, US Amalco assumed the Second Loan.

[16] At all times material to this appeal USGP, NSULC, and LLC were "hybrid entities", meaning that they were treated differently under Canadian and U.S. tax laws. These entities formed the tower in the tower structure. Specifically:

a. USGP was treated as a partnership for purposes of the *Act*, but elected to be treated as a U.S. resident corporation for U.S. tax purposes;

b. NSULC was treated as taxable Canadian corporation under the *Act*, but was a "disregarded" entity for U.S. tax purposes (meaning that it was not regarded as having an existence separate from its owner); and

c. LLC was treated as a non-resident corporation and foreign affiliate of NSULC and of Emergis under the *Act*, but was a disregarded entity for U.S. tax purposes.

[17] US Holdco was a U.S. resident corporation and a directly-owned foreign affiliate of Emergis for Canadian tax purposes. It was a U.S. resident corporation for U.S. tax purposes.

[18] US Amalco was a U.S. resident corporation and a foreign affiliate of Emergis for Canadian tax purposes. It was a U.S. resident corporation for U.S. tax purposes and for treaty purposes.

[19] From the Canadian tax perspective, in Emergis's 2000 and 2001 taxation years:

a. US Amalco paid interest on the Second Loan to LLC;

b. NSULC received dividend income from its shares of LLC in US dollars, equivalent to CAD$42,940,070 and CAD$58,467,044 in 2000 and 2001, respectively, NSULC included the amounts in its income under subsection 90(1) and claimed an offsetting deduction for this amount in computing its taxable income under paragraph 113(1)(a) as dividends received on its shares of a foreign affiliate (LLC) prescribed to have been paid out of the exempt surplus of the affiliate;

c. USGP was required to compute its (net) income from each source under paragraph 96(1)(c) and, for this purpose, USGP recognized dividend income received from its shares of NSULC under subsection 82(1) (US$28,758,167 in 2000 and US$37,759,263 in 2001) and claimed a substantially offsetting deduction under paragraph 20(1)(c) for interest it paid to Emergis on the First Loan (US$25,506,296 in 2000 and US$32,622,207).

d. USGP's (net) income computed under paragraph 96(1)(c) above was in turn allocated to Emergis and Cansubco under paragraph 96(1)(f) to the extent of their respective shares as partners of USGP; and, in this respect, Emergis reported in Schedule 1 of its T2 tax return its 99.9% allocated share of USGP's income.

e. Emergis included in its income under subsection 12(3) the interest paid to it by USGP on the First Loan and Emergis reported this amount in Schedule 1 of its T2 tax return.

f. In computing its taxable income under subsection 112(1), Emergis claimed a deduction in respect of its 99.9% share of dividend income received by USGP from NSULC on page 3 of its T2 tax return.

[20] In Emergis's 2000 and 2001 taxation years, Emergis paid U.S. withholding tax equivalent to the amount of CAD$3,808,456 and CAD$5,051,276 respectively, on its interest income received from USGP on the First Loan.

[21] In filing its tax returns under the *Act,* Emergis deducted this U.S. withholding tax in computing its income from a business or property under subsection 20(12) on the basis that the U.S. withholding tax constituted non-business income tax paid by Emergis to the U.S. government in respect of that income, i.e., income from the First Loan: $3,808,456 for its 2000 taxation year and $5,051,276 for its 2001 taxation year.

[22] The U.S. tax rules disregarded the dividend payment from LLC to NSULC and the dividend payment from NSULC to USGP because LLC and NSULC were both disregarded entities for U.S. tax purposes. Thus, no U.S. tax was payable on dividends paid by LCC to NSULC or on dividends paid by NSULC to USGP in 2000 and 2001.

Position of the parties

[23] Even though the parties have agreed on all the relevant facts of the present appeal, they take opposing views on every aspect of the interpretation of subsection 20(12) (the text, context and purpose), and disagree on the weight to be given to the reasons of this Court (2012 TCC 3) and of the Federal Court of Appeal (2013 FCA 163) in *FLSmidth*.

Appellant's position

a. FLSmidth

[24] The reasons in *FLSmidth* are not determinative of the issue in this appeal because both the facts and the issue under appeal are different. The facts in *FLSmidth* are substantially similar to the tower structure described above but there are two important differences. First, in *FLSmidth*, the deduction under subsection 20(12) for U.S. income tax was claimed by the partnership as the notional taxpayer under subsection 96(1) of the *Act*. In this appeal, the partnership (USGP) did not deduct the U.S. income tax it paid. Second, no U.S. withholding tax was paid by the corporate partner in *FLSmidth*. So a deduction under subsection 20(12) for this type of U.S income tax was not considered in *FLSmidth*. In this appeal, a deduction under subsection 20(12) for the U.S. withholding tax paid directly by Emergis is the sole issue.

b. Text

[25] According to the Appellant, it is fundamental that the words and phrases of subsection 20(12) have flexible meanings, and argues that the words "in respect of", as found in the exclusionary clause of subsection 20(12) must be interpreted narrowly rather than broadly. The Appellant also argues that the words "can reasonably be regarded" are not actually an economic substance doctrine.

[26] The Appellant submits that in considering whether it can obtain foreign tax relief, the only source of income that should be looked at is the First Loan because the U.S. tax has been imposed on income from the First Loan and not on income from a share of the capital stock of a foreign affiliate.

[27] Although the income received by NSULC on the shares of LLC is undoubtedly "income from a share of the capital stock of a foreign affiliate", NSULC is a subsidiary of Emergis and its income is therefore that of a separate taxpayer, such that it cannot be said to be the income on which the U.S. tax was paid.

c. Context

[28] In its contextual arguments, Emergis reiterates its view that only Emergis' own sources of income (as interest-recipient) can be considered when interpreting the exclusionary clause and the reference to "income from a share of the capital stock of a foreign affiliate". In support, it claims that the scheme of the *Act* as a whole, in particular Subdivision b of Division B-"Income or Loss from a Business or Property", is evidence that taxation is always imposed on separate taxpayers, such that the dividend income received by a subsidiary (NSULC) is irrelevant when computing Emergis' own sources of income. Furthermore, since the partnership is treated as a separate taxpayer for the purposes of computing its taxable income under the *Act*, the partnership's sources of income cannot be said to be those of Emergis.

[29] Emergis also refers to subsection 126(1), the foreign tax credit provision for non-business-income taxes paid, so as to highlight that just like in subsection 20(12), there is an exclusionary clause for any "income from the share of the capital stock

of a foreign affiliate". For our purposes, the relevant parts of subsection 126(1) are the following:

> Foreign tax deduction (foreign tax credit)
>
> 126 (1) A taxpayer who was resident in Canada at any time in a taxation year may deduct from the tax for the year otherwise payable under this Part by the taxpayer an amount equal to
>
> (a) such part of any non-business- income tax paid by the taxpayer for the year to the government of a country other than Canada (except where the taxpayer is a corporation, any such tax or part thereof that may reasonably be regarded as having been paid by the taxpayer in respect of income from a share of the capital stock of a foreign affiliate of the taxpayer) as the taxpayer may claim,
>
> not exceeding however,
>
> (b) that proportion of the tax for the year otherwise payable […]
>
> […]
>
> from sources in that country, on the assumption that
>
> (D) where the taxpayer is a corporation, it had no income from shares of the capital stock of a foreign affiliate of the taxpayer, and
>
> […]

[30] Emergis' position with respect to subsection 126(1) and its relationship with 20(12) is that because the foreign tax credit provision is restricted to considering only the income received by the taxpayer who directly paid the tax, one must interpret subsection 20(12) in a similar manner and hold that the Minister cannot be allowed to look at the dividend income of another taxpayer down the line for restricting the deduction in subsection 20(12).

d. Purpose

[31] The Appellant emphasizes that the only purpose of subsection 20(12) is to provide alternate relief for non-business income paid, and nothing else. As for the exclusionary clause, it is only meant to apply where taxpayers directly receive dividends from foreign affiliates. The principle of separate entity taxation means that the type of income that has been received by a taxpayer should not be looked at to

conclude that the tax was paid in respect of a share of another taxpayer down the corporate chain.

[32] The Appellant acknowledges that the interest payment (and the NSULC dividend) received by Emergis were ultimately not taxable in Canada. However, the reason why both were not taxable is because of the deduction obtained under subsection 112(1) and not under section 113. Therefore, even if the dividend from NSULC can be considered "income from a share" because of Emergis' deemed ownership in NSULC, it is not income from a share of a foreign affiliate.

[33] For the Appellant, the fact that no tax was payable in Canada cannot be relied on to deny the subsection 20(12) deduction. Contrary to the foreign tax credit in subsection 126(1), the deduction in subsection 20(12) does not require any Canadian income tax payable. Dismissing the appeal on that basis would amount to reading in an unexpressed legislative intention under the guise of purposive interpretation, something both the Supreme Court in *Shell Canada Limited v. Canada* (1999) 3 S.C.R. 622 at par. 43-46 and the Federal Court of Appeal in *FLSmidth* have advised this Court against doing. Here are the submissions of the Appellant on that point:

> The foreign tax credit was introduced in the Act because the jurisprudence had decided that an income tax – whether provincial or foreign – could not be deducted as a general business expense in computing profit.
>
> Subsection 20(12) was enacted in 1978 to address certain limitations in subsection 126(1). The foreign tax credit in subsection 126(1) was (and continues to be) limited to the Canadian tax otherwise payable in the year – if any – on the taxpayer's net income under the Act from specified sources in the foreign country. [...] The deduction in computing income (not tax) in subsection 20(12) for non-business income tax was introduced in large part to address such problems, because it does *not* require that the taxpayer have a source of income in the foreign country (let alone net income from that source) or have any Canadian tax otherwise payable. (par. 53 and 54).

Respondent's position

a. FLSmidth

[34] The Respondent submits the case of *FLSmidth* is dispositive of the present appeal.

[35] The facts in the two cases are substantially similar. Emergis' corporate structure is almost a mirror image of the taxpayer, Dorr Oliver, in *FLSmidth*.

[36] The corporate cross-border structure and its tax efficacy are the same. In both cases, a "tower structure" is used to finance the acquisition of a U.S. operating business. In both "tower structures", three different "hybrid entities", i.e. entities that are treated differently under U.S. and Canadian tax law, are used. The combination of the hybrid entities resulted in a tax efficient outcome because it permits a deduction of interest payments in both countries on the same flow of income ("double dips" deduction for interest).

[37] In both Emergis' and *FLSmidth* appeals, the foreign tax sought to be deducted has been paid somewhere along this tower structure. In both cases, the Respondent relies at least partly on the exclusionary clause on the basis that the tax was paid on "the income from a share of LLC" to deny the subsection 20(12) deduction.

b. <u>Text</u>

[38] The Respondent essentially relies on the TCC's decision in *FLSmidth* to say that the words "in respect of" in the exclusionary clause of subsection 20(12) should receive a broad interpretation. The Respondent says that, on the facts of this case, the interest was paid out with the funds from the LLC dividends, such that one can conclude the U.S. withholding tax imposed on the interest payment had "some relationship or connection" with the dividend paid by LLC to NSULC. The broadness of the words "in respect of" would permit to consider an indirect link between the Appellant and the dividends received by an affiliate down the chain.

[39] In detailing that apparent "relationship or connection" between the withholding tax and the dividends received by NSULC, the Respondent relies on subsection 93.1(1) of the *Act* to say that Emergis in fact directly owned NSULC, such that the allocated income of the partnership from the dividends (although nil because the U.S. partnership claimed a paragraph 20(1)(c) deduction), can be regarded as the income in respect of which the U.S. tax was paid.

[40] In further support, the Respondent argues the words "can reasonably be regarded" are there for a reason: they allow for an economic substance approach. There is a presumption against tautology in statutory interpretation that would imply those words in fact allow to look through NSULC to the income from LLC. It is apparent that the Respondent gives substantial weight to the TCC's reasons in *FLSmidth*.

c. Context

[41] The Respondent relies on subsection 113(1) to claim that where an exemption for dividends has been granted down the chain, the foreign affiliate regime provides comprehensive relief such that the subsection 20(12) deduction should not be available when U.S. tax is paid up the chain. In *FLSmidth*, the Tax Court did mention that the exclusionary clause in subsection 20(12) was there “because relief from foreign taxation on dividends from foreign affiliates is dealt with comprehensively elsewhere in the Act”. The FCA, on the other hand, had held that it is not in all cases where a section 113 exemption has been obtained can one conclude subsection 20(12) should be denied.

[42] The Respondent submits that the FCA’s comments in *FLSmidth* were made only *in obiter*, and that in any event, under the facts of this case, the foreign affiliate regime did provide sufficient relief such that the deduction in subsection 20(12) should not also be allowed. The Respondent also argues that subsection 20(12) only provides relief in a non-foreign affiliate context.

[43] Although the dividends paid out by NSULC to the partnership and allocated to Emergis have benefited from a section 112 deduction (and not a section 113 deduction), the Respondent says the result is the same in that both have the same objective and result, such that the “intercorporate dividends are washed out of the taxable income of the recipient corporation”. Effectively, the tax on the income flowing from the dividend has already been prepaid, which would explain why the recipient of the dividend is not taxable on it.

[44] Furthermore, the Respondent notes that under U.S. tax law, the money receivable by the U.S. partnership has been received on account of an interest payment made by U.S. Amalco. This is relevant because under Canadian tax law, the interest payable by U.S. Amalco has benefited from a recharacterization as active business income under subparagraph 95(2)(a)(ii) such that it is included in the “exempt surplus” of LLC. This also explains why NSULC was able to claim a section 113 exemption on reception of the LLC dividends. U.S. Amalco’s interest payment therefore has benefited from a complete deduction when computing Canadian tax payable, pursuant to paragraph 113(1)(a). The Respondent further states that it is this “same interest income” on which USGP was taxed in the United States, such that Canada has already provided foreign relief on that income and should not do so again pursuant to subsection 20(12).

d. Purpose

[45] The Respondent submits that the purpose of the foreign tax relief provisions in the *Act* (including section 113 and subsections 126(1) and 20(12)) is to recognize that a taxpayer might be subject to international double taxation and to accordingly relieve it from the burden of paying taxes in two countries. In the present case, the combination of two forms of relief, such as section 113 and subsection 20(12), would amount to double Canadian recognition of foreign taxes paid on the same income, which was not intended by Parliament. The exclusionary clause in subsection 20(12) is there specifically because the two systems are not intended to overlap: it is meant to prevent a taxpayer from taking advantage of a credit or deduction where he has already benefited of foreign tax relief elsewhere in the *Act*.

[46] For the Respondent, the non-taxation of the interest income in Canada must mean that no deduction for the U.S. tax paid should be granted, because that would permit the taxpayer to reduce otherwise taxable income from other sources of the taxpayer. The interest received by Emergis is not taxable in Canada. In the absence of any double taxation concerns, relief for foreign taxes paid on an interest payment not even taxable should not be available.

Analysis

[47] This is a statutory interpretation case which implies that a textual, contextual and purposive analysis of subsection 20(12) is required, as per the Supreme Court of Canada's guidance in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

[48] Although Emergis' corporate structure is almost a mirror image of the corporate structure used in *FLSmidth,* there are significant differences in both the facts and issues under appeal that can only lead to one conclusion: the reasons given by the Tax Court of Canada and by the Federal Court of Appeal in *FLSmidth* are not determinative of the result in this case.

[49] The major differences are attributable to the fact that the taxes claimed as a deduction are different in that they were not paid by the same entity and were not paid for the same type of income.

[50] In *FLSmidth,* the deduction claimed was for U.S. tax paid by the U.S. partnership, in computing its net taxable income. Although in both cases, from a U.S. perspective, the U.S. partnership had received an interest payment from U.S. Holdings, in *FLSmidth* the interest payable by the U.S. partnership did not cover all

of its income, such that there was a net income in the partnership on which it paid U.S. tax. This also implied that there was an issue with the first condition of subsection 20(12), whether the taxes had been paid in respect of the taxpayer's (Dorr-Oliver's) income (the entity that paid the tax was not in fact the Canadian taxpayer, it was the GL&V Limited Partnership).This is another notable difference between the two cases since in Emergis' appeal, only the second condition of subsection 20(12) is controversial.

[51] In *FLSmidth,* the U.S. partnership also had credit facilities on which it paid interest (much like USGP paid interest to Emergis) that reduced its net taxable income. However, in *FLSmidth,* no withholding taxes had been imposed or claimed as a deduction under the *Act* on the interest payment pursuant to the First Loan.

[52] In Emergis' appeal, the parent "taxpayer", Emergis itself, has provided all of the financing (no need for credit facilities).There is thus an additional or different loan [the "First Loan"], the interest payable on which is sufficient to reduce to nil the net income of the U.S. partnership. This also resulted in no net tax payable in Canada, when computing the U.S. partnership's Part I tax payable in Canada.

[53] The existence of this interest payment to the parent entity (Emergis) is a fundamental difference because it is on that interest payment that the U.S. imposed the withholding taxes now sought to be deducted under subsection 20(12). They were thus imposed on the gross income of the recipient of the cross border payment, *Emergis*. Presumably, this is the reason why the Respondent is not contesting the applicability of the first condition of subsection 20(12).

[54] Emergis, as a member of the U.S. partnership, is also taxable on its allocated income of the partnership. In the present case, however, through the use of the interest payment, the Emergis financing structure resulted in a modification of the nature of the amount included in its income although it is the same amount that has to be included (interest versus dividend). The allocation of partnership income is inversely proportional to the interest receivable in *Emergis* (the bigger the interest received, the lower its allocated partnership income). For Canadian purposes, however, the First Loan is clearly distinct from the dividends received on the shares of NSULC. Because the question under appeal is whether the tax paid on the interest can reasonably be regarded as tax paid in respect of the dividends, it is necessary to consider the fact that they are inversely proportional in considering whether there is a connection between them.

[55] Furthermore, in *FLSmidth*, the U.S. tax was paid on interest received by the U.S. partnership. In Emergis, the tax is paid on interest paid by the U.S. partnership (and received by the taxpayer Emergis).One major difference is that the former is recharacterized as active business income for Canadian purposes, whereas the latter is recognized as an interest-bearing loan for Canadian purposes. The interest paid by the U.S. partnership is not, from the *Act*'s perspective, income from a share but that does not answer the question. The question is whether the U.S. tax can be said to have been paid in respect of income from a share.

[56] The relevant findings of both the Tax Court of Canada ("TCC") and the Federal Court of Appeal ("FCA") in *FLSmidth* concerning the exclusionary clause in subsection 20(12) are hereinafter summarized:

a. <u>TCC</u>

[57] The Court said three different things to support its final conclusion that the U.S. taxes could really be regarded as having been paid in respect of income from the shares of LLC (par. 65).

[58] First, the Court said that the taxes had been paid down the chain, which meant they had affected the flow of income and the amount of the dividend ultimately received by the U.S. partnership (par. 57-58):

> [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] Second, Paris J. looked at the text of subsection 20(12) and found that the words “can reasonably be regarded” did “enable the Minister to look through NSULC” so as to find a connection between the LLC dividend and the income received by the U.S. partnership. Therefore, because the dividends had funded the income received by the U.S. partnership, there was a sufficient connection.

[60] Finally, the judge held that the purpose of the exclusionary clause supported his view that “in respect of” be interpreted broadly:

> [67] … [T]he 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.

b. <u>FCA</u>

[61] The issue before the FCA is closer to the one in the present case because only the second condition (exclusionary clause) was put at issue before the FCA. However, this did not prevent the FCA from dismissing the appeal based on a reading of both conditions, because the FCA held that whether the judge misconstrued the words “in respect of” (by applying them broadly or not), the appeal could not succeed (par. 45). Because if a broad interpretation of those words was an error, than the first condition would not have been met, such that it was impossible for *FLSmidth* to meet the first condition but not have the second apply.

[62] The FCA emphasized that the Tax Court judge’s conclusion on the second condition “rest[ed] entirely on the broad meaning which the Tax Court judge gave to the phrase “in respect of” (par. 35). Interestingly, the FCA dismissed the appeal

without explicitly agreeing with any of the three findings made by the Tax Court judge in support of the application of the exclusionary clause.

[63] For the first one, it rejected the TCC's conclusion that the U.S. taxes had affected the flow of income. The FCA in fact agreed with the appellant in that case that the U.S. tax did not reduce the amount of the dividends paid by LLC to NSULC (par. 38). In any event, the FCA said that the use made of the dividends after having been included in NSULC (for example by paying interest) did not have the effect of reducing the dividend payable and computed in the U.S. partnership's income under the *Act* (par. 42).

[64] For the second reason given by the TCC judge, the FCA refused to take position on whether the judge's interpretation of the words "can reasonably be regarded" had been made in error because that would not have influenced the outcome of the appeal (par. 34 and 35).

[65] As for the third one- the conclusion of Paris J. that Parliament had intended to exclude the application of subsection 20(12) when relief is granted under section 113, the FCA said it is "not clear that the foreign affiliate regime always provides for a comprehensive solution to foreign tax paid on dividends from a foreign affiliate", and therefore the Court stated that it "would not go as far as to say that subsection 113(1) excludes the subsection 20(12) in all cases in which it applies" (par. 51-53).

[66] In summary, the FCA's decision does not help us in our case. It only emphasizes that the TCC judge's reasons where grounded on a broad interpretation of the words "in respect of" as found in the second condition of subsection 20(12). The FCA simply held that even if such a broad interpretation of the provision had been made in error, the appellant could not have won because the two occurrences of the words "in respect of" in subsection 20(12) must be interpreted in a similar manner.

[67] In the present case, it now matters directly whether one must interpret these words broadly or narrowly. Hence, the FCA decision in *FLSmidth* does not resolve the issue before us and this Court must now review the text, context and purpose of the provision to determine if the exclusionary clause should be interpreted in the same broad manner as it had been in the TCC decision in *FLSmidth*.

<u>Textual analysis</u>

[68] Although Emergis' arguments have some merit, I am not convinced I should depart from the interpretation of subsection 20(12) given by Paris J. I agree with the Respondent that the words "in respect of" are very broad, and agree that Parliament could simply have used to words foreign tax "paid on that income" rather than "paid in respect of that income" to convey a narrower meaning. The Supreme Court of Canada described the words "in respect of" as probably the widest expression intended to convey some connection between the two related matters (see *Nowegijick v. The Queen*, (1983) 1 S.C.R. 29).

[69] However, as highlighted by the Respondent, it is still necessary to find a connection between the U.S. tax paid and the dividend income received. The words "in respect of", in and by themselves, are not broad enough to create a link where none exists.

[70] In *FLSmidth*, the connection was clearly met: because the income received by the person who had in fact paid the tax (the U.S. partnership), had been recharacterized as active business income under *Act* and was from a Canadian perspective, actually received by the partnership in the form of dividends. In this appeal, the same cannot be said. The situation is different because the taxpayer who ultimately bore the U.S. tax [Emergis], did not directly receive dividends from the partnership. Rather, the U.S. tax was imposed on the interest payment received by Emergis and not on Emergis' allocation of the NSULC dividend.

[71] However, the reference in subsection 20(12) to the U.S. tax "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" clearly suggests to consider whether the income from shares received by a corporation other than the taxpayer can reasonably be regarded as the one in respect of which the U.S. tax paid by the taxpayer claiming the deduction.

[72] For this purpose, consideration should be given to the fact that the LLC dividend partly or wholly funded the interest payments on the First Loan in determining whether there is a significant connection between the U.S. tax paid and the LLC dividend.

[73] Since it is admitted by the parties that USGP used the dividend income it received from its shares of NSULC to pay interest of US $32,622,207 (computed before U.S. withholding tax on that interest) to Emergis on the First Loan, the U.S. withholding tax paid on the interest income paid by the USGP to Emergis may

reasonably be considered as being “connected with or related to” the dividend income paid by LLC to NSULC.

[74] As subsection 93.1(1) of the *Act* operates to deem Emergis to own a proportionate share of the NSULC shares owned by USGP equal to its proportionate interest in the partnership, with the result Emergis had an equity percentage in LLC of 99.9%, it is a “further and distinct connection” that if Emergis had not owned the NSULC shares, it would not have had the dividend funds to pay the interest. Given the flow of funds in this tower structure, there is some connection between the interest income paid by USGP and the dividends paid by LLC to USGP, which were reclaimed and reported by Emergis through its partnership interest in USGP.

[75] The brood language used in subsection 20(12) was clearly intended to capture indirect flows of income considering that corporate structure involving foreign affiliates often contain several tiers.

[76] Both the Tax Court of Canada and the Federal Court of Appeal agreed in *FLSmidth* that it is possible to “look through” the entities created by a taxpayer to evaluate the economic substance of a transaction regardless of its legal form.

Contextual analysis

[77] Both parties have submitted that other provisions of the *Act* that pertain to foreign tax relief should be looked at. The Respondent focuses on the exemption for dividends of foreign affiliates (subsection 113(1)) and the Appellant on the foreign tax credit for non-business-income taxes (subsection 126(1)). I agree with both, all of these provisions are relevant.

[78] In the broad context of the *Act*, there are three ways by which the relief for foreign income taxes is provided: through exemption (section 113), through credits (section 126) or through deduction (subsection 20(12)). Both parties agree that only one of these three measures is available with respect to each item of income received by a Canadian resident on which foreign income tax has been paid. This is self-evident between section 126 and subsection 20(12) in that they are mutually exclusive. One cannot claim subsection 126(1) credit where the foreign tax has been “deducted by virtue of subsection 20(12) in computing the taxpayer’s income for the year” (see the definition of “non-business income tax” of subsection 126(7)). As for the exemption versus the deduction, they are also mutually exclusive, which is precisely why an exclusionary clause was added to subsection 20(12) deduction and why subsection 126(1) does not permit a credit or deduction where the tax has been

paid "in respect of" income from the shares of a foreign affiliate. The specific reference to income from a share of a foreign affiliate implies that foreign tax has already been recognized by Canada elsewhere in the *Act*.

[79] The tax treatment given to the income flow in this matter was as follows:

(i) for Canadian tax purposes, LLC utilized paragraph 95(2)(a) to recharacterize the interest income derived from foreign accrual property income (FAPI) into active business income and thus included the income in LLC's exempt surplus;

(ii) the dividends paid out of the exempt surplus of LLC to NSULC were fully deductible by NSULC under paragraph 113(1) a) *Act* ("the surplus regime");

(iii) the dividends received by USGP from NSULC were allocated to the partners by virtue of section 96, and the partners were permitted a complete deduction pursuant ss. 112(1) *Act*;

(iv) USGP paid interest income to Emergis on the First Loan. US tax was withheld on this interest income. Emergis included in income its 99.9% share of USGP's net income, but also claimed a 112(1) deduction on the NSULC dividends equivalent to the inclusion.

[80] As a result, Emergis paid no tax in Canada because the interest income that LLC received from U S Amalco was distributed as a non-taxable dividend to NSULC out of the exempt surplus of LCC, and thereafter was distributed as a non-taxable dividend by NSULC to Emergis through the USGP and then distributed by USGP to Emergis as interest on the First Loan. However, this interest was simultaneously negated by Emergis' 99.9% share of USGP's interest expense, since Emergis is a 99.9% partner in USGP (i.e. Emergis is on the both sides of the same transaction: the interest payment and the interest receipt). As a result, Emergis paid no Canadian tax on the interest income. Not only was no tax paid in Canada on the interest income, but assuming that the interest and dividend transaction were the only relevant ones in the 2000 and 2001 years, the subsection 20(12) deduction claimed by Emergis would generate non-capital losses of US$3,770,372 and US$5,002,325, respectively, that can be applied against other income. Allowing the 20(12) deduction actually provides a deduction against Emergis' other income, and not against the interest income from USGP because that income was completely offset by the interest expense, on the same transactions, deduction by USGP under 20(1)(c) of the *Act*, which flowed through Emergis.

Purposive analysis

[81] As for the purpose of the provision and of the exclusionary clause, I agree with both parties' submissions. The deduction is a form of alternative relief for when the credit in subsection 126(1) is not available. However, the exclusionary clause is also intended to restrict the availability of foreign tax relief where the provisions that deal with foreign affiliates can be said to have provided sufficient relief. In other words, the deduction is available to relieve for the burden of international taxation, but the exclusionary clause is there to prevent a taxpayer from claiming twice the relief on the same source of income. Clearly, there has been two sorts of reliefs obtained here but the question here is whether the deduction claimed under subsection 20(12) and section 113 were for the same source of income.

[82] I do find a connection between the dividend and interest payment. That is because Emergis has been able to claim both an inclusion and deduction on that interest payment. Because part of that interest income is not recognized in Canada, one can notionally see the tax as having been imposed on the income Canada does recognize, i.e. the income from a share.

[83] The connection results from the fact that the interest is not taxable in Canada only because the LLC dividend was exempt. The fact that no tax is payable on the interest payment in Canada is not in itself necessarily relevant. However, it will be where the reason why the interest (or other source of income) is not recognized and taxable under Part I of the *Act* is because an exemption for foreign affiliates was provided. In the present case, the reason why 99.9% of the interest was deducted and not taxable under the *Act* is because the taxpayer had income from a share of a foreign affiliate. The interest deduction is dependent on a purpose of earning income which in this case is the dividend flowing from LLC and on from NSULC.

[84] Although the section 112 deduction claimed by the partnership is not for dividend income of a foreign affiliate (NSULC is Canadian), the section 112 deduction can be claimed only because of the hybrid nature of USGP. Had USGP not been treated differently in both countries, Emergis would not have been able to claim the section 112 deduction (which is only available to intercorporate dividends between Canadian corporations). There is therefore no foreign element to the NSULC dividend. But since there is foreign tax paid, the foreign element must be connected to the LLC dividend, which is in effect the only cross-border transaction from the *Act*'s perspective.

[85] When two reliefs are claimed in respect of one cross-border structure, it is logical that only one be granted by Canada where the *Act* sees only one source of foreign income. Here, the only cross-border source of income recognized by the *Act*

is the income from a share of LLC, which can reasonably be regarded as the income on which foreign tax was levied, since the interest income is seen as paid by a Canadian resident to another.

[86] Canada will not recognize the foreign component to the transaction where from its perspective it already has been recognized in the form of income from a share. This is precisely why "in respect of" should be interpreted broadly: not because it is meant to connect two different transactions, but to determine if only one of the two transactions should qualify for the underlying tax relief.

[87] It is not because the interest payment was not taxable in Canada that the exclusionary clause applied: it is because the LLC dividend in combination with the hybrid nature of the US partnership has resulted in only one inbound cross-border transaction having been perceived by Canada: the LLC dividend. In other words, Canada only sees one cross-border transaction: the LLC dividend. Canada fully exempts that income under subsection 113(1). The ultimate cross-border interest payment received by Emergis, although it is the one on which U.S. tax was paid, is partly a payment made from Emergis to itself. For 99.9% of the interest received, Emergis' foreign source of income can reasonably be regarded to be that of the LLC dividend, such that if any foreign tax was paid it must be regarded as having been paid in respect of that foreign source income.

[88] The hybrid nature of USGP was necessary for the interest not to be taxable in Emergis' income. Without the dividend allocation and interest deduction claimed by the partnership being allocated to Emergis, the interest would have been fully taxable.

[89] Canada already subsidizes the earning of foreign income by permitting its residents to deduct interest on money borrowed to earn exempt dividends. Granting an additional deduction in the circumstances of this case, on top of the paragraph 20(1)(c) deduction claimed to reduce to nil the income on the interest payment, would amount to Canada subsidizing the government of another country when it imposes tax that from Canada's perspective is (partly) not even recognized.

Conclusion

[90] In summary, the words "in respect of" are to be interpreted broadly. The income from a share of a corporation other than the taxpayer should be considered. In the present instance, although subsection 20(12) does not include a requirement that the income on which tax was paid be taxable in Canada, the exemption obtained

by NSULC on the LLC dividend is the reason why Emergis is ultimately not taxable on it. The section 113 exemption therefore is related to the paragraph 20(1)(c) deduction Emergis was allowed to claim on the interest income on which U.S. tax was paid.

[91] For 99.9% of the partnership's income, both the Canadian tax system and the U.S. tax system see the income as having "crossed the border" only once before being received by Emergis. Although the U.S. imposes tax on what it views as being a cross-border interest payment, Canada only sees foreign income as having crossed the border when it is received by a Canadian resident in the form of a foreign affiliate dividend. To the extent that the interest income will ultimately not be taxable in Canada because of the section 113 exemption, the U.S. tax paid can reasonably be regarded as having been paid on the dividends paid out of LLC, because this is the foreign source of income Canada does recognize.

[92] For the foregoing reasons, the appeal is dismissed with costs to the Respondent.

Signed at Montréal, Québec, this 19th day of March 2021.

"Réal Favreau"

Favreau J.

CITATION:	2021 TCC 23
COURT FILE NO.:	2017-1901(IT)G
STYLE OF CAUSE:	EMERGIS INC. AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Vancouver, British Columbia
DATE OF HEARING:	October 16, 2019
REASONS FOR JUDGMENT BY:	The Honourable Justice Réal Favreau
DATE OF JUDGMENT:	March 19, 2021

APPEARANCES:

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Court File No.: 2017-1901(IT)G

GENERAL PROCEDURE

TAX COURT OF CANADA

BETWEEN:

EMERGIS INC.

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

PARTIAL AGREED STATEMENT OF FACTS AND ISSUE

The Appellant and the Respondent agree, for purposes of this appeal and any appeal therefrom, that the following facts are true. The parties may adduce additional evidence provided that such evidence does not contradict these facts. The parties are free to make submissions with respect to the degree of relevance or weight to be attributed to these facts, and are not to be taken as agreeing to such relevance or weight.

Part A – The Appellant

1. At all times material to this appeal, the Appellant (**Emergis**) was a Canadian public company owned 65% by BCE Inc. (another Canadian public company) and had a fiscal year ending December 31.

Part B – The Acquisition of UP&UP and Tower Structure

2. In its 2000 taxation year, Emergis indirectly acquired an arm's length U.S. operating company (**UP&UP**) and for that purpose established a cross-border-financing structure known in the tax community as a "tower structure". The acquisition, including the tower structure, involved the steps set out below.

3. On February 3, 2000, Emergis incorporated Jetco Inc. (**Jetco**) under the laws of Delaware U.S.

4. On March 15, 2000:

    (a) Emergis caused 3701123 Canada Inc. (**Cansubco**) to be incorporated; and

    (b) Emergis and Cansubco caused BCE Emergis General Partnership (**USGP**) to be formed under the laws of Delaware, U.S., with Emergis as the 99.9% partner and Cansubco as the 0.1% partner.

5. On March 16, 2000, 3040697 Nova Scotia Unlimited Liability Company (**NSULC**) was incorporated with USGP as its sole shareholder.

6. On March 17, 2000:

    (a) BCE Emergis LLC (**LLC**) was organized as a limited liability company under the laws of Delaware, U.S. by NSULC and USGP; and

    (b) Emergis subscribed for 100 shares of BCE Emergis US Holdings Inc. (**US Holdco**), a newly created Delaware corporation.

7. On March 22, 2000:

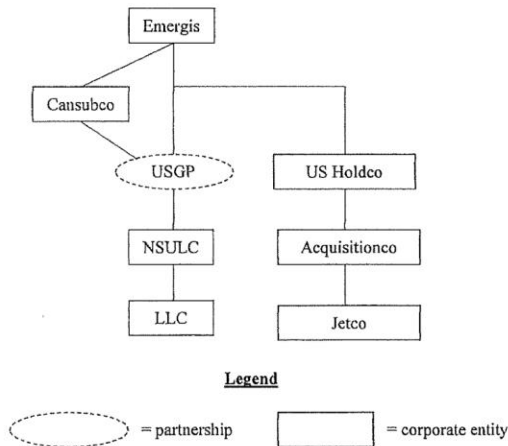
   (a) US Holdco subscribed for 100 shares of an indirect U.S. subsidiary of Emergis (**Acquisitionco**); and

   (b) US Holdco acquired all of Jetco's issued shares owned by Emergis in consideration for 100 common shares of US Holdco.

8. On March 24, 2000, US Holdco transferred all the shares of Jetco to Acquisitionco, in consideration for 100 common shares of Acquisitionco.

9. At this point, the <u>legal</u> structure could be shown schematically as appears in **Figure 1** below. (The tax-characterization of these entities, for Canadian and U.S. tax purposes, is described below under Part C – Tax Characterization of the Entities.)

Figure 1 – Legal Structure Pre-Acquisition



10. Also on March 24, 2000:

    (a) Emergis subscribed for Cansubco shares in the amount of US$34,400;

    (b) Emergis and Cansubco made capital contributions to USGP, based on their respective partnership percentages, totalling US$33,385,535;

    (c) Emergis lent USGP US$266,670,000 at an annual interest rate of 12.25% for a ten-year term, which interest rate was reduced to 12.127% after October 1, 2000 due to a change in the interest payment schedule from quarterly to monthly (the **First Loan**);

    (d) USGP used the funds provided by the First Loan and the Appellant's and Cansubco's capital contributions to subscribe for US$300,002,000 of the capital stock of NSULC;

    (e) USGP subscribed for 1 share of LLC for US$100;

    (f) NSULC subscribed for shares of LLC for US$300,001,000;

    (g) Emergis subscribed for 2,424,720 shares of US Holdco, for US$242,472,050;

    (h) US Holdco subscribed for 2,424,710 shares of Acquisitionco, for US$242,47 1,050; and

    (i) LLC lent Acquisitionco US$300,000,000 at an annual interest rate of 12.5% for a 10-year term, which interest rate was reduced to 12.372% after September 27, 2000 due to a change in the interest payment schedule from quarterly to monthly (the **Second Loan**).

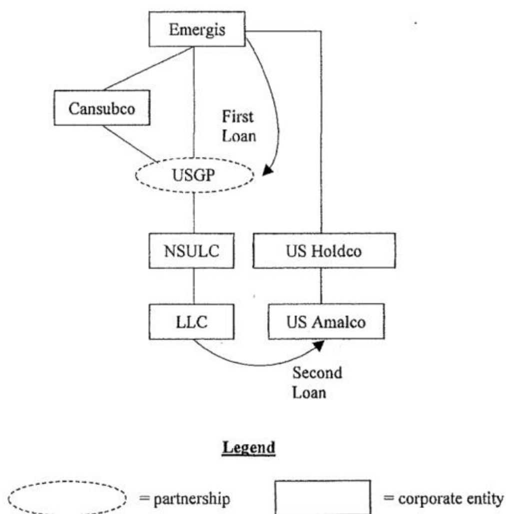
11. On March 28, 2000 Jetco and UP&UP merged and thereby formed a new U.S. corporation (**US Mergco**).

12. On March 29, 2000, Acquisitionco was merged into US Mergco to form **US Amalco** and by virtue of this merger US Amalco assumed the Second Loan.

13. US Amalco is a US resident for tax and for treaty purposes.

14. At this point, the acquisition of UP&UP was complete and the legal structure could be depicted schematically as shown in Figure 2 below. (The tax characterization of these entities, for Canadian and U.S. tax purposes, is described below under Part C – Tax Characterization of the Entities.)

Figure 2 – Legal Structure Post-Acquisition



Part C – Tax Characterization of the Entities

15. At all times material to this appeal USGP, NSULC, and LLC were "hybrid entities", meaning that they were treated differently under Canadian and U.S. tax laws. These entities formed the tower in the tower structure. Specifically:

    (a) USGP was treated as a partnership for purposes of the Act,[1] but elected to be treated as a U.S. resident corporation for U.S. tax purposes;

    (b) NSULC was treated as taxable Canadian corporation under the Act, but was a "disregarded" entity for U.S. tax purposes (meaning that it was not regarded as having an existence separate from its owner); and

    (c) LLC was treated as a non-resident corporation and foreign affiliate of NSULC and of Emergis under the Act, but was a disregarded entity for U.S. tax purposes.

16. US Holdco was a U.S. resident corporation and a directly-owned foreign affiliate of Emergis for Canadian tax purposes. It was a U.S. resident corporation for U.S. tax purposes.

17. US Amalco was a U.S. resident corporation and a foreign affiliate of Emergis for Canadian tax purposes. It was a U.S. resident corporation for U.S. tax purposes.

18. As a result of the foregoing, the relevant portions of the legal structure could be depicted schematically from the Canadian and U.S. tax perspectives as shown in **Figure 3** below.

19. A further depiction of the full structure is attached as Schedule A.

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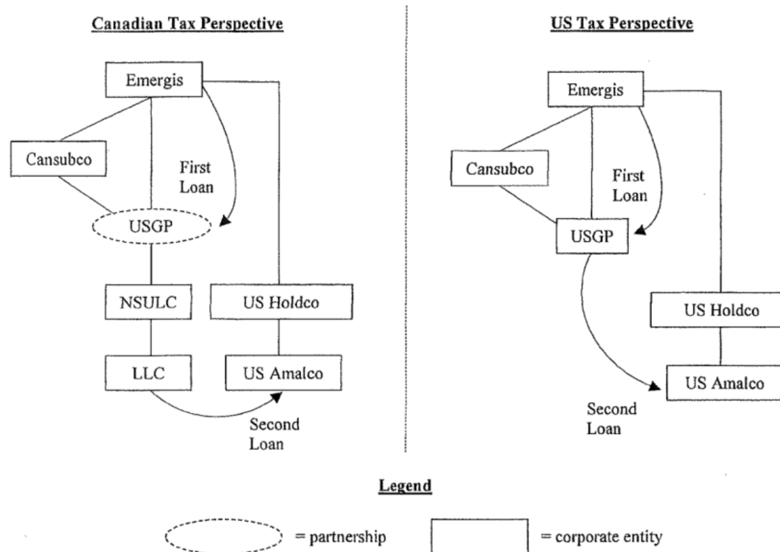
[1] Section references are to the *Income Tax Act* (Canada) (the **Act**) unless noted otherwise.

Figure 3 – Tax Structure



Part D – The Dividends, Interest, and U.S. Withholding Tax

20. From the Canadian tax perspective, in Emergis's 2000 and 2001 taxation years:

(a) US Amalco paid interest on the Second Loan to LLC;

(b) NSULC received dividend income from its shares of LLC in US dollars, equivalent to CAD $42,940,070 and CAD $58,467,044 in 2000 and 2001, respectively. NSULC included the amounts in its income under subsection 90(1) and claimed an offsetting deduction for this amount in computing its taxable income under paragraph 113(1)(a) as dividends received on its shares of a foreign affiliate (LLC) prescribed to have been paid out of the exempt surplus of the affiliate;

(c) USGP was required to compute its (net) income from each source under paragraph 96(1)(c) and for this purpose USGP recognized dividend income received from its shares of NSULC under subsection 82(1) and claimed a substantially offsetting deduction under paragraph 20(1)(c) for interest it paid to Emergis on the First Loan;

(d) USGP's (net) income computed under paragraph 96(1)(c) above was in turn allocated to Emergis and Cansubco under paragraph 96(1)(f) to the extent of their respective shares as partners of USGP; and in this respect Emergis reported in Schedule 1 of its T2 tax return its 99.9% allocated share of USGP's income.

(e) Emergis included in its income under subsection 12(3) the interest paid to it by USGP on the First Loan and Emergis reported this amount in Schedule 1 of its T2 tax return.

(f) In computing its taxable income under subsection 112(1), Emergis claimed a deduction in respect of its 99.9% share of dividend income received by USGP from NSULC on page 3 of its T2 tax return.

21. In Emergis's 2000 and 2001 taxation years, Emergis paid U.S. withholding tax equivalent to the amount of CAD $3,808,456 and CAD $5,051,276, respectively, on its interest income received from USGP on the First Loan.

22. In filing its tax returns under the Act, Emergis deducted this U.S. withholding tax in computing its income from a business or property under subsection 20(12) on the basis that the U.S. withholding tax constituted non-business income tax paid by Emergis to the U.S. government in respect of that income, i.e., income from the First Loan: $3,808,456 for its 2000 taxation year and $5,051,276 for its 2001 taxation year.

23. The U.S. tax rules disregarded the dividend payment from LLC to NSULC and the dividend payment from NSULC to USGP because LLC and NSULC were both

disregarded entities for U.S. tax purposes. Thus, no U.S. tax was payable on dividends paid by LLC to NSULC or on dividends paid by NSULC to USGP in 2000 and 2001.

24. As described in paragraph 10(d) above, USGP used the funds from the First Loan to acquire its only asset, i.e., the shares of NSULC. USGP used the dividend income it received from its shares of NSULC to pay interest owing to Emergis on the First Loan.

25. More specifically, in 2000, and in the following order:

(a) LLC paid a dividend to NSULC, denominated in U.S. dollars, equivalent to CAD $42,940,070;

(b) NSULC used the dividend income it received from its shares of LLC to pay a dividend of U.S. $28,758,167 to USGP;

(c) USGP used the dividend income it received from its shares of NSULC to pay interest of U.S. $25,506,296 (computed before U.S. withholding tax on that interest) to Emergis on the First Loan; and,

(d) Emergis paid U.S. withholding tax in U.S. dollars equivalent to the amount of CAD $3,808,456 on its U.S. $25,506,296 of interest income from the First Loan.

26. More specifically, in 2001, and in the following order:

(a) LLC paid a dividend to NSULC, denominated in US dollars, equivalent to CAD $58,467,044;

(b) NSULC used the dividend income it received from its shares of LLC to pay a dividend of US$37,759,263 to USGP;

(c) USGP used the dividend income it received from its shares of NSULC to pay interest of US$32,622,207 (computed before U.S. withholding tax on that interest) to Emergis on the First Loan; and,

(d) Emergis paid U.S. withholding tax in U.S. dollars equivalent to the amount of CAD $5,051,276 on its US$32,622,207 of interest income from the First Loan.

27. Assuming the foregoing were the only relevant transactions in Emergis's 2000 and 2001 taxation year, and a subsection 20(12) deduction was available with respect to the U.S. withholding tax paid, the calculation of Emergis's income from a business or property under section 3 in Division B of Part I of the Act and the calculation of its taxable income under Division C of Part I the Act would be as shown in chart below:

Item	Emergis	2000 Taxation Year		2001 Taxation Year	
	DIVISION B – COMPUTATION OF EMERGIS' INCOME				
	Inclusions				
I	s. 12(1)(c), 12(3) interest income from USGP on the First Loan		$38,084,560		$50.512.758
	Emergis allocation of USGP's income:				
	USGP total income:				
II.a.	Dividend income (from NSULC to USGP)	$42,940,193		$58,467,059	
II.b	Interest expense (First Loan)	-$38.084.471		-$50.512.758	
	Other items	-$5.599		-$44.179	
	USGP's net income for tax purposes	$4,850,123		$7,910,122	
		x 99.9%		x 99.9%	
	Emergis' 99.9% share 12(1)(l) & 96(1)(c)		$4,845,060		$7,902,212
	Deductions				
III	s. 20(12) foreign non-business tax		-$3,808,456		-$5,051,276
	Income for the Year				
	s. 3 Emergis' net income for the year		**$39,121,164**		**$53,406,267**
	DIVISION C – COMPUTATION OF EMERGIS' TAXABLE INCOME				
	Deductions				
IV	s. 112(1) dividend from NSULC (99.9%)		-$42,897,130		-$58,408,592
	Carryover Amount				
	s. 111(8) "non-capital loss" for the year		-$3,770,372		-$5,002,325
	DIVISION A – EMERGIS' LIABILITY FOR TAX				
	s. 2(2) Emergis' taxable income for the year		**Nil**		**Nil**

Items I and II.b offset each other
Items IV and II.a offset each other

28. Emergis reported its interest income from the First Loan under subsection 12(3), the allocation of its 99.9% share of USGP's (net) income from USGP's shares of NSULC under paragraph 96(1)(f), and its deduction under subsection 112(1) in respect of its 99.9% share of dividends USGP received from NSULC – all as described in paragraph 27 above.[2]

29. In 2000 and 2001, NSULC's only assets were its shares of LLC and the dividend income from those shares, and USGP's only significant assets were its shares of NSULC and the dividend income from those shares.

30. The U.S. income tax paid by USGP, as a U.S. resident corporation on its net income for U.S. tax purposes from the Second Loan, is not relevant in this appeal because Emergis did not claim any deductions under subsection 20(12) in respect of any U.S. income tax paid by USGP.

Part E – Tower Structure Unwound

31. Emergis unwound the tower structure in its 2002 taxation year due to changes in U.S. tax law, which changes made the structure undesirable for U.S. tax purposes. After July 2002, Emergis pursued a Hungarian-financing structure instead.

Part F – Issue

32. The parties agree that the U.S. withholding taxes of CAD $3,808,456 and CAD $5,051,276 paid by Emergis in its 2000 and 2001 taxation years, respectively, represented non-business income taxes paid by Emergis to the U.S. government in respect of Emergis's income from the First Loan. Accordingly, the parties agree that the first condition in subsection 20(12) is met.

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[2] The amounts reported by Emergis in 2000 and 2001 differed only slightly from the amounts shown in paragraph 27 above. The difference arose solely from rounding and the application of exchange rates converting US dollars to Canadian dollars. This difference is not material to the issue in this appeal.

33. The issue in this appeal is whether the second condition in subsection 20(12) also applies, that is, whether these U.S. withholding taxes of $3,808,456 and $5,051,276 could, in whole or in part, reasonably be regarded as having been paid by Emergis in respect of income from a share of the capital stock of a foreign affiliate of Emergis.

34. If this second condition is satisfied, Emergis is not entitled to the deduction that it claimed under subsection 20(12) as described above. On the other hand, if the second condition does not apply, Emergis is entitled to the deduction that it claimed under subsection 20(12) as described above.

DATED at Vancouver, British Columbia, this 19th day of February 2019.

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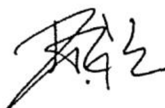

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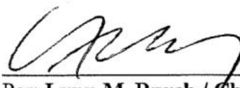

Per: **Lynn M. Burch / Christa Akey**
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Emergis Inc. v. HMTQ

Tax Court of Canada Appeal No. 2017-1901(IT)G

Agreed Statement of Facts Schedule A