Montreal 1967 Apr. 19-20 — Ottawa May 3

BETWEEN:

INTERPROVINCIAL PIPE LINE COMPANY .... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE .... RESPONDENT.

Income tax—Foreign tax credit—Interest on bonds in U.S.A.—Withholding tax paid in U.S.A.—U.S. bonds purchased from money borrowed by taxpayer—Interest paid on money borrowed—Calculation of foreign tax credit—Income Tax Act, ss. 11(1)(c), 41(1)(b)(i), 139(1a) and (1b), am. 1960, c. 43, s. 33(5)—Canada-U.S.A. Tax Convention, Art. XV.

In 1960 appellant, a company resident in Canada, received $2,421,165.80 interest on bonds of a United States company and paid interest of $2,363,966.79 on money borrowed to buy those bonds. The amount by which the interest received exceeded the interest paid, *viz* $57,199, was required to be taken into account in computing appellant's income for 1960 under Part I of the *Income Tax Act,* the tax attributable thereto being $28,599.50. Appellant paid the United States Government in 1960 a 15% withholding tax, *viz* $363,174.87, on the said bond interest and sought to deduct this sum as being the foreign tax credit on the tax otherwise payable by appellant under Part I of the *Income Tax Act* (which was in excess of $8,000,000).

Held, the foreign tax credit to which appellant was entitled was $28,599.50, being the amount by which its tax for 1960 under Part I of the *Income Tax Act* was increased by reason of its purchase of the bonds.

The interest paid on money borrowed to purchase the bonds was deductible from the interest received on those bonds under s. 11(1)(*c*) of the *Income Tax Act,* which was made applicable by s. 139(1*b*), enacted in 1960, to the calculation of the foreign tax credit allowed by s. 41(1)(*b*) in respect of the income from the U.S. bonds. Article XV of the *Canada-U.S.A. Tax Convention,* as changed in 1950, made applicable the foreign tax credit provision of each country's domestic law as it might be from time to time.

Interprovincial Pipe Line Co. v. M.N.R. [1959] S.C.R. 763, distinguished.

INCOME TAX appeal.

P. F. Vineberg, Q.C. and *L. Phillips, Q.C.* for appellant.

G. W. Ainslie and *Bruce Verchere* for respondent.

JACKETT P.:—These two appeals, which have been argued on a case stated by the parties under Rule 150, raise questions as to the amounts of the foreign tax credits to which the appellant is entitled for the 1960 and 1961 taxation

years, respectively, in the computation of the income taxes payable by it under Part I of the *Income Tax Act* for those years.

There is, in effect, only one problem to be dealt with, and it is the same for each of the two taxation years.

While the facts are stated with considerable detail in the stated case, I am satisfied that they may, for the purpose of considering the legal question involved, be put in very general terms that are applicable to each of the taxation years in question.

The appellant was resident in Canada, had a business in Canada from which it had a profit for the year, and owned bonds issued by a company that carried on business in the United States (which company happened to be a wholly-owned subsidiary of the appellant) from which it received the contractual interest in the year. During the year, the company paid interest on bonds that it had issued in earlier years to raise money

(a) part of which was used for the purpose of earning income from its Canadian business, and

(b) part of which had been used to purchase the bonds of the United States company to which I have already referred.

The amount of interest received in the year from the United States company in respect of the United States bonds (in 1960 this amounted to $2,421,165.80) was slightly more than the interest it paid in the year on that part of its bonds the proceeds of which have been used to buy the United States bonds (in 1960 this amounted to $2,363,966.79).

Borrowing the money to acquire the United States bonds and acquisition of such bonds had two results on the appellant's tax position as it would have been had there been no provision for foreign tax credits in the Canadian law:

1. The appellant paid "income tax" in the year, as a "non-resident" of the United States, to the United States Government in an amount equal to 15 per cent of the gross amount of the interest received from the United States company. (For 1960 this was $363,174.87.)

2. In the computation of the appellant's income for the year under Part I of the *Income Tax Act*, it had to bring in the interest received from the United States bonds

on the revenue side ($2,421,165.80 for 1960), and it was entitled to deduct the interest paid on the money borrowed to buy those bonds ($2,363,966.79 for 1960) so that its income for the year was increased by the difference between those amounts ($57,199.01 for 1960) as a result of having acquired the United States bonds. This would have resulted in an additional tax for the year of about 50 per cent of the increase in the income for the year ($28,599.50 for 1960) if there had been no foreign tax credit.

It may therefore be seen, that the amount of tax so paid in the year to the United States Government on the interest received from the United States company is substantially greater than the amount by which the appellant's tax under Part I of the *Income Tax Act* for the year before any foreign tax credit is deducted exceeds the amount that such tax would have been if the appellant had never bought the United States bonds.

In these circumstances the question is whether the appellant is entitled to deduct from the tax otherwise payable by it under Part I of the *Income Tax Act*, as a foreign tax credit,

(a) the whole of the tax paid by it to the United States Government ($363,174.87 for 1960), or

(b) a portion of the income tax otherwise payable by it under Part I computed by reference to the relationship of the increase in its Part I income for the year arising from having acquired the United States bonds to the whole of its Part I income for the year ($27,840.76 for 1960).

Substantially the same question arose between the parties in respect of earlier taxation years and it was established by a decision of the Supreme Court of Canada[1] that the appellant was entitled, in respect of each of those years, to deduct the larger amount. There are differences between the provisions of the *Income Tax Act* as it applies to 1960 and 1961 and the provisions of that Act as it applied to those earlier years. I propose first to consider the question having regard only to the statutory provisions applicable to 1960

[1] [1959] S.C.R. 763.

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and 1961, and then to consider what application the decision of the Supreme Court of Canada has to the present state of the statutes.

While it is probably not, strictly speaking, necessary to do so, I find so much difficulty in bearing in mind the inter-relationships of the various aspects of the *Income Tax Act* that come into play, directly or indirectly, in forming an appreciation of the problem raised by this appeal that I propose to preface my examination of the section by which provision is made for foreign tax credits by a brief review of the general structure of the Act in so far as it seems to me to be relevant.

Part I of the *Income Tax Act* imposes an "income tax" on the "taxable income" of every person resident in Canada in a taxation year and upon the "taxable income earned in Canada" of every person who was employed in Canada or who carried on business in Canada in a taxation year (section 2).

The commencement point for determining the base on which the tax is imposed is, in each case, the taxpayer's "income for the year". [Where a person is resident in Canada, personal exemptions, business losses, etc., are deducted from "income for the year" to obtain his "taxable income" for the year (section 2(3)); and where he is a non-resident person, to obtain his "taxable income earned in Canada" for the year, the reasonably applicable part of personal exemptions, business losses, etc., are deducted from the part of his "income for the year" that may reasonably be attributed to what he did in Canada (section 31).]

This basic concept of "income for the year" is sometimes thought of as "world income". A taxpayer's "income for a . . . year" is his "income for the year from all sources inside or outside Canada". In addition to income from any other possible sources, it includes income for the year from the ordinary sources, i.e., businesses, property, and offices and employments (section 3). In so far as "income for the year" consists of income from businesses or property, it is computed on a profit basis (section 4). It is, however, a single amount for any one taxpayer for any one year.[2] All the

[2] Compare *Interprovincial Pipe Line Co. v. Minister of National Revenue,* [1959] S.C.R. 763, per Judson J. at page 768: "Sections 3 and 4 of the Act do not require a separate computation of income from each source for the taxpayer is subject to tax on income from all sources."

revenue items (whether they are brought in by virtue of business and commercial principles that have been brought into play by the "profit" concept or by virtue of special provisions such as section 6) must be brought in on one side; all the expense and other deductible items (whether they are brought in by virtue of such business or commercial principles or by virtue of special provisions such as section 11) must be brought in on the other side; and the deductible items must be set off against the revenue items. The net amount is the taxpayer's "income for the year".

By reason of the prominence of interest payments and interest receipts in this case, it should be noted at this point that

(a) section 6(1)(*b*) provides that, without restricting the generality of section 3, amounts received or receivable in the year as "interest" must be included in computing a taxpayer's income for the year, and

(b) section 11(1)(*c*) authorizes the deduction, in computing a taxpayer's income for a year, of an amount paid or payable in the year as "interest" on "borrowed money" used "for the purpose of earning income from a business or property".

While world income for the year, on a net basis, is thus the commencement point for determining the income tax for a year payable under Part I of the *Income Tax Act* to the Canadian Government by persons resident in Canada and by non-residents who are employed in Canada or carry on business in Canada, and all of such taxes are computed at the graduated rates set out in Part I, under Part III, persons who are not resident in Canada pay, *inter alia*, an "income tax" at a flat rate of 15 per cent on every "amount" that a person resident in Canada pays to him as "interest".

The result is that the Canadian Government levies (a) an income tax on every resident of Canada computed by reference to his world income, (b) an income tax on every non-resident computed by reference to income earned in Canada, and (c) an income tax on every non-resident computed by reference to certain revenue receipts from persons resident in Canada. Assuming, therefore, that a Canadian resident had income sources in Canada and also in a foreign country that had a tax scheme similar to the Canadian tax scheme, such Canadian resident would pay a tax on his

world income to the Canadian Government and a tax to the foreign government on his income from sources in that country. This would, with some justification, be thought of as "double taxation" on the income derived from sources in the foreign country. The general purpose of the foreign tax credits provision (section 41), as I understand it, is to avoid any such double taxation by allowing to a person resident in Canada in respect of the income tax payable by him to the government of a foreign country where he has income sources a deduction from the tax otherwise payable to the Canadian Government on his world income.

In the light of that very brief outline of the background against which, as I understand it, section 41 must be considered, I turn to an examination of the provisions of that section in relation to the facts of this case. Section 41(1) (which is the only part of section 41 that must be considered), as amended by section 13 of chapter 43 of the Statutes of 1960, reads as follows:

41. (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 an amount equal to the lesser of

(*a*) any income or profits tax paid by him to the government of a country other than Canada for the year (except any such tax or part thereof that may reasonably be regarded as having been paid by him in respect of dividends received from that country, by reason of which he is entitled to a deduction under subsection (1) of section 28 for the year in which they were received), or

(*b*) that proportion of the tax for the year otherwise payable under this Part that

(i) the taxpayer's income

(A) for the year, if section 29 is not applicable, or

(B) if section 29 is applicable, for the period or periods in the year referred to in paragraph (*a*) thereof,

from sources in that country, minus amounts that are deductible under subsection (1) of section 28 by reason of dividends received from a corporation described in paragraph (*d*) of subsection (1) of section 28 that were included in computing his income for the year or such period or periods, as the case may be, from sources in that country,

is of

(ii) the taxpayer's income

(A) for the year, if section 29 is not applicable, or

(B) if section 29 is applicable, for the period or periods in the year referred to in paragraph (*a*) thereof,

minus amounts that are deductible for the year or such period or periods, as the case may be, under section 28.

It was common ground, during the argument of these appeals, that, for the purposes of this case, section 41(1) may be considered as though certain irrelevant portions had been deleted so that it would read as follows:

(1) A taxpayer who was resident in Canada...in a taxation year may deduct from the tax for the year otherwise payable under this Part an amount equal to the lesser of

(a) any income or profits tax paid by him to the government of a country other than Canada for the year ...., or

(b) that proportion of the tax for the year otherwise payable under this Part that

(i) the taxpayer's income

(A) for the year...

from sources in that country...

is of

(ii) the taxpayer's income

(A) for the year...

It is common ground in this case that the 15 per cent tax paid by the appellant to the United States Government in the year is an "income...tax" paid by the appellant to that government for the year and is therefore an amount that falls within the language of paragraph (*a*) of section 41(1). (As already indicated, for 1960, it amounts to $363,174.87.)

There is no dispute as to the amount of the tax for the year "otherwise payable under this Part" by the appellant within the meaning of those words in paragraph (*b*) of section 41(1). (For 1960 this amounted to $8,115,929.95.)

It is also common ground that the amount of the appellant's "income for the year" as established under the various provisions of Part I before making the deductions permitted by Division C for the calculation of Taxable Income is the amount that is referred to in subparagraph (ii) of paragraph (*b*) of section 41(1). (For 1960 this amounted to $16,674,223.23.)

The problem that is raised by the appeal is what amount is indicated by the words "the taxpayer's income...for the year...from sources in that country" in subparagraph (i) of paragraph (*b*) of section 41(1).

There is no question that what is referred to is the amount of "the taxpayer's income for the year" from sources in the United States. The appellant says, however, that those words refer to the gross amount of the interest received in

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the year by the appellant from the United States company. The respondent says, on the other hand, that those words must be read with subsections (1a) and (1b) of section 139 of the Act and that, when so read, they refer to the amount of the interest so received in that year less the interest paid in the year that was deductible in computing income under Part I for the year to the extent that that interest was paid on monies that had been borrowed to acquire the United States bonds in respect of which the interest was so received in the year.

The relevant parts of subsections (1a) and (1b) of section 139 read as follows:

> (1a) For the purposes of this Act,
>
> (*a*) a taxpayer's income for a taxation year from a business, employment, property or other source of income or from sources in a particular place means the taxpayer's income computed in accordance with this Act on the assumption that he had during the taxation year no income except from that source or those sources, and was allowed no deductions in computing his income for the taxation year except such deductions as may reasonably be regarded as wholly applicable to that source or those sources and except such part of any other deductions as may reasonably be regarded as applicable to that source or those sources;
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> * * *
>
> (1b) In applying subsection (1a) for the purposes of sections 31 and 41, all deductions allowed in computing the income of a taxpayer for a taxation year for the purposes of Part I, except any deduction permitted by paragraph (*l*), (*la*), (*o*) or (*t*) of subsection (1) of section 11 or section 79B, shall be deemed to be applicable either wholly or in part to a particular source or to sources in a particular place.

Bearing in mind that the only income the appellant had in the year from sources in the United States was interest from the bonds of the United States company and that interest from bonds is income the source of which is "property",[3] the applicable part of subsection (1a), as I read it, is as follows:

> a taxpayer's income for a taxation year from ... property ... means the taxpayer's income computed in accordance with this Act on the assumption that he had during the taxation year no income except from that source.... and was allowed no deductions in computing his income for the taxation year except such deductions as may reasonably

[3] See *Interprovincial Pipe Line Co. v. Minister of National Revenue,* [1959] S.C.R. 763 at page 769.

be regarded as wholly applicable to that source ... and except such part of any other deductions as may reasonably be regarded as applicable to that source ...;[4]

As interest on borrowed money is only deductible in computing world income by virtue of the special provision in section 11(1)(*c*), it would be doubtful whether it could be regarded as having any application to a particular source of income were it not for subsection (1b) *supra,* which specifically provides, *inter alia,* that, in applying subsection (1a) for the purposes of section 41, such a deduction shall be deemed to be applicable either wholly or in part to a particular source.

Having regard to the provisions of section 11(1)(*c*) which limit the deduction of interest to interest on borrowed money used for the purpose of earning income from "a business" or "property", and to the fact that the interest deduction that the respondent maintains should be set off against the interest receipt in this case is only deductible because it is interest on money that was borrowed to acquire the bonds which gave rise to the interest receipts, I cannot escape the conclusion that subsection (1a) of section 139, read with subsection (1b) thereof, defines the appellant's income from the United States bonds for a year, for the purposes of section 41, to be the amount that its world income would be for the purposes of Part I of the *Income Tax Act* if its only revenue receipts were the interest receipts from the United States bonds and its only deductions were the interest payments made on the monies borrowed to purchase those bonds.[5]

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[4] The result would be precisely the same, as I read the subsection, if one were to focus on the words "sources in a particular place" rather than "property" in subsection (1a). The sources in the particular place here would be the bonds (i e. property) in the United States. It is clear that the interest on the bonds is income the source of which is "property" (see Note #1 *supra*), and the amount under section 41(1)(*b*) will be nil unless that source is in the United States.

[5] Having to apply the requirement in subsection (1b) of section 139 that an interest deduction under section 11(1)(*c*) shall be deemed to be applicable either in whole or in part to a particular source, and having regard to the provisions of section 11(1)(*c*) under which interest is only deductible if paid on borrowed money used for the purpose of earning income from "a business" or "property", it would seem that the source to which a particular interest deduction must be deemed to be applicable is the "business" or the "property" in respect of which the borrowed money (on which it was paid) was used.

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This is the method that the respondent followed and, if the matter were a matter of first impression on a reading of the *Income Tax Act* alone, I would conclude that he was right.

The matter is not, however, that simple, because the subject of foreign tax credits is dealt with by tax conventions between Canada and the United States of America that have beer given statutory effect by statute.

On March 4, 1942, a Convention and Protocol was agreed upon by the two countries. The parts that may have some bearing on our problem appear to be the following:

CONVENTION

The Government of Canada and the Government of the United States of America, being desirous of further promoting the flow of commerce between the two countries, of avoiding double taxation and of preventing fiscal evasion in the case of income taxes, have decided to conclude a Convention and for that purpose have appointed as their Plenipotentiaries:

Mr. Leighton McCarthy, K.C., Envoy Extraordinary and Minister Plenipotentiary of Canada at Washington; and

Mr Sumner Welles, Acting Secretary of State of the United States of America; who, having communicated to one another their full powers found in good and due form, have agreed upon the following Articles:

ARTICLE I

An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable in accordance with the Articles of this Convention to its permanent establishment in the latter State.

No account shall be taken in determining the tax in one of the contracting States, of the mere purchase of merchandise effected therein by an enterprise of the other State.

ARTICLE II

For the purposes of this Convention, the term "industrial and commercial profits" shall not include income in the form of rentals and royalties, interest, dividends management charges, or gains derived from the sale or exchange of capital assets.

Subject to the provisions of this Convention such items of income shall be taxed separately or together with industrial and commercial profits in accordance with the laws of the contracting States.

* * *

ARTICLE XI

1. The rate of income tax imposed by one of the contracting States, in respect of income derived from sources therein, upon indi-

viduals residing in, or corporations organized under the laws of, the other contracting State, and not engaged in trade or business in the former State and having no office or place of business therein, shall not exceed 15 percent for each taxable year.

* * *

ARTICLE XV

In accordance with the provisions of Section 8 of the Income War Tax Act as in effect on the day of the entry into force of this Convention, Canada agrees to allow as a deduction from the Dominion income and excess profits taxes on any income which was derived from sources within the United States of America and was there taxed, the appropriate amount of such taxes paid to the United States of America.

In accordance with the provisions of Section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of this Convention, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada.

* * *

PROTOCOL

At the moment of signing the Convention for the avoidance of double taxation, and the establishment of rules of reciprocal administrative assistance in the case of income taxes, this day concluded between Canada and the United States of America, the undersigned plenipotentiaries have agreed upon the following provisions and definitions:

1. The taxes referred to in this Convention are:

(*a*) for the United States of America: the Federal income taxes, including surtaxes, and excess-profits taxes.

(*b*) for Canada: the Dominion income taxes, including surtaxes, and excess-profits taxes.

2. In the event of appreciable changes in the fiscal laws of either of the contracting States, the Governments of the two contracting States will consult together.

3. As used in this Convention:

(*a*) the terms "person", "individual" and "corporation", shall have the same meanings, respectively, as they have under the revenue laws of the taxing State or the State furnishing the information, as the case may be;

(*b*) the term "enterprise" includes every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity;

* * *

Chapter 21 of the Statutes of 1943 has this Convention and Protocol in a Schedule and reads in part as follows:

2. The Convention and Protocol entered into between Canada and the United States of America, which are set out in the Schedule to this Act, are hereby approved and declared to have the force of law in Canada.

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3. In the event of any inconsistency between the provisions of this Act or of the said Convention and Protocol and the operation of any other law, the provisions of this Act and of the Convention and Protocol shall, to the extent of such inconsistency, prevail.

On June 12, 1950, a new agreement was entered into between the two nations reading in part as follows:

ARTICLE I.

The provisions of the Convention and Protocol between Canada and the United States of America, signed at Washington on March 4, 1942, are hereby modified and supplemented as follows:

* * *

(1) Article XV is amended as follows:

(A) By striking out of the first paragraph thereof, effective January 1, 1949, the following:

"In accordance with the provisions of Section 8 of the Income War Tax Act as in effect on the day of the entry into force of this Convention,"

and inserting in lieu thereof the following:

"1. As far as may be in accordance with the provisions of The Income Tax Act,"

(B) By striking out of the second paragraph thereof the following:

"In accordance with the provisions of Section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of this Convention,"

and inserting in lieu thereof the following:

"2. As far as may be in accordance with the provisions of the United States Internal Revenue Code,"

Section 1 of chapter 27 of the Statutes of 1950 reads as follows:

1. The Convention entered into between Canada and the United States of America, set out in Schedule A, is approved and declared to have the force of law in Canada, and shall be deemed to be included in and to form part of the Convention and Protocol set out in the Schedule to *The Canada-United States of America Tax Convention Act*, 1943.

It is common ground that the 15 per cent tax paid by the appellant to the United States Government is a Federal income tax within paragraph 1(*a*) of the Protocol to the 1942 Convention and therefore one of the taxes "paid to the United States of America" to which the first paragraph of Article XV of the Convention applies. As that Article was found in the 1942 Convention, it is clear that the deduction Canada agreed to allow at that time was in

accordance with the provisions of section 8 of the *Income War Tax Act* as it was on January 1, 1941, when it read in part as follows:

> 8. A taxpayer shall be entitled to deduct from the tax that would otherwise be payable by him under this Act,
>
> (*a*) the amount paid to Great Britain or any of its self-governing colonies or dependencies for income tax in respect of the income of the taxpayer derived from sources therein; and
>
> (*b*) the amount paid to any foreign country for income tax in respect of the income of the taxpayer derived from sources therein, if such foreign country in imposing such tax allows a similar credit to persons in receipt of income derived from sources within Canada.
>
> Provided that the Minister may in his discretion allow a taxpayer to deduct from the sum total of his income tax and excess profits tax the sum total of income tax and excess profits tax paid to Great Britain or to any of its self-governing dominions or dependencies or to any foreign country if such foreign country in imposing taxes in respect of income and excess profits allows a similar credit to persons in receipt of profits derived from sources within Canada.
>
> 2. Such deduction shall not exceed the same proportion of the tax otherwise payable under this Act or the sum total of the income tax and excess profits tax otherwise payable under this Act and *The Excess Profits Tax Act, 1940,* as provided for in the proviso to subsection one of this section, as that which the taxpayer's net profits from sources within such country and taxed therein bears to his entire net profits from all sources, without taking into account the exemptions provided by paragraphs (*c*), (*d*), (*e*), (*ee*) and (i) of subsection one of section five of this Act and by subsections two and three of the said section five.

It therefore follows that the words in Article XV as it was originally "the appropriate amount of such taxes paid to the United States of America" is the amount of such taxes determined in accordance with section 8 of the *Income War Tax Act* as set out above. Had the words substituted for "In accordance with the provisions of section 8 of the *Income War Tax Act* as in effect on the day of the entry into force of this Convention" been merely the words "... in accordance with the provisions of *The Income Tax Act*", it would have seemed clear enough that

(a) the reference was to the provision of the *Income Tax Act* providing for a foreign tax credit, whatever its number might happen to be, and

(b) in view of the deliberate dropping of the reference to the provision as of a certain date, the reference was to

the appropriate provision of the *Income Tax Act* as it might be at the relevant time[6].

It is noteworthy that similar changes were made in the parallel provision in Article XV dealing with a United States foreign tax credit. In effect, having regard to the original form of the two parts of Article XV and the nature of the changes made in 1950, it seems clear that the parties were saying that, instead of mutual covenants to apply, to their respective interlocking tax systems, the foreign tax credit provision that had been worked out by the domestic law for all nations *as of a specified date,* they would mutually covenant to apply as between each other whatever foreign tax credit provision their respective domestic laws might *from time to time* adopt for all nations. This view of the provision seems to be reinforced by the addition, in 1950, of the words that were not previously there, namely, "As far as may be." While these words have no very evident precise effect, they seem to be allowing for the possibility that a time may arrive when there will be no provision of general application in the domestic law for a foreign tax credit, in which event there would be no obligation on the contracting power to allow one in respect of United States taxes.

If the above were the correct view of the effect of Article XV of the Tax Convention as amended in 1950 and as in force and applicable to the 1960 and 1961 taxation years, the Convention would not require any alteration in the appellant's rights as determined under section 41 of the *Income Tax Act* apart from the Convention; and the tentative conclusion that I have already reached would not be

[6] An argument was made that, if "the taxpayer's income...from sources in that country" in section 41(1)(*b*) were interpreted, by virtue of subsection (1a) and subsection (1b) of section 139, as meaning the net amount, the result would be that the United States would have been contravening Article XI of the Tax Convention by charging a tax that was grossly in excess of 15 per cent of that net amount. I do not see anything in this argument. Article XI is clearly an agreement that the tax on non-residents will not exceed 15 per cent of the gross amount. Article XV, as I understand, is a covenant to allow in relation to the United States the tax credit provided by domestic law in relation to foreign countries generally. Canadian domestic law has chosen a figure worked out by a statutory formula (which has no significance in relation to Article XI) as such foreign tax credit in relation to foreign countries generally and that figure is therefore what the appellant is entitled to in relation to the United States by virtue of Article XV.

altered by the operation of the statute giving the Convention the force of law and making it prevail when inconsistent with the *Income Tax Act*.

I turn now to consider whether anything was decided in *Interprovincial Pipe Line Co. v. Minister of National Revenue*[7] that would bring me to a different conclusion than that which I have reached by a consideration of the statutes as a matter of first impression.

As already indicated, the facts giving rise to that case were for all practical purposes the same as those upon which I must decide these appeals and the question that had to be decided then was the same question that has to be decided now. However, there have been changes in the *Income Tax Act*, so that, in form at least, the questions of statutory interpretation that arise now are not the same as those that arose at that time.

In lieu of section 41 of the *Income Tax Act* as set out above, which is applicable to the 1960 and 1961 taxation years, section 38(1) of the 1948 *Income Tax Act*, which was applicable to some of the years in question[8] in the earlier case, reads as follows:

> 38. (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 an amount equal to the lesser of
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> (*a*) the tax paid by him to the government of a country other than Canada on his income from sources therein for the year, or
>
> (*b*) that proportion of the tax for the year otherwise payable under this Part that
>
> (i) that part of the taxpayer's income
>
> (A) for the year, if section 28 is not applicable, or
>
> (B) if section 28 is applicable, for the period or periods in the year referred to in paragraph (*a*) thereof,
>
> from sources in that country that was not exempt from income tax in that country minus amounts that are deductible for the year or such period or periods, as the case may be, under paragraph (*d*) of subsection (1) of section 27,
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> is of
>
> (ii) the taxpayer's income
>
> (A) for the year, if section 28 is not applicable, or
>
> (B) if section 28 is applicable, for the period or periods in the year referred to in paragraph (*a*) thereof,
>
> minus amounts that are deductible for the year or such period or periods, as the case may be, under section 27.

[7] [1959] S.C.R 763

[8] There is nothing in the wording of the section applicable for the other years that affects the matter. *Idem* at page 766.

The other difference between the legislation applicable to 1960 and 1961 and that applicable to the earlier years is that subsections (1a) and (1b) of section 139 of the present Act, set out above as being applicable to the 1960 and 1961 taxation years, were not in the Act applicable to the earlier years, which did, however, have a provision which appeared in the 1948 *Income Tax Act* as follows:

> 127. (1) In this Act,
>
> (*av*) a taxpayer's income from a business, employment, property or other source of income or from sources in a particular place means the taxpayer's income computed in accordance with this Act on the assumption that he had during the taxation year no income except from that source or those sources of income and was entitled to no deductions except those related to that source or those sources; and

The reasons of four of the five judges for the judgment of the Supreme Court of Canada in 1959 were delivered by Judson J. As I appreciate his reasons for holding that the appellant was entitled, by virtue of section 38 of the 1948 *Income Tax Act,* to a foreign tax credit equal to the full amount of the 15 per cent tax paid to the United States Government, they are contained in that part of his judgment that reads as follows:

> The appellant is a Canadian company. It did pay a 15 per cent. withholding tax to the United States on income from sources therein. To deprive the appellant of the right to the tax deduction it is necessary to substitute for "on his income from sources therein" the words "on his profits from sources therein" and I do not think that s. 4 affords the statutory basis for such a substitution.
>
> First, s. 4 is expressly made subject to the other provisions of Part I of the Act. One of these, affecting the matter, is s. 6(*b*), which provides:
>
> "6. Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year
>
> (*b*) amounts received in the year or receivable in the year (depending upon the method regularly followed by the taxpayer in computing his profit) as interest or on account or in lieu of payment of, or in satisfaction of interest;"
>
> Section 6(*b*) imperatively requires that the whole of the interest from United States sources must be brought into account in the computation of income and on the other side of the account there is a deduction that must be allowed under s. 11(1)(*c*) for interest on "borrowed money used for the purpose of earning income from a business or property". This, in fact, is what has actually happened. The full interest receipt has been brought into account and the full interest payment has been claimed and allowed as a deduction without allocation, but, for the purpose of denying the appellant the right to the tax credit under s. 38(1), a subsidiary calculation has been

made within this framework for the purpose of showing that when the allocable expense is set against the United States interest receipt, there is no profit on this branch of the appellant's activity and, consequently, no right to a tax credit.

I can see no basis for any allocation of the appellant's borrowings to its investment in its subsidiary for the purpose of producing this result under s. 38(1). The appellant's borrowings and the interest paid thereon were related to the business as a whole and no part of the borrowings and the interest paid thereon can be segregated and attributed to the investment in the subsidiary. The interest paid by the appellant to its own bondholders was, under s. 11(1)(*c*), a deduction given to the appellant for the purpose of computing its income from all sources. Sections 3 and 4 of the Act do not require a separate computation of income from each source for the taxpayer is subject to tax on income from all sources. The deduction against income given by s. 11(1)(*c*) is attributable to all sources of income and there is no authority to break it up and relate various parts of the deduction to various sources. For this reason I do not regard the interest paid and claimed and allowed as a deduction, as being related to the source of the United States interest receipt in this case, and consequently, s. 139(1)(*az*), formerly s. 127(1)(*av*) of the 1948 *Income Tax Act,* does not, in my opinion, authorize the allocation which the Minister has made in this case.

Returning then to s. 38(1), my conclusion is that the appellant has paid a tax on income to the United States from sources therein and that its right to the foreign tax deduction cannot be destroyed by this unauthorized and artificial attribution of an offsetting expense which tends to show that there has been no profit from the source.

In the present appeal no problem arises under paragraph (*a*) of section 41(1), which refers to "any income ... tax paid by him to the government of a country other than Canada". It is conceded that the 15 per cent tax paid on gross interest receipts to the United States Government falls within those words. In the earlier case, Judson J. only found it necessary to consider the effect of the corresponding paragraph of section 38(1) and did not find it necessary to deal with the effect of paragraph (*b*) of that subsection. However, the words in paragraph (*a*) of section 38(1) that had to be considered were "tax paid ... to the government of a country other than Canada on his income from sources therein" which would seem to include, in substance, the same concept which gives difficulty here in section 41(1)(*b*)(i), namely, "the taxpayer's income . . . for the year . . . from sources in that country".

The difference, as I see it, between the problem dealt with by the Supreme Court of Canada in 1959 and that with which I have to deal is this: Interest from bonds is in itself income apart from some special statutory direc-

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tion. Even a definition of income as "profit" would not permit a setting off of interest on money borrowed to acquire the bonds because such interest is not deductible in computing profit in the absence of special statutory direction. (See *Bennett and White Construction Co. Ltd. v. Minister of National Revenue*[9].) The special direction in section 127(1)(*av*) did not authorize the setting off of such interest payments for the reasons given by Judson J. in the passage quoted above. Here subsection (1a) of section 139, when read with subsection (1b) thereof, specifically requires, in effect, that such interest be set off for the purpose of determining the taxpayer's income for the year from these United States bonds for the purposes of section 41.

For the above reasons, I conclude that there is nothing in the 1959 judgment of the Supreme Court of Canada that affects in any way the conclusion that I have already set out as to the effect of the *Income Tax Act* as applicable to the 1960 and 1961 taxation years.

The remaining question is whether the judgment of the Supreme Court of Canada constrains me to come to a different conclusion as to the effect of the legislation giving the Convention the force of law on the facts of this case for the 1960 and 1961 taxation years.

The material part of the reasons delivered by Judson J. reads as follows:

> I have no doubt that the 15 per cent withholding tax was properly payable under the laws of the United States and Art. XI(1) of the Canada-U.S. Reciprocal Tax Convention in respect of income derived from sources in the United States and that this withholding tax is a tax on income not profits. Article XI(1) reads as follows:
>
> > "(1) The rate of income tax imposed by one of the contracting States, in respect of income derived from sources therein, upon individuals residing in, or corporations organized under the laws of, the other contracting State, and not having a permanent establishment in the former State, shall not exceed fifteen per cent for each taxable year."
>
> Nevertheless, the judgment holds that the appellant's income from United States sources is nil notwithstanding the obvious fact of these large interest receipts. These are not industrial and commercial profits and, as such, allocable in accordance with Art. I of the Convention. Indeed, by Art. II, interest is expressly excluded from industrial and commercial profits and is left to be dealt with on an income, not a profits' basis by Art. XI(1) above quoted. I am therefore of the

[9] [1949] S.C.R. 287.

opinion that the denial of this foreign tax deduction is not only contrary to s. 38(1) of the Act but also offends Art. XV(1) of the Convention, which reads:

> "(1) As far as may be in accordance with the provisions of The Income Tax Act, Canada agrees to allow as a deduction from the Dominion income and excess profits taxes on any income which was derived from sources within the United States of America and was there taxed, the appropriate amount of such taxes paid to the United States of America"

On my reading of the Tax Convention, I should have also reached the conclusion that the denial of the foreign tax deduction for the earlier years as authorized by section 38(1) of the Act also offended Article XV(1) of the Convention. As indicated, however, as it seems to me, when the *Income Tax Act* expressly limits the foreign tax deduction in respect of taxes paid to foreign governments generally to an amount that is less than the full amount paid to the foreign government, it is only the lesser amount that the Canadian Government has bound itself, by Article XV(1), to allow in the case of taxes paid to the United States Government. It is only "the appropriate amount of such taxes paid to the United States of America" that it has agreed to allow as a deduction "As far as may be in accordance with . . . *The Income Tax Act*".

I have to admit that it is not at all clear to me that the Supreme Court of Canada has viewed Article XV(1) as I do. On the other hand, the problem that I have had in applying the provisions of Article XV was not before that Court and I do not find in its judgment any indication as to what effect would have been given to that provision in these circumstances. If I found in the judgment of the Supreme Court of Canada an indication as to how the Article should be applied in these circumstances, I would, of course, be relieved of any duty to do anything but apply it. As I do not find in that judgment any such indication, I must give the Article the application that, unaided by authority, I understand it to have. I accordingly conclude that the Convention and the legislation giving it the force of law do not change the result that I reach under the *Income Tax Act*.

Having regard to the terms of the stated case, which contains an agreement as to the judgment that is to be delivered depending on the conclusion reached by the Court, the appeals are dismissed with costs.