INTERPROVINCIAL PIPE LINE COMPANY ..... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

1959
Jun. 19
*Oct. 6

ON APPEAL FROM THE EXCHEQUER COURT OF CANADA

Taxation—Income tax—Foreign tax credit—Interest from U.S. sources—No business carried on there—Payment of U.S. withholding tax—Whether tax credit dependent on whether profit made in U.S.—Interest paid on borrowed money exceeding U.S. interest receipts—Canada-U.S. Tax Convention—The Income Tax Act, 1948 (Can.), c. 52, ss. 3, 4, 6(b), 11(1)(c), 38(1), 127(1)(av)—The Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4, 6(b), 11(1)(c), 41(1), 139(1)(az).

The appellant company's pipe lines were connected by a pipe running through the United States which was owned and operated by a wholly owned U.S. subsidiary company. The appellant carried on no business there. The appellant had raised all the capital needed for the construction of the pipe line largely through the issue of bonds and debentures in Canada. The appellant also financed the construction of the U S. section of the line and took from its subsidiary

*PRESENT: Kerwin C.J. and Taschereau, Locke, Judson and Ritchie JJ.

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interest-bearing demand notes and bonds. In addition, the appellant made certain temporarily investments in United States Treasury bills. In the years 1950 to 1954 inclusive, the appellant received substantial amounts of interest in the U.S. from its subsidiary and the Treasury bills. A withholding tax of 15 per cent. of these amounts was paid by the appellant to the U.S. Government.

The Minister ruled that the appellant was not entitled to deduct from its taxes the amount of taxes paid to the U.S., on the ground that the interest received from the U.S. did not exceed the interest paid, and deducted as expenses, on the borrowed money used to acquire the U.S. investments; there being no profit from sources in the U.S., there was therefore no income. The Minister's ruling was upheld by the Exchequer Court.

Held: The appellant company was entitled to a tax credit.

Per Kerwin C.J. and Taschereau, Judson and Ritchie JJ.: The denial of the foreign tax deduction was contrary to s. 41(1) of the Act (s. 38(1) of the 1948 Act), and also offended Art. XV of the Canada-U.S. Tax Convention. To deprive the appellant of the right given by s. 38(1) to a deduction of the tax paid in the U.S. "on income from sources therein", it would be necessary to replace those words by the words "on profits from sources therein". Section 4 did not afford statutory authority for such a substitution. Section 4 is expressly made subject to the other provisions of Part I of the Act, one of which is s. 6(*b*) which imperatively requires that the whole of the interest from U.S. sources must be brought into account in the computation of income. The deduction against income given by s. 11(1)(*c*) is attributable to all sources of income, and there was no authority to break it up and relate various parts of the deduction to various sources. Having paid the U.S. tax on its income from U.S. sources, the appellant's right to the foreign tax deduction could not be destroyed by the unauthorized and artificial attribution of an offsetting expense tending to show that there had been no profit from such source.

The source of the income was property—an investment in a subsidiary company—, and was not income from a business, because the appellant did not carry on any business in the U.S. It was an error to hold that the appellant carried on business there and to use that finding as the basis for an allocation of expense and a refusal of the foreign tax deduction under s. 38(1).

The withholding tax was properly payable under the laws of the United States and the Canada-U.S. Tax Convention, and was a tax on income, not on profits. There would be double taxation if the deduction were not allowed.

Per Locke J.: Paragraphs (av) of s. 127 (1) and (az) of s.139(1) were intended to prevent a taxpayer who might be engaged in two separate businesses not related to each other by reason of their nature from taking into account losses or expenses incurred in one in computing the taxable income of the other. These subsections had therefore no application to this case.

There was no authority in either the Act of 1948 or of 1952 for splitting up the income of the business of the appellant into parts or segments for the purpose of applying the clear provisions of s. 11(1)(*c*), as was done

in this case. The income of the business of the appellant to be determined in order to ascertain what was taxable income was the entire income of the appellant and not that income split up into parts according to the situs of the source of that income.

APPEAL from a judgment of Thurlow J. of the Exchequer Court of Canada[1], affirming a ruling of the Minister. Appeal allowed.

L. Phillips, Q.C., R. B. Burgess, Q.C., and *P. F. Vineberg,* for the appellant.

A. S. Pattillo, Q.C. and *F. J. Cross,* for the respondent.

The judgment of Kerwin C.J. and Taschereau, Judson and Ritchie JJ. was delivered by

JUDSON J.:—The appellant, a corporation incorporated by special Act of the Parliament of Canada, owns and operates a crude oil pipe line running from Redwater, Alberta, to a point on the international boundary south of Winnipeg, and from a point on the international boundary near Sarnia to a point near the City of Toronto. The connecting link is in the United States and is owned and operated by Lakehead Pipe Line Company Inc., a wholly owned subsidiary company of the appellant incorporated in the State of Delaware and having its main office in Superior, Wisconsin. The appellant has no office or place of business or permanent establishment in the United States and carries on no business there.

For the purpose of construction of the pipe line the appellant raised all the capital, the greater part of which was borrowed from the public who purchased bonds and debentures. Lakehead, the United States subsidiary, did no independent financing. It borrowed from Interprovincial and this Company took from its subsidiary interest-bearing demand notes and bonds. Interprovincial also made certain investments in United States Treasury bills pending the need of these funds for construction purposes. Consequently, in the years 1950 to 1954 inclusive, Interprovincial received substantial payments of interest in the United States from its subsidiary and the Treasury bills. It paid on this interest a 15 per cent. withholding tax to the United

[1] [1959] C.T.C. 1, 59 D.T.C. 1018.

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States and the sole question in the litigation is whether it is entitled under s. 38(1) of the 1948 *Income Tax Act* to a tax credit for this withholding tax for the years 1950 to 1952, and under s. 41(1) of the *Income Tax Act* for the years 1953 and 1954. The Minister ruled that Interprovincial was not so entitled. This ruling was affirmed on appeal to the Exchequer Court[1] and Interprovincial now appeals to this Court. There is no difference in the wording of the section for these two periods which can affect these reasons.

The United States tax credit was disallowed because the Minister ruled that Interprovincial had no profit from the receipts of interest from United States sources, having paid interest on its own borrowings to an amount equal to or in excess of these receipts and these interest payments having been recognized as deductible expenses. The right to a tax credit was therefore made to depend upon the existence of a profit after setting off one item against the other and the basis for the decision was the interpretation of s. 4 of the *Income Tax Act,* which provides as follows:

> 4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

The reasoning is that s. 4 compels one to read the word "income" as meaning "profit" in s. 38(1) of the Act. This is indicated very clearly in the following paragraph from the reasons of the learned trial judge:

> By s. 4 of *The Income Tax Act,* however, income for a taxation year from a business or property is declared, subject to the other provisions of Part 1, to be the profit therefrom for the year and, since the source of the interest in question on which tax was paid to the United States was clearly either a business or property and no other provision of Part 1 declares that interest earnings are to be brought into the computation of income or taxed on any other basis, it follows, in my opinion, that what is to be regarded for the purposes of Part 1 of *The Income Tax Act* as the income from such business or property is not the gross amount of such interest for each year but the profit from such property or business for the year. If there is no profit from a business or property for any year, there is no income therefrom for that year. Section 38(1) of *The Income Tax Act* can thus afford a tax credit only in a year in which the appellant had a profit for the year from the business or property in the United States from which the interest in question flowed.

[1] [1959] C.T.C. 1, 59 D.T.C. 1018.

In my respectful opinion, there is error here in stating that "no other provision of Part I declares that interest earnings are to be brought into the computation of income or taxed on any other basis" for such a finding ignores the imperative provisions of s. 6(*b*) of the Act. In my opinion it is the payment of the withholding tax of 15 per cent. in the United States on this interest receipt—not profit—an interest receipt which the taxpayer is required to bring into the computation of income by s. 6(*b*), which gives the right to the foreign tax deduction under s. 38(1).

It is unnecessary to set out in full the provisions of s. 38(1). This section gives the right to a deduction from tax of the lesser of two amounts, namely, the foreign tax or an amount calculated according to the formula in subparagraph (*b*). There is no question here that the 15 per cent. withholding tax in the United States is the lesser of these two amounts and, consequently, I omit the complicated alternative provisions and confine my consideration to the meaning to be given to the first alternative. Section 38(1), so limited, reads:

> 38. (1) A taxpayer who was a 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*) the tax paid by him to the government of a country other than Canada on his income from sources therein for the year.

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;

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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.

So far I have considered the source of this income to be property—an investment by the appellant in a subsidiary company. I think that this is the correct view of the matter and I turn now to a consideration of the finding of the learned trial judge, which, with respect, I also consider to be erroneous, that the appellant had only one source of income and that from the business of operating the Interprovincial Pipe Line. This finding is expressed in the following paragraph:

> The portion of the Appellant's income-producing process which I think can be regarded as carried on in the United States consisted of the holding of its investments in Lakehead and in United States Treasury bills and the *controlling* of Lakehead . . . . It is not easy to envisage a division of the Appellant's business on such lines, but it is clear that the revenues from the Appellant's investments in Lakehead and in United States Treasury bonds accrued to the Appellant in the United States, and taking the holding of these investments as the portion of the business carried on there and the revenues from them as the revenue from that portion of the business, one has a starting point for the necessary computation.

The fact is that the appellant carried on no business in the United States. Had it done so it would have been taxed there not on the basis of a withholding tax of 15 per cent. on interest received from sources in the United States (Art. XI(1) of the Convention) but in respect of its industrial and commercial profits attributable to its activity in the United States and determined in accordance with Art. I of the Convention. Industrial and commercial profits do not include interest. The business carried on in the United States was that of Lakehead and not the appellant, and the fact that Lakehead was wholly controlled by the appellant does not make it the appellant's business.

The appellant is, therefore, in this anomalous position. According to the United States view it does not carry on business and must pay a withholding tax of 15 per cent. on interest. According to the judgment under appeal it does carry on business in the United States, this business being the controlling of Lakehead and the holding of investments. There are no disputed facts in this case and it is, in my respectful opinion, error to hold that the activities of the

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appellant constitute the carrying on of a business in the United States and to use this finding as the basis for an allocation of expense and a refusal of the foreign tax deduction under s. 38(1).

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 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.

This interest receipt has been subject to double taxation and the appropriate foreign tax deduction has not been allowed. I would allow the appeal with costs both here and below and set aside the re-assessments complained of for the years 1950 to 1954 inclusive.

LOCKE J.:—On the argument of this appeal it was admitted by counsel for the appellant that the moneys used for the purchase of the bonds of its wholly owned subsidiary Lakehead Pipe Line Company Inc. and the United States Treasury bills were derived from the sale of its own debentures in Canada, the interest upon which was allowed as

a business expense for the taxation years in question under the provisions of s. 11(1)(*c*) of the *Income Tax Act*, 1948, c. 52, and of the *Income Tax Act*, R.S.C. 1952, c. 148.

There remains accordingly no disputed question of fact. The question of law is as to the proper interpretation of s. 127(1)(*av*) of the Act of 1948, reenacted *verbatim* as s. 139(1)(*az*) in c. 148.

The undertaking of the appellant company as originally contemplated was the construction of a pipe line for carriage of Canadian oil from various points in the Provinces of Alberta and Saskatchewan to the Port of Superior, Wisconsin, on Lake Superior, from which point it was contemplated that the oil would be transported by tanker to Sarnia or other Canadian ports. To accomplish this it was necessary that, for a considerable distance, the line should pass through the States of Minnesota and Wisconsin. Due, apparently, to the alien land laws of these states, it was not possible for the appellant to acquire in its own name the necessary rights-of-way and properties in the United States, and it was for this reason that it caused to be incorporated the Lakehead Company, all of the shares of which at all relevant times have been owned and controlled by it. The Lakehead Company has its head office at Superior, Wisconsin, and, by reason of its shareholdings, its operations have at all times been subject to the control and direction of the appellant.

The line was completed in Canada from the Redwater field in Alberta to the American border at Gretna, Man. and continued from that point through the states mentioned to Superior. At a later date, for reasons explained in the evidence of the witness Waldon, the line was extended from Superior to Sarnia and Canadian oil has since that time passed through the line owned by the Lakehead Company to Sarnia in bond.

Paragraph (*av*) of s. 127(1) of the Act of 1948, so far as it is necessary to consider it, read:

> 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.

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and the terms of para. (*az*) of s. 139(1) of c. 148 are identical. No similar provision appeared in the *Income War Tax Act*, R.S.C. 1947, c. 97, as amended. We have not been referred to any decided case and I have not been able to discover any in which this language has been interpreted by the Courts.

The section of which this paragraph forms part appears under the sub-heading "Interpretation" in both statutes and defines various terms that are used in the Act.

Section 3 of both statutes, under the sub-heading "Computation of Income, General Rules", declares that the income of a taxpayer for the purposes of Part 1 of the Act is his income for the year from all sources inside or outside Canada from, *inter alia,* all businesses and property.

Section 6 of both Acts provides that there shall be included in computing the income of a taxpayer for a taxation year amounts received as interest or on account of or in lieu of payment of or in satisfaction of interest.

Paragraphs (*av*) of s. 127(1) and (*az*) of s. 139(1) were intended, in my opinion, to prevent a taxpayer who might be engaged in two separate businesess not related to each other by reason of their nature from taking into account losses or expenses incurred in one in computing the taxable income of the other. By way of illustration, if a person engages in business as a hardware merchant in a country town and, at the same time, engages in farming or ranching, losses sustained or expenditures incurred in operations of the latter nature may not be taken into account in computing the taxable income from the hardware business, and vice-versa. The reason is that these operations are not related one to the other in the sense intended. The taxpayer's income from the hardware business is to be reckoned as if he had during the taxation year no income except from that source, according to the subsection. If, on the other hand, the merchant's business was that of the sale of produce and he should operate a truck farm for the purposes

of obtaining supplies for his business, presumably these businesses would be considered to be related, within the meaning of the subsection.

As thus interpreted, I consider that the subsection has no application to the matters under consideration in this appeal. The learned trial judge has found that the appellant had only one business which was of the nature above stated. He has also found that part of the appellant's business was carried on in the United States by reason of its ownership and control of the Lakehead Company and the probability that it carried moneys on deposit in the State of Wisconsin, and otherwise engaged in business activities incidental to its receipt of income from its subsidiary. With respect, I disagree with this finding but I think it is an irrelevant consideration in determining the question to be decided. The finding that the appellant had but one business is, in my view, fatal to the contention advanced on behalf of the Minister.

I find no authority in either Act for splitting up the income of the business of a taxpayer into parts or segments for the purpose of applying the clear provisions of s. 11(1)(*c*), as has been done in the present case. In computing the taxable income, the appellant company, of necessity, brought into its accounts the full amount of the interest paid to it upon the securities of its subsidiary and the United States Treasury notes. The allowance permitted by subs. (1)(*a*) of s. 38 of the 1948 Act and subs. (1)(*a*) of s. 41 of c. 148 (which, while slightly amplified, is indistinguishable in meaning) is a deduction from the tax payable for the year in question. Accordingly, as the accounts show, the full amount received in the United States was entered as a receipt in the appellant's accounts and the 15 per cent. tax, which admittedly was properly levied by the Government of the United States and paid by the appellant in that country, was deducted from the tax otherwise payable.

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The judgment appealed from has interpreted the word "income" in these subsections as if it read "profit" and, admittedly, if that interpretation is correct, no profit resulted to the appellant from the receipt of these moneys, since the annual cost of it of the funds used in the purchase of the securities exceeded the amounts paid in the United States.

I can find no support for this interpretation either in s. 4 or elsewhere in either Act. The word "income" is used rather loosely in both of these statutes. The attempt to define "income" made in s. 3(1) of the *Income War Tax Act* was not repeated in either. Thus, in s. 3 the income of a taxpayer is stated to include all income, meaning all *receipts* from, *inter alia,* all businesses and property. In s. 4, however, income from a business is said to be the profit therefrom for the year, in this sense meaning the *taxable income.* The deductions allowed are not deductions from income in the sense that that expression is used in s. 3 but from the tax payable in Canada after all of the receipts from the business have been brought into account, as required.

The interest payable by the subsidiary was a receipt classified as income by s. 3, necessarily brought into account by reason of subs. (*b*) of s. 6. The income of the business in question to be determined in order to ascertain what is taxable income is the entire income of the appellant and not that income split up into parts according to the situs of the source of that income. It is income in the sense of s. 3 that is referred to in s. 127(1)(*av*) and in s. 139(1)(*az*), in my opinion.

For these reasons, I would allow this appeal with costs throughout.

It is common ground that the 15 per cent. withholding tax was properly payable under the laws of the United States and, in view of my conclusion, based upon what I consider to be the proper interpretation to be placed upon these sections of the *Income Tax Act,* I express no view as

to the bearing or the effect of the Reciprocal Tax Convention made between Canada and the United States upon the matters in dispute.

*Appeal allowed with costs***.*

Solicitors for the appellant: Phillips, Bloomfield, Vineberg & Goodman, Montreal.

Solicitor for the respondent: A. A. McGrory, Ottawa.