Department of Finance has to date declined to accept this recommendation.[15] Consequently, for the foreseeable future, the principles from the above-noted cases will govern the courts' view of settlement agreements and cost submissions supported by settlement offers.

Even if compromise settlements in tax cases are provided for in legislation, a proposed amendment to section 147 of the Tax Court of Canada Rules may present an additional hurdle to obtaining an enhanced cost award in connection with a compromise settlement offer. The proposed rule, if enacted in its present form, will provide that the party seeking to obtain the enhanced cost award has the burden of proving that "there is a relationship between the terms of the settlement offer and the judgment."[16]

John Sorensen and Stevan Novoselac

TAX COURT OF CANADA

FOREIGN TAX DEDUCTION DENIED FOR TOWER STRUCTURE

FLSmidth Ltd. v. The Queen
2012 TCC 3

KEYWORDS: FOREIGN TAXES ■ DEDUCTIONS ■ DOUBLE DIP ■ TOWER STRUCTURE

In *FLSmidth Ltd. v. The Queen*,[17] the Tax Court of Canada upheld an assessment by the Canada Revenue Agency (CRA) denying a Canadian-resident partner a deduction under subsection 20(12) of the Income Tax Act in respect of the partner's proportionate share of US income taxes paid on income derived from a tower structure.

Tower structures, in various forms, have been used by cross-border corporate groups for well over a decade. Generally, the objective of these structures is to permit the corporate group to claim an interest expense in both Canada and the United States in respect of a single economic borrowing. Tower structures have been the subject of scrutiny by the Department of Finance in recent years, and their form and use have been affected, to varying degrees, by amendments to the Canada-US income tax convention[18] and to the Act.[19] *FLSmidth* provided the Canadian courts

15 See S. Sebastian Elawny, Timothy Fitzsimmons, and Samantha Iorio, "Deal or No Deal?" *Tax Topics* no. 2032, February 17, 2011, 1-4, at 4.

16 Tax Court of Canada Practice Note no. 18, supra note 5, proposed section 147(3.1)(d)(i).

17 2012 TCC 3.

18 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the US treaty").

19 See, for example, former section 18.2 of the Act, enacted into law by SC 2007, c. 35 and subsequently repealed by SC 2009, c. 2.

with their first opportunity to review such structures. Interestingly, the CRA did not challenge the double dip that is the hallmark of these tower structures and provides the vast majority of the tax savings. Instead, the CRA reassessed on the basis that the taxpayer was ineligible to claim a foreign tax deduction in respect of certain incidental profits derived from the tower structure.

The CRA was successful before Paris J of the Tax Court in challenging the foreign tax deduction under subsection 20(12). However, in doing so, it allowed the court to underline the broad application of the subsection 20(12) deduction. Drawing upon the Supreme Court jurisprudence considering the broad meaning of "in respect of," the Tax Court implicitly suggested that a subsection 20(12) deduction could be claimed by individuals (including trusts) in a broad range of circumstances. The decision also suggests that there is a broad range of situations in which a corporation may claim a subsection 20(12) deduction provided that the subject foreign taxes 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.

Overview

The subject appeal was in respect of deductions claimed by the appellant's Ontario-incorporated predecessor corporation, GL&V/Dorr-Oliver Canada Inc. under subsection 20(12) in the taxation year ended March 31, 2002. (The appellant and its predecessor corporation are referred to collectively herein as "FLSmidthCo" or "the taxpayer.") Subsection 20(12) permits taxpayers, in certain circumstances, to claim a deduction in calculating their income from a business or property in respect of certain taxes paid to a foreign government. In the relevant taxation year, subsection 20(12) read as follows:

> (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 tax, 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.

For the purposes of the *FLSmidth* decision, the provision may be separated into two components, both of which were required to be satisfied for FLSmidthCo to validly deduct the amounts paid in respect of foreign taxes under subsection 20(12). These two elements may be summarized as follows:

1. Did the limited partnership of which FLSmidthCo was a partner pay US income tax in respect of a source of property income under the Act?
2. Could the US tax reasonably be regarded as having been paid in respect of income from a share of the capital stock of a foreign affiliate of FLSmidthCo?

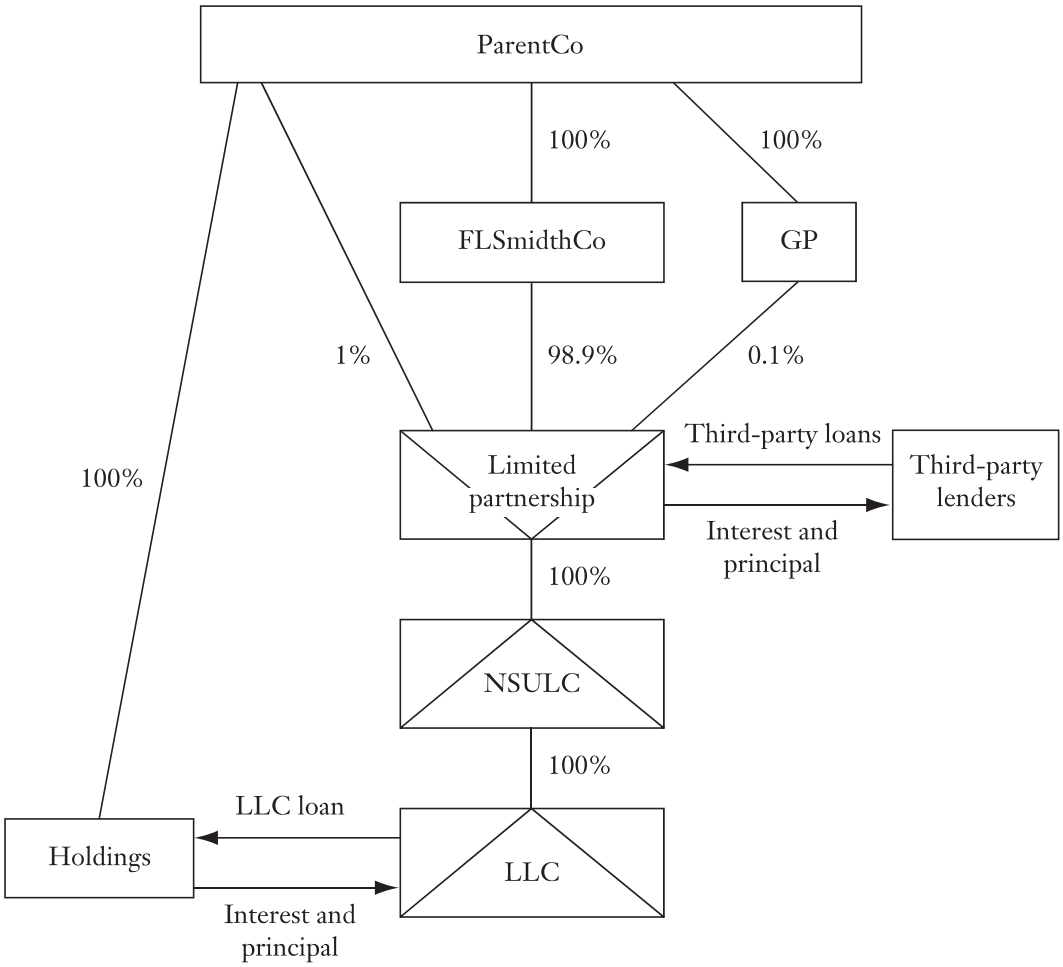
The Structure and Its Tax Consequences

The tower structure established by the FLSmidth corporate group was adopted to facilitate the tax-efficient financing of US acquisitions by generating deductible interest expenses in both Canada and the United States in respect of the funds borrowed to acquire a US target. The FLSmidth corporate group was able to achieve this objective because of the differences in entity characterization between the Canadian and US tax systems of certain legal forms as either flowthrough vehicles (that is, "fiscally transparent" or "disregarded" entities) or vehicles taxable in their own right. Such entities are frequently referred to as "hybrid entities."

The tower structure utilized by the FLSmidth corporate group is illustrated in figure 1. The establishment and financing of the structure may be summarized as follows:

1. FLSmidthCo and Quebec-incorporated GL&V Acquisition Inc. ("GP") were wholly owned subsidiaries of a Quebec-incorporated corporation, Groupe Laperrière & Verrault ("ParentCo").
2. GL&V and Peg Limited Partnership ("the limited partnership") was constituted under the laws of the state of Delaware. GP acted as the general partner and held a 0.1 percent interest in the partnership. FLSmidthCo and ParentCo held 98.9 percent and 1 percent limited partnership interests, respectively, in the limited partnership. The limited partnership filed an election with the US Internal Revenue Service to be treated as a US-resident corporation for US tax purposes. Such an election had no effect on the flowthrough nature of the partnership under Canadian tax law.
3. GL&V Company ("NSULC") was a Nova Scotia unlimited liability company wholly owned by the limited partnership. NSULC was a disregarded entity for the purposes of US taxation but was treated as a taxable corporation under Canadian tax law.
4. GL&V Finance, LLC ("LLC") was a limited liability company constituted under the laws of Delaware. The sole member of LLC was NSULC. LLC was a disregarded entity under US tax law but was treated as a taxable corporation under Canadian tax law.
5. GL&V Holdings ("Holdings") was a wholly owned US-resident subsidiary of ParentCo. It was in the business of providing capital and loans to indirect wholly owned subsidiaries of ParentCo to purchase US-resident companies.
6. A syndicate of third-party lenders advanced funds under a credit facility ("the third-party loans") to the limited partnership. The limited partnership used the loaned funds to acquire shares in NSULC. NSULC, in turn, used the subscription proceeds to subscribe for additional membership interests in LLC.
7. LLC used the subscription proceeds to make interest-bearing loans ("the LLC loans") to Holdings. The interest rate charged on the LLC loans was marginally higher than the interest rate charged on the third-party loans.
8. During the taxation year ended March 31, 2002, LLC distributed income it had previously earned on the LLC loans to NSULC as a dividend. The dividend

FIGURE 1 Tower Structure Used in the FLSmidth Case



included interest income earned on the LLC loans in the year ended March 31, 2002 and interest income earned in previous taxation years. NSULC used the proceeds of the dividends from LLC to pay dividends to the limited partnership. The limited partnership, in turn, used a portion of these dividends to pay interest payable on the third-party loans.

These transactions gave rise to different tax consequences in Canada and the United States. For US tax purposes, the "regarded" character of the limited partnership and the "disregarded" character of LLC and NSULC resulted in the interest on the LLC loans being characterized as having been received directly by the limited partnership. The dividends declared by NSULC and LLC were similarly disregarded for US tax purposes. Accordingly, the United States perceived the limited partnership to have received revenue in the form of interest on the LLC loans and to have paid deductible interest expenses on the third-party loans used to acquire the shares in NSULC. The difference between these amounts gave rise to taxable profits in the hands of the limited partnership ("LP profits").

Conversely, for Canadian tax purposes, NSULC and LLC were characterized as taxable corporations. Pursuant to paragraph 95(2)(a), interest paid on the LLC loan was deemed to be income from an active business for the purposes of determining whether the earned interest should be characterized as "exempt surplus."[20] Since LLC was a foreign affiliate[21] of NSULC, dividends out of LLC's exempt surplus could be received by NSULC free of tax pursuant to paragraph 113(1)(a). Since partnerships are generally not taxable entities under the Act, profits of the limited partnership were allocated to the partners in proportion to their proportionate partnership interests. The NSULC dividends retained their character as dividends from a Canadian-resident corporation, allowing the corporate partners to deduct the amount of those dividends when calculating taxable income pursuant to section 112. In completing its return for the year ending March 31, 2002, FLSmidthCo took the position that it was also eligible for a deduction under subsection 20(12) in respect of US taxes paid on the LP profits. The minister disagreed and reassessed on that basis.

The Decision

In Respect of Income from a Business or Property

The Crown argued before the Tax Court that a subsection 20(12) deduction was available only if the foreign taxes were paid in respect of income that arose from the same source of business or property income giving rise to the Canadian tax liability under the Act. Accordingly, the Crown suggested that taxes paid in respect of a disregarded source of income under the Act could not give rise to a deduction under subsection 20(12). It took the position that the taxes payable in respect of the interest income on the LLC loans could not be deducted against the profits of the limited partnership calculated under the Act since the limited partnership's only source of income under the Act was the dividend income it received from NSULC.

The Crown noted that this interpretation produced a result that was consistent with the apparent objective of the provision to eliminate instances of double taxation. The Crown observed that, from the perspective of the Act, there was no double taxation of the limited partnership since the US taxes were paid in respect of interest income earned by LLC and not by the limited partnership.

The court, however, concluded that the Crown's interpretation of the phrase "tax paid . . . in respect of that income" was too narrow. The court noted that the Crown was essentially requesting that the phrase "tax paid . . . in respect of that income" be interpreted as "tax paid . . . on that income." The court did not consider it appropriate to depart from the Supreme Court of Canada's broad interpretation of the phrase "in respect of."[22]

20 As defined in regulation 5907(1).

21 As defined at subsection 95(1).

22 Supra note 17, at paragraphs 37-38.

In the often cited case of *Nowegijick v. The Queen*, the Supreme Court held that the words "in respect of" were "words of the widest possible scope," and noted:

> They import such meanings as "in relation to," "with reference to" or "in connection with." The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters.[23]

The Tax Court in FLSmidth also noted that the interpretation of "tax paid . . . in respect of" proposed by the Crown, which would require a "direct" connection between the foreign taxes and the Canadian source of income, was inconsistent with various technical interpretations published by the CRA (though it acknowledged that such interpretations are not binding on the courts). In two particular examples quoted by the court, Canadian-resident individuals were allowed deductions under subsection 20(12) where the relevant income had been earned in the United States by a disregarded entity.[24]

The court observed that the Crown's proposed interpretation of the provision could have easily been drafted by Parliament, if so intended, by simply replacing "paid . . . in respect of that income" with "paid . . . on that income."[25] Rather than requiring the foreign taxes to be paid "on" a taxpayer's income from a business or property, the court concluded that it was sufficient for a taxpayer seeking to make a subsection 20(12) deduction to demonstrate that the foreign taxes were "related to" or "connected with" such income. This broad interpretation of the phrase "in respect of" is consistent with both the interpretation of the Supreme Court in *Nowegijick* and the CRA's subsequent interpretation of the phrase.

On the other end of the spectrum, the court rejected an alternative argument put forward by the taxpayer that "income from a business or property" was a reference to a consolidated pool of income from all business and property sources. The court found no basis for departing from the well-established practice under the Act of calculating the profits from each source of business income and property income separately.[26]

On the basis of these reasons, the court concluded that

> the payment of the U.S. tax was related to or connected with the dividend income received by the [limited partnership] from NSULC because the indirect source of the dividend income received by the [limited partnership] was the interest income received

23 [1983] 1 SCR 29, at 39 (SCC).

24 See CRA document nos. 1999-0010295, February 21, 2000, and 2008-0284351I7, July 22, 2008.

25 Supra note 17, at paragraph 45.

26 The Tax Court cited, among others, Iacobucci J in *Hickman Motors Ltd. v. Canada*, [1997] 2 SCR 336, at paragraph 138: "The requirement to calculate income from each 'sub-source' separately is fundamental to the entire taxing scheme set up by Parliament. To suggest otherwise, as my colleague does, is to ignore the plain words of the Act." Supra note 17, at paragraph 31.

> by LLC from Holdings and the payment of the tax reduced the amount available to NSULC that could be paid out to the limited partnership as dividends. Furthermore . . . if the appellant had not owned the NSULC shares, it would not have had to pay the U.S. tax. This, in my view, is also sufficient to link the payment of the U.S. tax and the dividend income received by the [limited partnership] from NSULC for the purposes of subsection 20(12).[27]

In Respect of Income from Shares in a Foreign Affiliate

A corporate taxpayer seeking to claim a deduction under subsection 20(12) must also demonstrate that the foreign taxes could not 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.

Pursuant to the deeming rule in subsection 93.1(1), FLSmidthCo was deemed to own a percentage of the NSULC shares equal to its proportionate interest in the limited partnership for the purposes of the foreign affiliate requirement in subsection 20(12). Accordingly, it was agreed by the parties that LLC was a foreign affiliate of FLSmidthCo for the purposes of subsection 20(12).

In establishing the scope of the phrase "in respect of" for the purposes of determining whether a foreign tax can reasonably be regarded as having been paid *in respect of* a share of the capital stock of a foreign affiliate, both the taxpayer and the Crown were put in the uncomfortable position of arguing the opposite position that they favoured in the previous analysis. The taxpayer favoured a limited scope of the phrase "in respect of," whereas the Crown favoured a more expansive interpretation. Accordingly, the taxpayer's resounding success in arguing for a broad interpretation of the phrase "in respect of" in the first portion of the analysis ultimately made success on the second portion of the analysis doubtful.

The taxpayer's primary arguments may be summarized as follows:[28]

1. It was alleged that US tax could not reasonably be regarded as having been paid by FLSmidthCo in respect of income from the shares of LLC because the shares of LLC were not a source of income to the corporation. Instead, it was argued that FLSmidthCo's sole source of income was the dividends it received indirectly from NSULC through the limited partnership.
2. It was also argued that the US taxes could not reasonably be regarded to have been paid in respect of the LLC dividends because the US taxes paid by the limited partnership became payable by operation of law, whether or not LLC declared a dividend.
3. The Tax Court was urged to respect the legal relationships established by the taxpayer. It was argued that—absent a sham or express legal authorization under the Act—the phrase "can reasonably be regarded" did not authorize

27 Supra note 17, at paragraph 46.

28 Ibid., at paragraphs 49-52.

the minister to ignore the existence of NSULC and to view the LLC dividends as having been received directly by the limited partnership.

4. Finally, it was argued that the Crown's denial of a deduction under subsection 20(12) was inconsistent with the US treaty and should be overturned accordingly. Pursuant to articles XXIV(2) and (3) of the US treaty, it was alleged that Canada had an obligation to permit the claimed subsection 20(12) deduction.

As previously noted, the first argument listed above—that the LLC dividends could not reasonably be regarded as giving rise to a source of income to FLSmidthCo—was a difficult one for the taxpayer, given its success in arguing for a broad interpretation of the phrase "in respect of" in the preliminary portion of the subsection 20(12) analysis. The court reiterated its view, as originally expressed by the Supreme Court in *Nowegijick*, that "in respect of" is to be understood broadly and is intended to convey a degree of closeness similar to "in relation to" or "in connection with."

Analogous to its treatment of the Crown under the first phase of the analysis, the court reframed the taxpayer's favoured interpretation as a request to interpret the phrase "tax . . . paid . . . in respect of income from a share . . . of a foreign affiliate" in subsection 20(12) to "tax . . . paid . . . on income from a share . . . of a foreign affiliate."[29] Refusing to so reinterpret the phrase, the court concluded that

> [FLSmidthCo] argued, and I accepted, on the first question in this appeal that the U.S. tax was paid by the [limited partnership] in respect of the dividend income received by the [limited partnership] from NSULC, although it was not paid on that income. [FLSmidthCo] 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 [limited 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 [limited partnership]. The payment of taxes thereby affected the flow of income at each step, from LLC through NSULC to the [limited 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 [limited partnership].[30]

The Tax Court generally appeared to agree with the proposition articulated by the Supreme Court in *Shell Canada Ltd. v. Canada*[31] that, absent a specific provision in the Act to the contrary, or a sham, a taxpayer's bona fide legal relationships must

29 Ibid., at paragraph 55.

30 Ibid., at paragraph 58.

31 [1999] 3 SCR 622.

be respected by the minister. The taxpayer identified deeming language in subsection 16(1) and section 68 that arguably provided stronger support for looking beyond the legal relationships of parties than that found in subsection 20(12). However, after considering these provisions, the Tax Court concluded that the phrase "can reasonably be regarded" in subsection 20(12) gave the minister ample authority to look beyond the strict legal relationships of a taxpayer to the "economic substance" of a transaction. The Tax Court reasoned that the stronger language found in subsection 16(1) and section 68 facilitated the recharacterization of legal relationships rather than simply permitting an analysis of economic substance over legal form. Alternatively, the taxpayer argued that the phrase "can reasonably be regarded" was inserted in the legislation to facilitate the apportionment of amounts between sources of income. The Tax Court did not, however, conclude that there was sufficient textual support for this proposition.[32]

After concluding that the US taxes could reasonably be regarded as having been paid in respect of income from the shares of LLC, the Tax Court considered whether the rejection of a subsection 20(12) deduction was consistent with the policy objective of the subsection to provide relief from foreign taxes paid in respect of amounts included in a taxpayer's income under the Act. The Tax Court agreed with the Crown that the rejection of FLSmidthCo's deduction was not inconsistent with the objective of this section since relief from foreign taxation on dividends from foreign affiliates is dealt with comprehensively elsewhere in the Act. Accordingly, it is reasonable to conclude that, in establishing the comprehensive regime in section 113 to address the taxation of dividends from foreign affiliates, Parliament intended to completely address the spectrum of relief available from double taxation, and that no further deductions under subsection 20(12) were intended. In the case of FLSmidthCo, the dividends received from NSULC were exempt from tax under paragraph 113(1)(a), and the dividends paid by NSULC to the limited partnership were funded by LLC dividends that had borne no Canadian tax.

Finally, the taxpayer argued that the Crown's position was inconsistent with Canada's obligations under the US treaty. Since the limited partnership paid income tax in the United States on its US-source income, it was argued that Canada was obliged to relieve the partners of the limited partnership from Canadian tax on that US-source income. In support of this argument, the taxpayer cited the following commentary published by the Organisation for Economic Co-operation and Development (OECD):

> The issue is therefore whether State R [in this case, Canada], which taxes partner A on his share in the partnership profits, is obliged, under the Convention, to give credit for the source tax that is levied in State P [the United States] on partnership P, which State P treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R flows-through the income of the partnership to the

32 Supra note 17, at paragraphs 59-64.

> partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership [to the partners] for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for the purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit.[33]

Accordingly, the taxpayer argued that subsection 20(12) should be interpreted in a manner consistent with Canada's obligation to provide relief from US taxes paid at the partnership level in respect of US-source income where Canadian tax law treats the profits as having flowed through to the partners.

Following a review of the treaty provisions, however, the court concluded that Canada is not obliged under the US treaty to provide relief from US tax assessable on US-source income that was not taxed in Canada. The court noted that no Canadian tax arose on the limited partnership's income justifying a deduction under subsection 20(12) since (1) the interest on the LLC loans was not taxed in Canada and was not recognized as income of the limited partnership for the purposes of the Act; (2) the dividend income of NSULC was not taxed in Canada because it was paid out of LLC's exempt surplus; and (3) the dividends paid by NSULC were not taxable in Canada because they were eligible for a deduction under section 112 when flowed through the limited partnership to the Canadian-resident corporate partners.[34] Accordingly, there was no reason to conclude that the narrow scope of subsection 20(12) favoured by the Crown was in breach of Canada's treaty obligations.

The court distinguished the treatment afforded from that suggested in the above-cited OECD commentary by noting that the commentary appeared to be predicated on the assumption that the income on which the tax was being paid flowed through to the partners rather than being disregarded for the purposes of Canada's domestic tax legislation. Moreover, no Canadian tax was paid on income derived from the income on which the US tax was paid by the limited partnership.[35] As a result, there was no double taxation requiring relief under the US treaty.

Conclusion

The *FLSmidth* decision provides a useful review of the foreign tax deduction under subsection 20(12) and, in particular, provides support to those taxpayers that attempt to frame the scope of foreign taxes eligible for the deduction in a broad manner. Under the first portion of the analysis, the court adopted a broad interpretation of the phrase "in respect of" when considering whether a foreign tax had been paid in

33 Organisation for Economic Co-operation and Development, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation no. 6 (Paris: OECD, 1999), at paragraph 139.

34 Supra note 17, at paragraphs 80-82.

35 Ibid., at paragraphs 83-85.

respect of a source of business or property income. This broad interpretation will be of particular assistance to individuals (including trusts) claiming a deduction for foreign taxes since the exclusion concerning foreign affiliates found in the text of subsection 20(12) is not applicable to such persons. Since individuals (including trusts) are ineligible to claim a deduction under section 113 for dividends received from foreign affiliates, access to the tax deductions and credits for foreign taxes under sections 20 and 126 takes on greater significance.

In contrast to the broad scope of application of the subsection 20(12) deduction available to individuals (including trusts), the *FLSmidth* decision confirms that corporations with foreign affiliates have more limited access to the deduction. Although the broad scope of the interpretation of "in respect of" favours corporate taxpayers seeking to make a deduction under subsection 20(12) where the income could not reasonably be regarded as being attributable to the shares of a foreign affiliate, that interpretation will not assist those corporations seeking to make a claim where the income might reasonably be regarded as being in respect of the shares of a foreign affiliate.

In contrast to individuals (including trusts), the Act and regulations provide a fairly comprehensive regime for addressing the potential double taxation of foreign affiliates. In this light, it seems that the court in *FLSmidth* was not prepared to go out of its way to interpret ambiguity about the scope of the subsection 20(12) deduction in a manner that would permit the taxpayer to deduct amounts of foreign tax when the underlying income was not taxable under the Canadian tax regime. Given the legislative authority to look beyond a taxpayer's legal relationships to the "economic substance" of a transaction, it is possible that a court may be more inclined to look to the policy rationale underlying a deduction.

Interestingly, as noted at the outset of this comment, although this is the first case in which a tower structure has been examined by the court, it did not raise the issue of the double-dip interest deduction that generally motivates the adoption of such structures. Instead, the CRA's challenge focused on the more peripheral issue of the foreign tax deduction under subsection 20(12) for taxes payable in respect of the interest rate spread between the LLC loans and the third-party loans. Although the decision did not indicate the amount of the interest rate spread or the total amount of the borrowings, the spread in such structures is typically small. Accordingly, one would expect that the CRA's denial of the subsection 20(12) deduction was a small tax cost to the taxpayer relative to the overall tax savings obtained through the use of the structure. Notwithstanding this imbalance, the taxpayer has appealed the decision to the Federal Court of Appeal.

Andrew Stirling