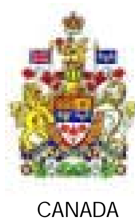
Federal Court of Appeal



Cour d'appel fédérale

Date: 20100517

Docket: A-218-09

Citation: 2010 FCA 124

CORAM: **SHARLOW J.A.**
DAWSON J.A.
TRUDEL J.A.

BETWEEN:

LEHIGH CEMENT LIMITED

Appellant

and

HER MAJESTY THE QUEEN

Respondent

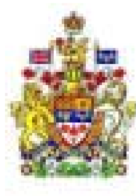
Heard at Vancouver, British Columbia, on March 10, 2010.

Judgment delivered at Ottawa, Ontario, on May 17, 2010.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: DAWSON J.A.
TRUDEL J.A.

Federal Court of Appeal



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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] The appellant Lehigh Cement Limited ("Lehigh"), a corporation resident in Canada, is appealing a judgment of the Tax Court of Canada (2009 TCC 237) upholding assessments made under Part XIII of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). Lehigh was assessed for unpaid non-resident withholding tax on interest paid in the years 1998 to 2002 to Bank Brussels Lambert (the "Belgian Bank"). The issue in this appeal is whether the assessments were justified by the general anti-avoidance rule in section 245 of the *Income Tax Act*.

The statutory scheme

[2] The *Income Tax Act* imposes a tax on all income of a person resident in Canada, and on certain Canadian source income of a person not resident in Canada. One provision that imposes tax on the Canadian source income of a non-resident is subsection 212(1) of the *Income Tax Act*. Generally, subsection 212(1) applies to investment or other passive income (including interest, dividends and rent) paid by a resident of Canada to a non-resident. Interest is dealt with in paragraph 212(1)(*b*).

[3] Paragraph 212(1)(*b*) has a long history. Its first statutory predecessor is found in section 9B of the *Income War Tax Act*, R.S.C. 1927, c.97. It became paragraph 96(1)(*b*) of the *Income Tax Act*, S.C. 1948, c. 52, and then paragraph 106(1)(*b*) of the *Income Tax Act*, R.S.C. 1952, c. 148. An amendment enacted as S.C. 1953, c. 40, subsection 81(1) changed the structure of paragraph 106(1)(*b*) so that the exemptions that had been included in the text of the charging provisions were instead listed as subparagraphs 106(1)(*b*)(i), (ii) and (iii). Paragraph 106(1)(*b*) became paragraph 212(1)(*b*) (see the *Income Tax Act*, S.C. 1970-71-72, c. 63). By 1974 there were 6 listed exemptions. By 2007 there were 11.

[4] The exemption in issue in this case is the seventh listed exemption, subparagraph 212(1)(*b*)(vii). The original version of that provision was enacted by S.C. 1974-75-76, c. 71, section 11, applicable in respect of any debt obligation issued after June 23, 1975. It provided an exemption from non-resident withholding tax for interest payable by a corporation resident in Canada to a non-resident person, subject to two main conditions. First, the resident of Canada and the person to

whom the interest was payable had to deal with each other at arm's length (the "arm's length test"). Second, the resident of Canada could not be obliged to pay more than 25% of the principal amount of the debt within 5 years of the date of the issuance of the evidence of indebtedness, except in the event of a default (the "5 year test").

[5] Subparagraph 212(1)(*b*)(vii) has been amended many times since 1975, but there are no amendments relevant to the issues raised in this appeal. The arm's length test and the 5 year test remained the two main conditions for entitlement to the subparagraph 212(1)(*b*)(vii) exemption throughout the period to which this appeal relates.

[6] In the years under appeal, paragraph 212(1)(*b*) and the exemption in issue, subparagraph 212(1)(*b*)(vii), read in relevant part as follows:

212. (1) Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of,	**212**. (1) Toute personne non-résidente doit payer un impôt sur le revenu de 25 % sur toute somme qu'une personne résidant au Canada lui paie ou porte à son crédit, ou est réputée en vertu de la partie I lui payer ou porter à son crédit, au titre ou en paiement intégral ou partiel :
…	[…]
(*b*) interest except …	*b*) d'intérêts, sauf : […]
(vii) interest payable by a corporation resident in Canada to a person with whom that corporation is dealing at arm's length on any obligation where the evidence of indebtedness was issued by that corporation after June 23, 1975 if under the terms of the obligation or any agreement relating thereto the corporation may not under any circumstances be obliged to pay more than 25% of	(vii) les intérêts payables sur un titre par une société résidant au Canada à une personne avec laquelle cette société n'a aucun lien de dépendance, lorsque le titre de créance a été émis par cette société après le 23 juin 1975, si, selon les modalités du titre ou d'une convention s'y rapportant, la société ne peut, en aucun cas, être tenue de verser plus de 25 %:

…	[…]
(B) … the principal amount of the obligation,	(B) […] du montant du principal de l’obligation,
within 5 years from the date of issue of … that obligation ….	dans les 5 années suivant la date de l’émission […] de cette obligation […].

[7] The 25% rate of tax specified in subsection 212(1) of the *Income Tax Act* may be reduced by an international income tax convention. During the period relevant to this appeal, the rate of tax on interest paid to a resident of Belgium was reduced to 15% by virtue of the *Canada-Belgium Income Tax Convention (1976)*, enacted as a law of Canada by *An Act to implement conventions for the avoidance of double taxation with respect to income tax between Canada and France, Canada and Belgium and Canada and Israel*, S.C. 1974-75-76, c. 104. (The 1976 convention was replaced effective 2004, see S.C. 2002, c. 24.)

[8] I note parenthetically that paragraph 212(1)(*b*) was changed substantially by S.C. 2007, c. 35, subsection 59(2), applicable after 2007. Paragraph 212(1)(*b*) now provides for two categories of interest that are subject to non-resident withholding tax. One category is “participating debt interest”, defined in subsection 212(3) as interest payable on the basis of the production from or the use of property (subject to numerous exceptions). The other is interest that is not “fully exempt interest” (as defined in subsection 212(3)) if the interest is paid or payable to a person with whom the payer is not dealing at arm’s length. The definition of “fully exempt interest” encompasses some of the exemptions that had previously appeared in one of the subparagraphs of 212(1)(*b*), but not the exemption in subparagraph 212(1)(*b*)(vii). Thus, it would appear that after 2007, interest (except

"participating interest") is not subject to non-resident withholding tax if it is paid by a resident of Canada to a non-resident person with which the resident of Canada deals at arm's length. It was not argued in this appeal that the 2007 amendments shed any light on the issues that arise in this case.

[9] The assessment under appeal was issued under the general anti-avoidance rule in section 245 of the *Income Tax Act*. Section 245 reads in relevant part as follows:

245. (1) In this section,	**245.** (1) Les définitions qui suivent s'appliquent au présent article.
"tax benefit" (« *avantage fiscal* ») means a reduction, avoidance or deferral of tax or other amount payable under this Act …;	« attribut fiscal » ("*tax consequencest*") S'agissant des attributs fiscaux d'une personne, […] impôt ou autre montant payable par cette personne […] en application de la présente loi […].
"tax consequences" (« *attribut fiscal* ») to a person means the amount of … tax or other amount payable by … the person under this Act … .	« avantage fiscal » ("*tax benefit*") Réduction, évitement ou report d'impôt ou d'un autre montant exigible en application de la présente loi […].
"transaction" (« *opération* ») includes an arrangement or event.	« opération » ("*transaction*") Sont assimilés à une opération une convention, un mécanisme ou un événement.
(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.	(2) En cas d'opération d'évitement, les attributs fiscaux d'une personne doivent être déterminés de façon raisonnable dans les circonstances de façon à supprimer un avantage fiscal qui, sans le présent article, découlerait, directement ou indirectement, de cette opération ou d'une série d'opérations dont cette opération fait partie.
(3) An avoidance transaction means any transaction	(3) L'opération d'évitement s'entend :
(*a*) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or	*a*) soit de l'opération dont, sans le présent article, découlerait, directement ou indirectement, un avantage fiscal, sauf s'il est raisonnable de considérer que l'opération est principalement effectuée pour des objets véritables — l'obtention de l'avantage fiscal n'étant pas considérée comme un objet véritable;

(*b*) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

b) soit de l’opération qui fait partie d’une série d’opérations dont, sans le présent article, découlerait, directement ou indirectement, un avantage fiscal, sauf s’il est raisonnable de considérer que l’opération est principalement effectuée pour des objets véritables — l’obtention de l’avantage fiscal n’étant pas considérée comme un objet véritable.

(4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction

(4) Le paragraphe (2) ne s’applique qu’à l’opération dont il est raisonnable de considérer, selon le cas :

(*a*) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of

a) qu’elle entraînerait, directement ou indirectement, s’il n’était pas tenu compte du présent article, un abus dans l’application des dispositions d’un ou de plusieurs des textes suivants :

(i) this Act,

(i) la présente loi,

… or

[…]

(*b*) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

b) qu’elle entraînerait, directement ou indirectement, un abus dans l’application de ces dispositions compte non tenu du présent article lues dans leur ensemble.

Facts

[10] The facts are not in dispute. Lehigh is a Canadian corporation that carries on business in Canada as a manufacturer of cement and other building materials. During the period covered by the assessments under appeal, Lehigh was a member of a related group of corporations (the “HZ group”) led by a German corporation, Heidelberger Zement. The HZ group included a Belgian corporation named CBR International Services S.A. (“International Services”) which acted as the treasury centre for the HZ group.

[11] In 1986, Lehigh borrowed $140 million from a consortium of Canadian banks. The loan (the "Lehigh debt") was later sold to one of the corporations within the HZ group using financing from one of the foreign corporations within the HZ group. Ownership of the Lehigh debt changed from time to time until August of 1997 but was always within the HZ group. In August of 1997, International Services held the Lehigh debt. While the Lehigh debt was held by a foreign corporation within the HZ group, the interest was subject to non-resident withholding tax at the rate of 15% pursuant to paragraph 212(1)(b). Lehigh withheld the tax as required and remitted it to the Crown.

[12] Until August of 1997, the Lehigh debt bore interest at a floating rate based on the Canadian prime rate. In August of 1997, the rate of interest payable on the Lehigh debt was at a historic low, 4.75%, but it was expected to increase to 6%. The term of the Lehigh debt was scheduled to end on September 15, 2009, subject to an option given to Lehigh to extend the term for successive periods of five years.

[13] In January of 1997, Lehigh began to look for ways to restructure the Lehigh debt to avoid non-resident withholding tax. An analysis in the spring of 1997 determined that, depending on the interest rate chosen, the present value of the tax saving that could be achieved by avoiding non-resident withholding tax would range from $13.1 to $19.7 million. The HZ group determined, and the Minister has accepted, that the market rate of interest for the Lehigh debt was 7%.

[14] In August of 1997, the terms of the Lehigh debt were amended as follows:

(a) The interest rate was changed from the Canadian prime rate to a fixed rate of 7% for the first five years.

(b) Except in the event of a default, Lehigh was not obliged to repay more than 25% of the principal amount within 5 years of the date upon which the new terms were agreed to.

(c) The holder of the Lehigh debt (then International Services) was given the right to sell to a third party all or any portion of the right to be paid interest on the loan.

(d) A withholding tax gross-up clause was added. That is, Lehigh agreed that if any withholding tax was payable on the interest, Lehigh would effectively bear the increased cost.

[15] In that same month, the Belgian Bank purchased from International Services, for approximately $42.7 million, the right to be paid all interest payable on the Lehigh debt before September 16, 2002, totalling approximately $49.5 million.

[16] As a condition of purchasing the right to be paid the interest on the Lehigh debt, the Belgian Bank required that its risk be mitigated in two ways. First, it required an agreement providing that, in the event of a default by Lehigh, International Services would be obliged to buy from the Belgian Bank, for a specified price, the right to be paid the interest. Second, International Services entered into a funding indemnity in favour of the Belgian Bank that protected the Belgian Bank from any hedging losses that could arise in the event of an early payout of interest. The Crown does not allege

that either of these risk mitigation measures is relevant to the application of the general anti-avoidance rule.

[17] After August of 1997, Lehigh paid the Belgian Bank directly all interest payable on the Lehigh debt. It is undisputed that the arm's length test and the 5 year test in subparagraph 212(1)(*b*)(vii) were then met. On that basis, Lehigh did not withhold any amount from the interest payments on account of non-resident withholding tax.

[18] The Minister took the position that even though interest payable to the Belgian Bank on the Lehigh debt was within the subparagraph 212(1)(*b*)(vii) exemption, non-resident withholding tax was payable on the interest on the basis of the application of the general anti-avoidance rule in section 245. If the Minister's reliance on the general anti-avoidance rule is well founded, Lehigh had a legal obligation to withhold the tax from the interest payments and to remit the withheld amounts on the Belgian Bank's account, failing which Lehigh itself would be liable to pay the amount that should have been withheld (see subsections 215(1) and (6) of the *Income Tax Act*).

[19] The argument of the Crown in the Tax Court and in this Court is essentially the same. The Tax Court judge accepted that argument. He dismissed Lehigh's appeal for reasons encapsulated in the following excerpts from paragraphs 39, 45 and 46 of his reasons (my emphasis):

> **¶39** Subparagraph (vii) is relatively straightforward. It is not drafted in the arcane hieroglyphics that so often decorate other parts of the *Act*. Left to myself, I might well have concluded that this exemption was intended to help Canadian corporations borrow from foreign arm's length lenders who would receive interest free from withholding tax. Having reviewed the articles quoted in paragraphs 37 and 38 above, I find that the purpose of subparagraph (vii) is to help Canadian corporations needing to borrow money

> by increasing their access to international capital markets. The cost of the withholding tax on interest paid to foreign lenders is often shifted to the Canadian borrower, thereby increasing the cost of capital. The exemption from withholding tax on arm's length borrowing from foreign lenders makes such borrowing more competitive with domestic borrowing in Canada.
>
> …
>
> **¶45** … In my opinion, the tax benefit in subparagraph (vii) of paying interest to a non-resident person free from withholding tax *applies only to the arm's length borrowing of capital from a non-resident lender.* That is the transaction "with a certain commercial purpose". In this appeal, [Lehigh] did not borrow any money from [the Belgian Bank] or any other non-resident lender. *The absence of a non-resident lender causes me to infer that the sale transaction between [International Services and the Belgian Bank] abused subparagraph (vii).*
>
> **¶46** … I find that the relationship between [International Services and the Belgian Bank] with respect to the sale of 20 quarterly interest amounts for $42 million; and the relationship between [Lehigh and the Belgian Bank] with respect to the payment of those 20 quarterly interest amounts are *wholly dissimilar to the arm's length borrower/lender relationship contemplated by subparagraph (vii). The sale transaction between [International Services and the Belgian Bank] frustrated the object, spirit and purpose of subparagraph (vii).*

Analysis

(a) The *Canada Trustco* case and subsection 245(4)

[20] Lehigh concedes that the transaction in issue in this case was an avoidance transaction within the meaning of subsection 245(3) of the *Income Tax Act*, and that it was intended to achieve the tax benefit that arose from the right to rely on the subparagraph 212(1)(*b*)(vii) exemption to avoid liability for non-resident withholding tax. However, Lehigh takes the position that the general anti-avoidance rule cannot apply because the transaction was not a misuse of subparagraph 212(1)(*b*)(vii) within the meaning of subsection 245(4).

[21] The leading case on the application of the general anti-avoidance rule is *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, 2005 SCC 54. The principles relating to subsection 245(4) are summarized in paragraph 66 of that case. Much of the discussion about subsection 245(4) is aimed at explaining the meaning of the phrases "misuse of the provisions" of the *Income Tax Act* and "abuse having regard to those provisions … read as a whole". In this case the Crown alleges a misuse of a single provision, subparagraph 212(1)(*b*)(vii).

[22] According to *Canada Trustco*, Lehigh is entitled to the benefit of the exemption in subparagraph 212(1)(*b*)(vii) unless allowing the benefit would be inconsistent with its object, spirit or purpose. The meaning of the phrase "object, spirit or purpose" is not fully explained but in the context of this case I take it as a reference to the purpose of the exemption in subparagraph 212(1)(*b*)(vii), determined on the basis of a textual, contextual and purposive interpretation.

[23] The burden is on the Minister to establish the purpose of subparagraph 212(1)(*b*)(vii) and to establish that allowing Lehigh the benefit of the exemption in subparagraph 212(1)(*b*)(vii) would be a misuse of that provision, in the sense that it would achieve an outcome that subparagraph 212(1)(*b*)(vii) is intended to prevent or is not intended to permit. Most importantly, if there is any doubt as to whether the transaction in issue results in a misuse of subparagraph 212(1)(*b*)(vii), Lehigh is entitled to the benefit of that doubt.

<u>(b) Positions of the parties</u>

[24] I summarize as follows the argument of Lehigh. The purpose of subparagraph 212(1)(*b*)(vii) should be discerned from its words, interpreted textually, contextually and purposively. According to the words of subsection 212(1)(*b*)(vii), interest payable on the Lehigh debt is free of non-resident withholding tax if the arm's length test and the 5 year test are met. Both tests were met in this case, and there is nothing about the transaction in issue that defeats or could tend to defeat the purpose of either of those tests. The 5 year test is intended to ensure that the debt is medium to long term debt, as the debt in issue clearly is. The arm's length test is intended to ensure that the contractual conditions governing the debt, particularly the interest rate, fairly reflect the applicable market. The Crown has admitted that the interest rate in this case is the market rate, and the Crown has not argued that there are any contractual terms that make the Lehigh debt or the transaction in issue inconsistent in any way with normal commercial practice. Since the statutory conditions of subparagraph 212(1)(*b*)(vii) have been met as a matter of both legal and economic substance, there can be no basis for the Crown's conclusion that the transaction has resulted in a misuse of subparagraph 212(1)(*b*)(vii).

[25] The Crown agrees that in this case the statutory conditions for the application of subparagraph 212(1)(*b*)(vii) are met, technically and substantively. However, the Crown argues that the subparagraph 212(1)(*b*)(vii) exemption is not intended to benefit a non-resident person who is legally entitled to be paid interest on a debt as a result of a transaction by which the right to be paid the interest is split from the right to be paid the principal amount. Specifically, the Crown asserts

that, because the transaction in this case did not result in Lehigh “accessing funds in an international capital market”, it is inconsistent with the underlying rationale of subparagraph 212(1)(*b*)(vii).

<u>(c) Discussion</u>

[26] Five observations may be made about the scope of subparagraph 212(1)(*b*)(vii) and the nature of the transaction that has given rise to this appeal.

[27] First, the parties agree that subparagraph 212(1)(*b*)(vii) provides for an exemption from the imposition of non-resident withholding tax on interest payable by a corporation resident in Canada to a non-resident. They also agree that the scope of the exemption is discerned from its words alone, and that no useful guidance is obtained by examining any of the other exemptions.

[28] Second, the language of subparagraph 212(1)(*b*)(vii) is broad enough to include *any* interest payable by a corporation resident in Canada to a non-resident, no matter how the non-resident may have become entitled to receive that interest. Such an entitlement could arise in a number of ways – by a loan to a corporation resident in Canada where the loan bears interest, by a sale of property to a corporation resident in Canada where the unpaid portion of the purchase price bears interest, or by a purchase of the right to be paid interest on a debt obligation of a corporation resident in Canada, with or without the right to be paid the principal amount of the debt.

[29] Third, the language of subparagraph 212(1)(*b*)(vii) requires the arm’s length test to be met in respect of the relationship between the person required to pay the interest and the person entitled

to be paid the interest. It does not require the arm's length test to be met in respect of the relationship between the person required to pay the principal amount of the debt and the person entitled to be paid the principal amount of the debt. If there had been a fiscal policy concern requiring the exemption in subparagraph 212(1)(*b*)(vii) to be available only where the same person was entitled to be paid the interest and the principal amount, it would have been simple to say so.

[30] Fourth, the splitting of interest and principal has long been a normal aspect of commercial financing transactions, including transactions involving government debt obligations such as treasury bills. The Crown has provided no evidence that that there is anything commercially unusual, in form or substance, about the splitting transaction in issue in this case.

[31] Fifth, in the specific context of non-resident withholding tax, Parliament was aware of the existence of such splitting transactions in 1975 when subparagraph 212(1)(*b*)(vii) was first enacted. The stripping of interest coupons is the subject of S.C. 1960-61, c. 17, s. 13, which provided for the enactment of section 132A of the *Income Tax Act*, R.S.C. 1952, c. 148, the predecessor to section 240 of the current *Income Tax Act*. Section 240 refers to a bond, debenture or similar obligation where the right to interest is evidenced by a coupon or other writing that does not form part of, or is capable of being detached from, the evidence of indebtedness. It requires such interest coupons to be marked "AX" if the interest would be subject to non-resident withholding tax if paid to a non-resident person, and otherwise to be marked "F", failing which the issuer of the debt obligation could be liable to a civil penalty.

[32] The Crown's position is not based on an interpretation of subparagraph 212(1)(*b*)(vii) or the statutory scheme of which it is a part. It is not based on any statutory provision or jurisprudence. It is an echo of a sentence in the budget paper released by the Department of Finance in 1975 when the enactment of the first version of subparagraph 212(1)(*b*)(vii) was proposed. The publication is entitled "*Budget: Highlights and Supplementary Information*" and is dated June 23, 1975. The following appears at page 21 of that publication (the emphasis is mine):

> WITHHOLDING TAX EXEMPTION
>
> The budget proposes to make it easier for Canadian business to borrow funds abroad by providing an exemption from the normal withholding tax on interest paid to non-residents.
>
> A similar exemption for all government debt -- federal, provincial and municipal -- was extended earlier this year to securities issued before 1979.
>
> Both these moves supplement the withdrawal on February 27, 1975 of foreign borrowing guidelines which since 1970 had requested borrowers to exhaust Canadian sources before floating issues outside the country.
>
> The new exemption for interest on private-sector loans is restricted to interest paid by a corporation resident in Canada to a non-arm's length [sic] lender on bonds, debentures or other debt obligations having a fixed term to maturity of not less than five years that are issued after budget date and before 1979.
>
> The term "arm's length" is well defined in tax law and generally means dealings between unrelated persons.
>
> *The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilitate access to funds in international capital markets.*

(The Crown says that in the fourth paragraph of this quotation, the reference to "non-arms' length" is wrong and should be read as "arm's length".)

[33] The Crown has produced no other publication of the Department of Finance and no Parliamentary document that purports to explain the underlying rationale of subparagraph 212(1)(*b*)(vii) or to explain the last sentence in the excerpt quoted above from the 1975 budget paper. I assume that no such publication exists.

[34] Although the Crown has cited a number of articles that discuss the scope of subparagraph 212(1)(*b*)(vii), some at great length and in great detail, those articles say nothing about the fiscal policy underlying the enactment of that provision, except to repeat what the 1975 budget paper said. A cursory review of the income tax literature discloses that subparagraph 212(1)(*b*)(vii) has spawned a great deal of learned comment, but the Crown has produced no authority that supports, expressly or by necessary implication, its proposition that a transaction that splits the interest and principal obligation between separate creditors, as was done in this case, would have been considered in 1975 or at any later time to have offended the fiscal policy objective of subparagraph 212(1)(*b*)(vii).

[35] It follows that the Crown's argument must be assessed only on the basis of the excerpt quoted above from the 1975 budget paper, and what inferences might reasonably be drawn from the sentence that uses the phrase "access to funds in international capital markets". In my view, that sentence is a shaky foundation for an assessment under the general anti-avoidance rule in section 245 of the *Income Tax Act*.

[36] I agree that the 1975 budget paper says something about the history of subparagraph 212(1)(*b*)(vii) and the business conditions prevailing in 1975 that motivated its enactment. However, in my view it does not address in any way the question at the core of this case, which is whether Lehigh's reliance on the exemption in subparagraph 212(1)(*b*)(vii) is a misuse of that provision for the sole reason that the Belgian Bank acquired the right to be paid the interest but not the principal amount of the Lehigh debt.

[37] When Parliament adds an exemption to the *Income Tax Act*, even one as detailed and specific as subparagraph 212(1)(*b*)(vii), it cannot possibly describe every transaction within or without the intended scope of the exemption. Therefore, it is conceivable that a transaction may misuse a statutory exemption comprised of one or more bright line tests such as, in this case, the arm's length test and the 5 year test. However, the fact that an exemption may be claimed in an unforeseen or novel manner, as may have occurred in this case, does not necessarily mean that the claim is a misuse of the exemption. It follows that the Crown cannot discharge the burden of establishing that a transaction results in the misuse of an exemption merely by asserting that the transaction was not foreseen or that it exploits a previously unnoticed legislative gap. As I read *Canada Trustco*, the Crown must establish by evidence and reasoned argument that the result of the impugned transaction is inconsistent with the purpose of the exemption, determined on the basis of a textual, contextual and purposive interpretation *of the exemption*.

[38] In this case, the Crown is inviting the Court to conclude that entitlement to the subparagraph 212(1)(*b*)(vii) exemption is not only subject to the express statutory conditions, but is also subject to a condition necessarily implied by the existence of a fiscal policy, evidenced *only* by a sentence in a 1975 budget paper that is said to explain why the exemption was enacted. In my view, the principles stated in *Canada Trustco* require that invitation to be rejected.

[39] I reach that conclusion because no trace of the alleged fiscal policy can be discerned or reasonably inferred from subparagraph 212(1)(*b*)(vii) itself, from the statutory scheme of which subsection 212(1)(*b*)(vii) is a part, or from any other provision of the *Income Tax Act* that could possibly be relevant to the textual, contextual and purposive interpretation of subparagraph 212(1)(*b*)(vii). In my view, it is fatal to the Crown's misuse argument that it finds no support in *any* provision of *the Income Tax Act*, or in *any* jurisprudence or other authority saying or suggesting that the splitting of the interest and principal obligations of a debt have any income tax implications in relation to subparagraph 212(1)(*b*)(vii), or any analogous provision or relevant statutory scheme.

[40] I would add that the Crown's argument also seems to suffer from an irreconcilable inconsistency. The Crown concedes that if International Services (the Belgian corporation related to Lehigh) had sold the Belgian Bank the right to be paid both the principal amount of the Lehigh debt and the interest, subparagraph 212(1)(*b*)(vii) would apply to exempt the interest from non-resident withholding tax and there would be no basis for invoking the general anti-avoidance rule. That is consistent with the well entrenched understanding of the scope of subparagraph 212(1)(*b*)(vii). And yet, I cannot see how such a hypothetical sale could be construed as a transaction that would give

Lehigh "access to funds in international capital markets". In that hypothetical sale, the only flow of money would have been from the foreign purchaser, Belgian Bank, to the foreign seller, International Services. Lehigh's financial position will not have changed at all, and no foreign capital would have flowed to any Canadian corporation.

[41] If subparagraph 212(1)(*b*)(vii) were actually intended to apply only if a resident of Canada "accesses" funds in an international capital market, there would seem to be no reason for the Crown to concede that this hypothetical sale transaction would not be a misuse of subparagraph 212(1)(*b*)(vii). And yet, it has been established for many years that such a sale transaction will entitle the foreign purchaser of the debt to claim the benefit of the subparagraph 212(1)(*b*)(vii) exemption if the arm's length test and the 5 year test are met after the sale. I am unable to discern any relevant distinction, in terms of the alleged underlying rationale of subparagraph 212(1)(*b*)(vii), between such a hypothetical sale proposed above and the transaction undertaken in this case.

[42] The Crown also argues that the transaction in issue in this case is abusive because the HZ group was able to extract part of Lehigh's Canadian source profits free of Canadian tax, which is not an intended result of subparagraph 212(1)(*b*)(vii). This assumes that interest payments generally are funded out of profits and that the consideration that the Belgian Bank paid International Services for the right to be paid the interest payments is somehow funded by the flow of profits from Lehigh to the Belgian Bank. Even if I were to accept those assumptions, it seems to me that again there is no relevant distinction between the hypothetical acceptable transaction described above, and the allegedly abusive transaction in this case. The interest is paid and as a matter of law is payable to the

Belgian Bank, not to any member of the HZ group. It is true that the Belgian Bank compensated the HZ group for the right to the interest payments. However, the Belgian Bank would also have compensated the HZ group if it had acquired the right to both principal and interest, although the pricing would undoubtedly have been different because of the difference in risk.

[43] The Crown's final argument is that the subparagraph 212(1)(*b*)(vii) exemption was intended to reduce the cost of borrowing, but in this case the interest borne by Lehigh was increased from the floating rate (which as of August of 1997 was 4.75%) to a fixed rate of 7% for 5 years. Essentially, the argument is that this change in the interest rate indicates a misuse of subparagraph 212(1)(*b*)(vii). There is no merit to this argument. The subparagraph 212(1)(*b*)(vii) exemption applies only if the payer and recipient of the interest deal at arm's length with each other. In my view, that statutory condition is an indication that Parliament intended the exemption to be available only where the relationship between payer and payee provided some assurance that the rate of interest would reflect a fair market rate. Here, the payer and payee of the interest dealt at arm's length with each other and, more importantly, the 7% interest rate was in fact the fair market rate for Lehigh's $140 million debt (a point conceded by the Crown). On these facts it is not reasonable to conclude that the 7% interest rate represents a misuse of subparagraph 212(1)(*b*)(vii).

[44] For these reasons, I have concluded that the Crown has failed to discharge the burden of establishing that the transaction in issue resulted in a misuse of subparagraph 212(1)(*b*)(vii). It follows that the reassessment under appeal cannot be justified by the general anti-avoidance rule in section 245.

Conclusion

[45] I would allow this appeal with costs in this Court and in the Tax Court. I would set aside the Tax Court judgment and, making the judgment that should have been made, I would allow the appeal and refer this matter back to the Minister for reassessment in accordance with these reasons.

"K. Sharlow"
J.A.

"I agree
Eleanor R. Dawson J.A."

"I agree
Johanne Trudel J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-218-09

APPEAL FROM A JUDGMENT OF THE HONOURABLE JUSTICE M.A. MOGAN DATED APRIL 29, 2009 NO. 2007-2107(IT)G

STYLE OF CAUSE:	Lehigh Cement Limited v. Her Majesty The Queen
PLACE OF HEARING:	Vancouver, British Columbia
DATE OF HEARING:	March 10, 2010
REASONS FOR JUDGMENT BY:	Sharlow J.A.
CONCURRED IN BY:	Dawson J.A. Trudel J.A.
DATED:	May 17, 2010

APPEARANCES:

Warren J.A. Mitchell, Q.C. Matthew G. Williams	FOR THE APPELLANT
Daniel Bourgeois Genevieve Leveille	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Thorsteinssons LLP Vancouver, British Columbia	FOR THE APPELLANT
John H. Sims, Q.C. Deputy Attorney General of Canada	FOR THE RESPONDENT