Docket: 2006-3236(IT)G

BETWEEN:

3850625 CANADA INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on November 2, 2009 at Calgary, Alberta

By: The Honourable Justice Judith Woods

Appearances:

Counsel for the Appellant:	Gerald Grenon Patrick Lindsay
Counsel for the Respondent:	Marta E. Burns Kim Palichuk

JUDGMENT

The appeal with respect to an assessment made under the *Income Tax Act* for the taxation year ended December 31, 1997 is allowed, and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that refund interest in the amount of $6,474,459.61 should be included in computing gross resource profits.

The appellant is entitled to costs.

Signed at Toronto, Ontario this 22nd day of February 2010.

"J. M. Woods"

Woods J.

Citation: 2010 TCC 104
Date: 20100222
Docket: 2006-3236(IT)G

BETWEEN:

3850625 CANADA INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Woods J.

[1] 3850625 Canada Inc., formerly known as Fording Coal Ltd., was issued income tax reassessments for the taxation years from 1985 to 1990, inclusive. It challenged the reassessments, but also paid the tax pending the appeal.

[2] Ultimately, the appellant was partially successful in the appeal and received back a portion of the tax that it had paid and interest thereon ("refund interest").

[3] The question to be decided is whether the refund interest may be included in computing income from the production and processing of a mineral resource for purposes of the now-repealed resource allowance in the *Income Tax Act*.

[4] The Minister of National Revenue reassessed 3850625 Canada Inc. to exclude refund interest in the amount of $6,474,459.61 in the calculation of the resource allowance. The assessment was for the taxation year ended December 31, 1997, when the refund interest was received.

Factual background

[5] The following statement of agreed facts (ASF) was filed by the parties.

1. The Appellant (formerly named Fording Coal Limited) is a Canadian corporation whose business at all relevant times consisted primarily of the production and sale of metallurgical and thermal coal;

2. On June 12, 1991, the Appellant filed notices of objection to reassessments by the Minister for taxation years 1985 to 1990;

3. The Appellant paid the taxes in dispute in order to avoid the prospect of accruing non-deductible arrears interest in the event that the objection proved unsuccessful;

4. Pursuant to Judgment of the Federal Court of Appeal dated January 22, 1996, the Appellant received notices of reassessment dated August 21, 1997 for the 1985 to 1990 taxation years showing a net refund of tax and interest in the amount of $17,201,922;

5. The issues which gave rise to the $17,201,922 refund are listed in paragraph 1 of the attached judgment of the Tax Court of Canada;

6. The $17,201,922 amount included refund interest of $6,474,459.61, paid pursuant to subsection 164(3) of the Act;

7. The parties are agreed that the refund interest is properly included in the Appellant's income for the purpose of Part I of the Act (thereby increasing its income by $6,474,459.61);

8. During the course of the audit, the Appellant requested that an adjustment be made to the calculation of its resource profits to include the refund interest amount; and

9. The parties dispute whether the refund interest is properly included in the calculation of the Appellant's resource profits for the purpose of the calculation of the resource allowance provided by paragraph 20(1)(v.1) of the Act as it applied for the Appellant's 1997 taxation year.

[6] Paragraph 5 of the ASF refers to a judgment of the Tax Court of Canada that entitled the appellant to the tax refund. The relevant part of that judgment is paragraph 1, which was issued without reasons and on consent of the parties. It is reproduced in an appendix to these reasons.

[7] For clarity, I would mention that another part of this judgment dealt with an issue that was not resolved on consent. It was ultimately resolved in favour of the Crown in the Federal Court of Appeal and accordingly none of the refund interest is attributable to this issue: *The Queen v. Fording Coal Ltd.*, 95 DTC 5672 (FCA).

[8] Paragraph 1 of the ASF states that the appellant's revenues are derived "primarily" from the production and sale of coal. Although the term "primarily" suggests more than 50%, it is not disputed that substantially all of the appellant's income was from this source during the relevant period.

[9] It is agreed by the parties that the appellant paid the assessments in order to avoid the prospect of non-deductible arrears interest. Essentially, it was a matter of prudent cash management.

[10] The decision to pay the tax was not motivated by the potential of earning interest if the appeal was successful. The appellant had term and revolving debt used in its business, and any excess cash likely would have been used to pay down this debt.

Legislative scheme

[11] From 1976 to 2006, the resource allowance provided a 25 percent reduction in tax on resource profits. The Minister of Finance described the provision upon its introduction in the 1975 federal budget as follows:

> […] I am introducing a new resource allowance, which would be an extra deduction from income equal to 25 per cent of production income from petroleum or mineral resources. For this purpose, production income would be calculated after operating expenses and capital cost allowances, but before interest, exploration and development, and earned depletion. This new allowance will be available to both corporate and individual taxpayers engaged in petroleum and mining operations.

[12] A brief history of the provision is included in a paper presented at the 2008 Annual Conference of the Canadian Tax Foundation. In "Basic Issues in Resource Taxation," Mar, Rowe and Aiken Bereti stated, at 10:19:

> In the 30 years preceding 2007, a portion of Crown royalties were not deductible in calculating taxable income. This restriction arose from a jurisdictional battle between the federal government and the provinces (most notably Alberta) with respect to the tax and royalty revenues applicable to the exploitation of natural resources. The resource allowance contained in the Act was a prescribed statutory allowance designed to compensate the taxpayer for the non-deductibility of (largely provincial) Crown royalties, but only to a maximum rate of 25 percent. In the mining sector, Crown royalties were generally well below the 25 percent rate contemplated by the resource allowance, and thus the resource allowance regime arguably came to be more a federal tax subsidy than a restriction on provincial royalties. The history of Crown royalties, the resource allowance, and the phase-out of the resource

> allowance is considered in detail in several papers. For all periods after 2006, Crown royalties can be fully deducted when calculating taxable income. As a result, the resource allowance has been repealed and has no effect after 2006.

[13] The statutory basis for the resource allowance was paragraph 20(1)(*v.1*) of the *Act* which at the relevant time provided:

> **20(1)** Notwithstanding paragraphs 18(1)(*a*), (*b*) and (*h*), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:
>
> […]
>
> **(v.1)** such amount as is allowed to the taxpayer for the year by regulation in respect of natural accumulations of petroleum or natural gas in Canada, oil or gas wells in Canada or mineral resources in Canada;

[14] The calculation of the allowance was provided for in Part XII of the *Income Tax Regulations*, and in particular sections 1204 and 1210.

[15] Subsection 1204(1) of the *Regulations* provides a definition of "gross resource profits," which is relevant in computing the base to which the 25 percent allowance applies. The relevant part of that provision is reproduced below:

> **1204**(1) For the purposes of this Part, "gross resource profits" of a taxpayer for a taxation year means the amount, if any, by which the aggregate of
>
> […]
>
> (*b*) the amount, if any, of the aggregate of his incomes for the year from
>
> […]
>
> (ii) the production and processing in Canada of
>
> (A) ore, other than iron ore or tar sands ore, from mineral resources in Canada operated by him to any stage that is not beyond the prime metal stage or its equivalent,
>
> (B) iron ore from mineral resources in Canada operated by him to any stage that is not beyond the pellet stage or its equivalent, and
>
> (C) tar sands ore from mineral resources in Canada operated by him to any stage that is not beyond the crude oil stage or its equivalent,
>
> (Emphasis added)

Analysis

[16] The question to be decided is whether the refund interest received by the appellant is sufficiently connected to the production and processing of coal as to be included in computing the appellant's "income … from the production and

processing of ore … from mineral resources" for purposes of s. 1204(1) of the *Regulations.*

[17] In one of the leading cases concerning the interpretation of this provision, *Echo Bay Mines Ltd. v. The Queen*, 92 DTC 6437 (FCTD), resource profits were determined to include income derived from hedging transactions. In detailed reasons, MacKay J. concluded, at 6447:

> […] The use of the words "aggregate" and "incomes", and the implicit inclusion of "income … derived from transporting, transmitting or processing" [to the primary metal stage] in the case of metals or minerals under 1204(1)(b) which arises from 1204(3), both signify that income from "production" may be generated by various activities provided those are found to be included in production activities. Production activities yield no income without sales. Activities reasonably interconnected with marketing the product, undertaken to assure its sale at a satisfactory price, to yield income, and hopefully a profit, are, in my view, activities that form an integral part of production which is to yield income, and resource profits, with Regulation 1204(1).

[18] The principle that flows from *Echo Bay Mines* is that production and processing income is not limited to revenues from the sale of mineral resources but it includes income from other activities that are integral to the production and processing activity.

[19] The respondent agrees with this formulation of the test, but it submits that the appellant has not demonstrated integration between the refund interest and the appellant's production and processing activities.

[20] I disagree with this submission. In my view, sufficient integration has been established on the facts of this case.

[21] First, the appellant's right to refund interest arose in the course of managing its tax obligations. These obligations, in turn, arose as a consequence of earning profits from the production and processing of coal. There is no other significant source of income on which the tax is payable.

[22] Bowman A.C.J. (as he then was) comments on this point in *Munich Reinsurance Co. v. The Queen*, 2000 DTC 2009 (TCC), aff'd 2002 DTC 6701 (FCA):

> [48] I think that quite apart from paragraph 12(1)(*c*) and subsection 138(9) the interest income earned on overpayments of tax to the Government of Canada is income from a business carried on in Canada. Its genesis is the income earned from the appellant's business in Canada upon which the appellant has an obligation to pay tax and in respect of which it must make instalment payments. It is not from casual investments made independently of its business. […]

[23] A similar comment was made by Sharlow J.A. in *Irving Oil Ltd. v. The Queen*, 2002 DTC 6716 (FCA):

> [16] […] [Irving Oil] was not attempting to derive a profit from tax deductions or tax credits in the *Income Tax Act*. It simply paid an outstanding tax liability, having determined in the exercise of its business judgment that it would be preferable to pay the tax than to provide security.

[24] These decisions involve a different statutory scheme and for this reason they are not dispositive of the issue in this appeal. However, the decisions are of considerable assistance in characterizing the nature of refund interest generally.

[25] The respondent suggests that there is not a sufficient interconnection between income tax and production and processing activities because income tax is paid not in the course of the resource business but after the resource activities are completed.

[26] This argument was considered, and rejected, by the Federal Court of Appeal in *Irving Oil Ltd.* and *Munich Reinsurance.* Although the context is different, the reasons given by the Court for rejecting this argument are equally applicable here.

[27] It is also useful to look at the nature of the issues in the tax dispute that led to the refund, namely, the issues on which the appellant was successful. If the factual circumstances that gave rise to these issues is integral to production and processing activities, sufficient integration has been established in my view.

[28] The tax issues that gave rise to the tax refund are outlined in the excerpt from the judgment of Rowe D.J. reproduced in the appendix. Based on the brief judgment, it appears that the amount at issue primarily related to activities that are integral to production and processing. There is not sufficient detail in the judgment to fully understand the issues, however. The respondent did not raise this as an issue or introduce any evidence as to the nature of the issues in the tax dispute.

[29] In these circumstances, I would agree with the appellant that it has led sufficient evidence to establish that the refund interest was integral to its production

and processing activities.

[30] The appeal will be allowed, and the assessment will be referred back to the Minister of National Revenue for reconsideration and reassessment to include the refund interest in computing gross resource profits for purposes of the resource allowance. The appellant is also entitled to costs.

Signed at Toronto, Ontario this 22nd day of February 2010.

"J. M. Woods"

Woods J.

Appendix

Paragraph 1 of judgment of Tax Court of Canada

1. Pursuant to the parties hereto, through their respective solicitors, having indicated their Consent to Judgment with respect to certain matters in issue on the basis that:

   (a) the Appellant realized the following foreign exchange gains to be included in or deducted from its resource profits in the following amounts in the respective taxation years:

$1,027,046.00	1985
$4,473,654.00	1986
$2,203,607.00	1987
$16,248,904.00	1988
($219,505.00)	1989;

   (b) the following amounts of Capital Cost Allowance in respect of property included in Class 28 and Class 41(A) of Schedule II are not deducted in the computation of the Appellant's resource profits in the respective taxation years:

$77,801.00	1986
$1,353,773.00	1987
$4,302,316.00	1988;

   (c) as a result of (a) and (b) supra, the Appellant's deductions were increased for additional resource allowance computed pursuant to paragraph 20(1)(v.1) of the Income Tax Act ("the Act") and section 1210 of the Income Tax Regulations ("the Regulations") and the earned depletion allowance computed pursuant to section 65 of the Act and sections 1201 and 1204 of the Regulations;

   (d) interest on money borrowed to finance the construction of the Appellant's Genesee Coal Mine is not deducted in the computation of the Appellant's resource profits in the following amounts and in the respective taxation years:

$808,972.00	1986
$1,657,250.00	1987
$4,687,107.00	1988,

thereby increasing the Appellant's deductions for earned depletion allowance computed pursuant to section 65 of the Act and sections 1201 and 1204 of the Regulations;

(e) the amount of $2,469,163.00 paid by the Appellant pursuant to the British Columbia Mineral Tax Act for the period January 1, 1990 to July 12, 1990 is deductible in its 1990 taxation year.

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APPEARANCES:

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