Federal Court of Appeal | Cour d'appel fédérale

Date: 20110324

Docket: A-116-10

Citation: 2011 FCA 117

CORAM: **NOËL J.A.**
PELLETIER J.A.
TRUDEL J.A.

BETWEEN:

HER MAJESTY THE QUEEN

Appellant

and

3850625 CANADA INC.

Respondent

Heard at Calgary, Alberta, on March 7, 2011.

Judgment delivered at Ottawa, Ontario, on March 24, 2011.

REASONS FOR JUDGMENT BY: NOËL J.A.

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

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REASONS FOR JUDGMENT

NOËL J.A.

[1] This is an appeal from a judgment of Woods J. of the Tax Court of Canada (the Tax Court Judge) allowing the appeal brought by 3850625 Canada Inc. (the respondent) and referring back to the Minister of National Revenue (the Minister) the assessment issued with respect to its 1997 taxation year for reassessment on the basis that a refund of interest in the amount of $6,474,459.61 (the refund interest) was to be included in the calculation of the respondent's resource allowance. The refund arose out of a dispute between the respondent and the Minister with respect to reassessments for prior taxation years.

FACTUAL BACKGROUND

[2] The parties filed the following agreed partial statement of facts before the Tax Court (appeal book, vol. 2 at pp. 62-64):

> 1. The [respondent] (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 [respondent] filed notices of objection to reassessments by the Minister for taxation years 1985 to 1990;
>
> 3. The [respondent] 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 [respondent] 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 Tax Court of Canada [judgment in *Fording Coal Ltd. v. Canada*, 95 D.T.C. 571];
>
> 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 [respondent]'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 [respondent] 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 [respondent]'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 [respondent]'s 1997 taxation year.

LEGISLATIVE DISPOSITIONS

[3] Resource allowance was phased out over a period of years ending in 2007. The statutory basis for the deduction of resource allowance as it applied with respect to the respondent's 1997 taxation year is paragraph 20(1)(*v.1*) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the Act):

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:	**20(1)** Malgré les alinéas 18(1)*a*), *b*) et *h*), sont déductibles dans le calcul du revenu tiré par un contribuable d'une entreprise ou d'un bien pour une année d'imposition celles des sommes suivantes qui se rapportent entièrement à cette source de revenus ou la partie des sommes suivantes qu'il est raisonnable de considérer comme s'y rapportant :
…	[…]
(*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;	(*v.1*) les sommes que le contribuable est autorisé, par règlement, à déduire pour l'année au titre de gisements naturels de pétrole ou de gaz naturel, de puits de pétrole ou de gaz ou de ressources minérales, situés au Canada;
…	[…]

[Emphasis added]

[4] In her reasons, the Tax Court Judge cited a passage from an article giving a brief history of the resource allowance provision (reasons at para. 12):

> 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.

[5] The calculation of the resource allowance was provided for in the *Income Tax Regulations*, C.R.C., c. 945 (the Regulations). Subsection 1204(1) defined "gross resource profits" as follows:

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	**1204**(1) Pour l'application de la présente partie, les bénéfices bruts relatifs à des ressources d'un contribuable pour une année d'imposition correspondent au montant éventuel par lequel le total :
…	[…]
(*b*) the amount, if any, of the aggregate of his incomes for the year from	*b*) du montant, s'il en est, de l'ensemble de ses revenus pour l'année tirés
…	[…]
(ii) the <u>production and processing</u> in Canada of	(ii) de <u>la production et du traitement</u> au Canada
(A) ore, other than iron ore or tar sands ore, from mineral resources in Canada operated by him to any	(A) du minerai, à l'exception du minerai de fer ou du minerai de sables asphaltiques, tiré de

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,

…

exceeds the aggregate of the taxpayer's losses for the year from the sources described in paragraph (*b*), where the taxpayer's incomes and losses are computed in accordance with the Act on the assumption that the taxpayer had during the year no incomes or losses except from those sources and was allowed no deductions in computing the taxpayer's income for the year other than

…

ressources minérales au Canada que le contribuable exploite, jusqu'à un stade qui ne dépasse pas le stade du métal primaire ou son équivalent,

(B) du minerai de fer tiré de ressources minérales au Canada que le contribuable exploite, jusqu'à un stade qui ne dépasse pas le stade de la boulette ou son équivalent, et

(C) du minerai de sables asphaltiques tiré de ressources minérales au Canada que le contribuable exploite, jusqu'à un stade qui ne dépasse pas le stade du pétrole brut ou son équivalent,

[…]

dépasse le total de ses pertes pour l'année provenant des sources visées à l'alinéa *b*), à condition que ses revenus et pertes soient calculés conformément à la Loi, selon l'hypothèse que ses seuls revenus et pertes pour l'année provenaient de ces sources et qu'il n'a eu droit à aucune déduction dans le calcul de son revenu pour l'année sauf :

[…]

[Emphasis added]

[6] Subsection 1206(2) of the Regulations and subsection 66(15) of the Act dealt with the term "production" as follows:

1206(2) In this Part,"joint exploration corporation", "principal-business corporation", "production" from a Canadian resource property, "reserve amount" and "shareholder corporation" have the meanings assigned by subsection 66(15) of the Act.	**1206**(2) Dans la présente partie, «société actionnaire», «société d'exploration en commun», «société exploitant une entreprise principale», «production» tiré d'un avoir minier canadien et provision s'entendent au sens du paragraphe 66(15) de la Loi.
66(15) In this section,	**66**(15) Les définitions qui suivent s'appliquent au présent article.
…	[…]
"production" from a Canadian resource property or a foreign resource property means	«production» S'il s'agit de la production tirée d'un avoir minier canadien ou d'un avoir minier étranger, les produits suivants tirés de cet avoir :
(*a*) petroleum, natural gas and related hydrocarbons produced from the property,	*a*) le pétrole, le gaz naturel et les hydrocarbures connexes;
(*b*) heavy crude oil produced from the property processed to any stage that is not beyond the crude oil stage or its equivalent,	*b*) le pétrole brut lourd transformé jusqu'à un stade qui ne dépasse pas celui du pétrole brut ou de son équivalent;
(*c*) ore (other than iron ore or tar sands) produced from the property processed to any stage that is not beyond the prime metal stage or its equivalent,	*c*) le minerai — à l'exclusion du minerai de fer et des sables asphaltiques — transformé jusqu'à un stade qui ne dépasse pas celui du métal primaire ou de son
(*d*) iron ore produced from the property processed to any	

stage that is not beyond the pellet stage or its equivalent,	équivalent;
(*e*) tar sands produced from the property processed to any stage that is not beyond the crude oil stage or its equivalent, and	*d*) le minerai de fer transformé jusqu'à un stade qui ne dépasse pas celui de la boulette ou de son équivalent; *e*) les sables asphaltiques transformés jusqu'à un stade qui ne dépasse pas celui du pétrole brut ou de son équivalent;
(*f*) any rental or royalty from the property computed by reference to the amount or value of the production of petroleum, natural gas or related hydrocarbons or ore;	*f*) sont assimilés à de la production les loyers et les redevances provenant d'un avoir minier canadien ou d'un avoir minier étranger et calculés sur la quantité ou la valeur de la production de pétrole, de gaz naturel ou d'hydrocarbures connexes ou de minerai.
…	[…]

[Emphasis added]

[7] Subsection 1210 of the Regulations provided the formula to be used in order to compute resource allowance for purposes of paragraph 20(1)(*v.1*) of the Act.

[8] The specific issue which the Tax Court Judge had to decide is whether the refund interest was to be included in the computation of the "gross resource profits" pursuant to subsection 1204(1) of the Regulations.

DECISION OF THE TAX COURT

[9] The Tax Court Judge identified *Echo Bay Mines Ltd. v. The Queen.*, [1992] 3 F.C. 707, 92 D.T.C. 6437 [*Echo Bay Mines*] as a leading case concerning the interpretation of subsection 1204(1). She held that the principle to be derived from that case is "that production and processing income is not limited to revenues from the sale of mineral resources but … includes income from other activities that are integral to the production and processing activity" (reasons at para. 18).

[10] Relying on *Munich Reinsurance Co. (Canada Branch) v. The Queen*, 2000 D.T.C. 2009 (T.C.C.); aff'd (2001), 2002 D.T.C. 6701 (F.C.A.) [*Munich Reinsurance*] and *The Queen v. Irving Oil Ltd.* (2001), 2002 D.T.C. 6716 (F.C.A.) [*Irving Oil*], the Tax Court Judge found that the respondent's "right to a 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" (reasons at para. 21). The Tax Court Judge recognized that *Munich Reinsurance* and *Irving Oil* dealt with a different scheme. However, they remained useful in characterizing the nature of refund.

[11] The Tax Court Judge went on to consider whether there was a sufficient connection between the refund and the production and processing activities. After considering the evidence, she held that the refund interest was integral to the respondent's production and processing activities. The appeal was accordingly allowed and the assessment was referred back to the Minister for reassessment on the basis that the refund interest should be included in the computation of "gross resource profits".

ALLEGED ERRORS

[12] The Crown submits that in so holding the Tax Court Judge did not apply the correct legal test. This error being one of law, the Crown asks that this issue be reviewed on a standard of correctness.

[13] In particular, the Crown contends that the concept of income from production and processing is narrow and that the Tax Court Judge failed to give effect to this concept. In support of this contention, the Crown relies on the decision of the Federal Court, Trial Division, in *Gulf Canada Ltd. v. The Queen*, 90 D.T.C. 6622; as affirmed on appeal (92 D.T.C. 6123 [*Gulf*]). In the Trial Division, McNair J. considered the scope of the phrase "income from production" under former sections 124.1 and 124.2 of the Act and concluded that these provisions establish their own separate scheme. In order to illustrate the narrow construction that is to be given to the phrase "production and processing", the Crown refers to *Cominco Ltd. v. The Queen.*, 84 D.T.C. 6535 (F.C.T.D.) where it was held that proceeds from a business interruption insurance did not arise out of the production or processing activities.

[14] The Crown further submits that the Tax Court Judge misconstrued the approach set out in *Echo Bay Mines*. According to the Crown, she "failed to recognize that in *Echo Bay Mines* the court concluded that hedging gains formed part of production income because such gains were one of the components of revenues from the sale of mineral resources" (Crown's memorandum at para. 24). The Crown also points to the decision of the Supreme Court of Canada in *Gunnar Mining Ltd. v. Minister of National Revenue*, 68 D.T.C. 5035 where it was held that the interest income from short-

term securities bought with profits generated by the operation of a mine was not attributable to production.

[15] The Crown submits that instead of relying on the jurisprudence relating to the interpretation of the specialized resource provisions, the Tax Court Judge relied on *Munich Reinsurance* and *Irving Oil*, two cases which are concerned with the computation of income generally, *i.e.* sections 3 and 4 of the Act. As such, "she incorrectly equated the word 'income' with 'income from the production of and processing of ore'" (Crown's memorandum at para. 29).

ANALYSIS & DISPOSITION

[16] The parties disagree as to the applicable standard of review. The Crown submits that correctness should apply as the Tax Court Judge failed to apply the correct test to determine whether the refund interest should be included in the calculation of the resource allowance. The respondent notes that during the trial, the Crown agreed with the approach adopted by the Tax Court Judge and that the dispute is therefore whether the test is met on the facts of this case. According to the respondent, this gives rise to a question of fact or mixed fact and law which cannot be overturned absent a palpable and overriding error.

[17] In her reasons, the Tax Court Judge identified *Echo Bay Mines* as "one of the leading cases" on the interpretation of subsection 1204(1) of the Regulations and quoted the following passage (reasons at para. 17):

> […] 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, within Regulation 1204(1).
>
> [Emphasis added]

[18] She then stated at paragraph 18 that:

> [t]he 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 Tax Court Judge pointed out that the Crown agreed with this formulation of the test (reasons at para. 19). In its memorandum of fact and law, the Crown does not dispute the Tax Court Judge’s statement to that effect.

[20] However, on appeal, the Crown contends that the construction that was given to the phrase “production and processing” in *Gulf* is more restrictive and that the Tax Court Judge erred in failing to follow that approach. In particular, the respondent refers to the following passage of the reasons of McNair J. at paragraph 44:

> I am satisfied to accept the submissions of plaintiff's counsel on this issue, namely, that sections 124.1 and 124.2 are much more specific in their scope and intendment than the calculation of income provisions under section 3 of the Act, in requiring that the income and deductions be related to production in the sense of extraction from the ground as the source of income. In my opinion, the scientific research expenditures in issue, being related to the long-term objectives of the plaintiff and not to the actual present production from mineral resources, ought not to be included in the calculations. …
>
> [Emphasis added]

[21] I do not read this passage as providing for an approach that is more restrictive than the one adopted by the Tax Court Judge. The reasoning is that in order to qualify for inclusion in the computation of "taxable production profits", the income (or the deductions) must be related to production in the narrow sense of extraction from the ground as a source of income. This does not restrict the qualifying activity to extraction *per se*. As was made clear on appeal, extraction *per se* is not a source of income; only the "business of production" can give rise to income (see the decision of the Appeal Division at p. 6127). In my respectful view, the *Gulf* test is consistent with the one set out in *Echo Bay Mines* and which the Tax Court Judge applied in this case, *i.e.* whether the refund interest was sufficiently connected to the production and processing activities to constitute income from that source. I therefore reject the contention that the Tax Court Judge applied the wrong legal test.

[22] The Tax Court Judge conducted her analysis in two parts. First, she sought to characterize the nature of the refund received (reasons at paras. 21-24). She relied on two decisions to the effect that interest income paid as a result of the management of tax obligations can constitute income

from a business. The first decision on which she relied is *Munich Reinsurance*. In that case, Sharlow J.A. stated at paragraph 33 as follows:

> However, in this case there is no factual basis for concluding that the appellant's right to tax refunds did not arise as part of its insurance business. The appellant's obligation to pay its Part I tax flowed from the fact that the appellant derived profit from carrying on an insurance business in Canada. The asset management decisions made by the appellant to comply with its tax obligations in the most advantageous way were decisions as to the use of the assets of its insurance business, and in that sense were decisions made in the course of its business. It follows that the right of the appellant to be paid its tax overpayments was a right acquired in the course of carrying on its business. Therefore it was property held in the course of carrying on that business and was property within the scope of subsection 138(9).

[23] The second decision relied upon by the Tax Court Judge is *Irving Oil*, wherein Sharlow J.A. stated:

> [16] The Crown in this case, like the taxpayer in *Munich Reinsurance*, also relies on more recent jurisprudence that stands for the proposition that, for income tax purposes, an advantage that flows exclusively from the provisions of the *Income Tax Act* is not income, and a business cannot consist solely of a transaction whose purpose is to reduce the income tax otherwise payable: *Moloney v. R.*, [1992] 2 C.T.C. 227, 92 D.T.C. 6570 (Fed. C.A.); *Loewen v. Minister of National Revenue*, [1994] 2 C.T.C. 75, 94 D.T.C. 6265 (Fed. C.A.). I am unable to draw any analogy between those cases and this one. The respondent was not engaging in tax avoidance transactions. It 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.
>
> …
>
> [18] I conclude, as did the Tax Court Judge, that there is no authority for the proposition that interest on an income tax refund can never be business income. As that proposition was the sole basis of the Crown's appeal, the appeal should be dismissed with costs.

[24] The Tax Court Judge acknowledged that these decisions dealt with different schemes – *i.e.* that relating to the treatment of insurance business income under subsection 138(9) in *Munich Reinsurance* and the treatment of active business income under section 125.1 in *Irving Oil* – but noted that they were nonetheless useful. In particular, she relied on these decisions to dispose of the Crown's argument that there was not a sufficient connection between income tax and production and processing activities because income tax is paid after these activities are completed (reasons at para. 25). I can detect no error in this regard.

[25] The Tax Court Judge focused her analysis on whether the refund was sufficiently connected to the production and processing activities to constitute income from that source. In this respect, she observed that the respondent earned its refund in the course of managing its tax obligations which in turn arose as a consequence of earning profits from the production and processing of coal (reasons at para. 21). Another consideration was the nature of the dispute which gave rise to the refund (reasons at para. 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 [respondent] 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.
>
> [Emphasis added]

[26] She went on to find that the refund interest was sufficiently connected to the respondent's production and processing activities to constitute income from that source. This finding was open to the Tax Court Judge on the evidence before her.

[27] The Tax Court Judge having conducted her analysis on the basis of the proper test, it was incumbent upon the appellant to show that an error of a palpable and overriding nature was committed in applying it. In my respectful view, no such error has been demonstrated.

[28] I would dismiss the appeal with costs.

"Marc Noël"

J.A.

"I agree
J.D. Denis Pelletier J.A."

"I agree
Johanne Trudel J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-116-10
APPEAL FROM A JUDGMENT OF THE HONOURABLE JUSTICE J.M. WOODS OF THE TAX COURT OF CANADA, DATED FEBRUARY 22, 2010, DOCKET NO 2006-3236(IT)G.	
STYLE OF CAUSE:	HER MAJESTY THE QUEEN and 3850625 CANADA INC.
PLACE OF HEARING:	Calgary, Alberta
DATE OF HEARING:	March 7, 2011
REASONS FOR JUDGMENT BY:	Noël J. A.
CONCURRED IN BY:	Pelletier J.A. Trudel J.A.
DATED:	March 24, 2011

APPEARANCES:

Marta Burns Marla Teeling	FOR THE APPELLANT
Gerald Grenon Patrick Lindsay	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Myles J. Kirvan Deputy Attorney General of Canada	FOR THE APPELLANT
Osler Hoskin & Harcourt LLP Calgary, Alberta	FOR THE RESPONDENT