Supreme Court of Canada
R. v. Melford Developments Inc., [1982] 2 S.C.R. 504
Date: 1982-09-28

Her Majesty The Queen *Appellant;*

and

Melford Developments Inc. *Respondent.*

File No.: 16482.

1982: June 1; 1982: September 28.

Present: Ritchie, Estey, McIntyre, Lamer and Wilson JJ.

ON APPEAL FROM THE FEDERAL COURT OF APPEAL

Taxation—Income tax—Guarantee fees—Non-resident—Withholding tax—International Tax Convention—Domestic Tax Law—Conflict—Whether guarantee fees paid to non-resident bank subject to taxation—Whether the Income Tax can override the provisions of the tax treaty—Income Tax Act, 1970-71-72 (Can.), c. 63 as amended, ss. 212(1)(b), 214(15)(a)—Canada-Germany Income Tax Agreement Act, 1956 (Can.), c. 33, s. 3—Canada-Germany Tax Convention, Articles II(2), III(1), (5).

Appellant seeks to recover withholding tax on a payment made by the respondent to a German bank which had no permanent establishment in Canada. The payment was made as a fee payable to the foreign bank for guaranteeing respondent's loan made by a Canadian bank. The issue here is whether the addition in 1974 of s. 214(15)(*a*) of the *Income Tax Act* deeming payments by way of guarantee fees to be payment of interest amended the provisions of the *Canada-Germany Tax Agreement Act, 1956* so as to expose the respondent to the burden of withholding tax when making payment of the guarantee fees to the non-resident guarantor.

Held: The appeal should be dismissed.

The guarantee fees were not "interest", within the terms of the Canada-Germany Tax Convention. The *Canada-Germany Income Tax Agreement Act, 1956,* being the legislative adoption of the international tax Agreement, had not been amended by the income tax amendment of 1974. There is no doubt that the effect of s. 3 of the 1956 Act was to make the operation of any other law of Parliament, including the *Income Tax Act,* subject to the terms of the 1956 Act and the incorporation Agreement. The guarantee fees were consequently not taxable as Article III(1) of the Agreement did not

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authorize the taxation of commercial profits of a nonresident where those profits were not earned through a permanent establishment in Canada.

Re: Farm Security Act, [1947] S.C.R. 394; *Bennett and White Construction Co. v. Minister of National Revenue,* [1949] S.C.R. 287; *Associates Corporation of North America v. The Queen,* [1980] 2 F.C. 377 affirmed [1980] 2 F.C. 382; *Inland Revenue Commissioners v. Collco Dealings Ltd.,* [1962] A.C. 1; *Woodend (K.V. Ceylon) Rubber and Tea Co. v. Commissioner of Inland Revenue,* [1971] A.C. 321, referred to.

APPEAL for a judgment of the Federal Court of Appeal (1981), 36 N.R. 9, [1981] 2 F.C. 627, [1981] C.T.C. 30, affirming a judgment of the Trial Division, [1980] 2 F.C. 713, [1980] C.T.C. 141. Appeal dismissed.

John R. Power, Q.C., and Jane Meagher, for the appellant.

John R. Dingle, for the respondent.

The judgment of the Court was delivered by

ESTEY J.—This appeal raises for settlement the principles applicable to the interpretation of domestic tax law and international tax conventions where their provisions are said to be competing. The appellant seeks to recover under the *Income Tax Act,* 1970-71-72 (Can.), c. 63, s. 1, as amended, withholding tax on a payment made by the respondent to a resident in Germany. The parties agree that the recipient of the payment does not carry on business in Canada and that the susceptibility to taxation of the payments in question depends entirely upon the application of Part XIII of the *Income Tax Act, supra,* relating to the taxation of non-residents and the Canada-Germany Tax Convention brought into the laws of this country by statute: The *Canada-Germany Income Tax Agreement Act, 1956,* 1956 (Can.), c. 33.

The payment in question was made by the respondent as a fee payable for the delivery by the

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non-resident recipient, a German bank, of its guaranty to the Bank of Nova Scotia for a loan by that bank to the respondent. The fee was calculated on the basis of one per cent per annum of the principal of the loan by the bank to the respondent. The appellant submits that this payment is properly subjected to withholding tax by reason of ss. 212(1)(*b*) and 214(15)*a*) found in Part XIII of the *Income Tax Act* where provision is made for the taxation of non-residents. It is the view of the appellant that the payment in question is, for the purposes of the *Income Tax Act,* “interest”. These provisions in the *Income Tax Act* are as follows:

PART XIII

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 him as, on account or in lieu of payment of, or in satisfaction of,

…

(*b*) interest except…

Section 214(15)

(15) For the purposes of this Part,

(*a*) where a non-resident person has entered into an agreement under the terms of which he agrees to guarantee the repayment, in whole or in part, of the principal amount of a bond, debenture, bill, note, mortgage, hypothec or similar obligation of a person resident in Canada, any amount paid or credited as consideration for the guarantee shall be deemed to be a payment of interest on that obligation;

(Added by 1974-75-76 (Can.), c. 26, s. 119(2)).

The respondent takes the view that whatever the *Income Tax Act* may provide, it cannot override the provisions of the tax treaty and, more particularly, the provisions of the Canadian statute introducing the tax treaty to the domestic law of Canada. Section 3 of that Act (which section alone in that statute relates to the issues arising on this appeal) provides as follows:

3. In the event of any inconsistency between the provisions of this Act, or the Agreement, and the operation of any other law, the provisions of this Act and the Agreement prevail to the extent of the inconsistency.

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By Article III(1) the contracting countries, Germany and Canada, agreed that industrial or commercial profits of an enterprise in Germany would not be subject to tax in Canada unless it carried on business in Canada through a permanent establishment here. Subsection (5) of Article III on the other hand excludes from such immunity income derived from within Canada by a German resident where the income arises, for example, from “dividends[,] interest, rents or royalties”. Article II(2) of the Convention provides that undefined terms in the Convention shall take the meaning which they have in the laws in force in the contracting countries. These provisions in the treaty it is convenient to set out in full, and they are as follows:

Article III

(1) The industrial or commercial profits of an enterprise of one of the territories shall not be subject to tax in the other territory unless the enterprise carries on a trade or business in the other territory through a permanent establishment situated therein. If it carries on a trade or business in that other territory through a permanent establishment situated therein, tax may be imposed on those profits in the other territory but only on so much of them as is attributable to that permanent establishment.

…

(5) Paragraphs (1) and (2) shall not be construed as preventing one of the contracting States from imposing pursuant to this Convention a tax on income (e.g. dividends[,] interest, rents or royalties) derived from sources within its territory by a resident of the other territory if such income is not attributable to a permanent establishment in the first-mentioned territory.

Article II

(2) In the application of the provisions of this Convention by one of the contracting States any term not otherwise defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws in force in the territory of that State relating to the taxes which are the subject of this Convention.

It will be seen from the combined effect of these provisions that Parliament in 1974, when s. 214(15) was introduced into the *Income Tax Act,* sought to extend withholding tax, theretofore

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referable to interest, to payments by way of guaranty fees or standby charges. The simple issue here arising is whether or not the 1974 legislation amends the Treaty so as to expose the respondent to the burden of withholding tax at the prescribed rate when making payment of the guaranty fees to the non-resident guarantor.

Urie J., writing on behalf of the Federal Court of Appeal, found that the above-mentioned sections of the *Income Tax Act* did not, when applied to the guaranty fee here in question, have the effect of converting that fee into "interest" for the purpose of s. 212 thereby necessitating the withholding of tax by the respondent pursuant to s. 215. His Lordship stated:

I am unable to agree with this contention. Whatever is the meaning of the phrase concluding the subsection, namely, "shall be deemed to be a payment of interest on that obligation" (presumably that obligation referring to the repayment of the mortgage) it is clear that it does not deem that the guarantee fee is "interest" but only that the payment of it shall be deemed to be "a payment of interest". Clearly the deeming of the payment

> to be what it is not does not change the character or nature of the thing that was paid. It could never in fact be a payment of interest because it was always a payment of a fee as consideration for the provision of the guarantee.

(Emphasis that of Urie J.)

With the greatest respect, I reach the opposite conclusion and for the purposes of this appeal would construe these sections of the *Income Tax Act* so as to obligate the respondent to effect the withholding but at the rate prescribed in the Act, namely 25 per cent rather than 15 per cent as claimed by the appellant. However, this does not by any means dispose of the appeal.

The critical issue on this appeal is whether or not Article III(5) of the Canada-Germany Agreement and s. 3 of the enacting statute interrupt the application of the *Income Tax Act* to this transaction.

As regards the definition of interest, counsel for the respondent placed reliance upon the comments of Rand J. in *Re: Farm Security Act,* [1947] S.C.R. 394 at p. 411 where His Lordship stated:

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> Interest is, in general terms, the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to, another.

Read literally, this statement would not require the payment of interest to be made to the owner of the capital advanced to the borrower. Indeed, it may be broad enough to embrace the very transaction now before the Court, namely a guaranty fee for the procurement of the money of another. If this indeed was the meaning in 1956 in the law of Canada of the term “interest”, then it can be argued that the 1974 *Tax Act* amendments are not in conflict with the 1956 statute. However, when the observation of Rand J., *supra,* is read in the context of the issue then before the Court it becomes apparent that no attempt was there being made to determine the extent of the definition of the term “interest” and I do not believe the comment should be taken as meaning that interest relates to anything other than the payment for the use of the principal advanced to the payor by the payee. Some light is shed on the above quoted passage from Rand J. when reference is made to the decision of this Court in *Bennett*

and White Construction Co. v. Minister of National Revenue, [1949] S.C.R. 287 in which the taxpayer argued that guaranty fees, like interest, were current expenses. The Court unanimously rejected the argument and Rand J., in his reasons, made the following observation at p. 293:

> Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (b). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue.

See also the judgment of Locke J. (Rinfret C.J. and Kellock J. concurring) at pp. 289-90:

> While the amounts paid to the guarantors were described as interest in the various resolutions which

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> authorized their payment, this was clearly inaccurate. Interest is paid by a borrower to a lender: a sum paid to a third person as the consideration for guaranteeing a loan cannot be so described.

Admittedly the issue in that case was different from that here raised, and the provisions of the *Income Tax Act* then before the Court were quite different. The principal question there was whether the payments in question were laid out by the taxpayer to "earn income", but none of the members of the Court suggested the payment of the guaranty fees was deductible as "interest" under the specific provision of the *Income Tax Act* relating to the payment of interest by the taxpayer.

Turning to the interpretation of "income" in Article III(5) of the Agreement, subsection (1) of Article III exempts "industrial or commercial profits" of a German enterprise wherever those profits are earned unless that German enterprise "carries on a trade or business" in Canada through a "permanent establishment" situated in Canada. This exemption of industrial and commercial profits is reduced by subs. (5) of the same Article which enables Canada (to transpose the terms of the subsection to the realities of this transaction), to tax the income of the German enterprise when it is "derived from sources within" Canada if such income (a) "is not attributable to a permanent establishment in" Canada, and (b) is "e.g. dividends[,] interest, rents or royalties". The first question arising from this analysis of the wording of the

subsection is whether or not the parenthetical expression after “income” creates a *genus* so as to limit the word “income” to like quantities or elements of income. The second question is whether or not the presence of the letters “e.g.” is limitative or expansive with reference to the preceding word “income”. Turning back to the first question, each of the four words describes a payment made in respect of an underlying or related property interest. Each is associated with the concept of income in the sense of receipts from or by reason of the ownership of shares in the case of dividends, principal in the case of interest, property in the case of rents, and rights or proper-

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ties in the case of royalties. To that extent at least there is a class created which might lead to the attribution by analogy to the word “income” of a meaning which would include guaranty fees. The guaranty payment received by the German bank from the respondent was made by the respondent in order to place the credit of the German bank within reach of the Canadian lending bank, the Bank of Nova Scotia, so as to obtain the loan in question. The asset of the German bank might by analogy be considered to be its credit worthiness and the “income” earned by that asset might be said to be the guaranty fee. In this sense Parliament, by revising the *Income Tax Act* so as to extend income to include guaranty fees received by a non-resident enterprise, would not contravene the provisions of subs. (5). This would be so not because the word “interest” has been expanded to include something else but because the word “income” has been expanded to include elements of income falling generically within the class of four but not being identical with any one and which included element is not to be excluded by the letters “e.g.”.

However, the presence of the letters “e.g.” may interrupt the application of this method of interpreting and discerning the sense of subs. (5). In my view the proper interpretation to be placed upon the parenthetical expression in subs. (5) is that it catalogues by way of illustration those items which ordinarily would be included in the exceptional term “income”, it being that type of revenue excised from industrial and commercial profits otherwise exempted by subs. (1). That being so, the illustrations must be taken in the context of the ordinary usage of the language at the time of the Agreement, in which case one can find no justification in any of the four words for excluding a fee in the nature of a guaranty fee from the previously exempted industrial and commercial profits. Further support for the view that “income” has no

independent force apart from the four parenthetical illustrations can be drawn from an examination of the succeeding articles in which

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specific regimes are set up for the taxation of dividends (Article VI), certain interest (Article VII), royalties (Article VIII) and rents (Article XIII). These articles provide maximum rates of taxation which may be imposed by the state in which they arise. On this question I am in respectful agreement with the conclusions of Urie J.:

> It will immediately be seen that Article VI deals with dividends, Article VII with "interest on bonds, securities, notes, debentures or any other form of indebtedness (exclusive of …)", Article VIII with copyright and industrial property and Article XIII with income from immovable property. All of the types of income referred to in those Articles are referred to parenthetically in paragraph 5 of Article III and as such they exemplify the kinds of income which Canada could tax notwithstanding that each might also be considered "industrial or commercial profits". The paragraph does not enable Canada to declare that a kind of income that was accorded exemption in the Convention as such profits and is not specifically provided for in the Articles that follow shall be taxable.

The next question is, with reference to Article II(2) of the Agreement, whether the term "laws in force" in Canada "relating to the taxes which are the subject of this Convention" means the laws as they existed in 1956 or the laws of Canada from time to time in force. Specifically the question is whether or not that expression includes the 1974 amendments to the *Income Tax Act.* This takes us first of all to an interpretation of the expression "relating to the taxes which are the subject of this Convention" as found at the end of subs. (2). The Convention makes industrial and commercial profits earned by a permanent establishment taxable in the country where the permanent establishment exists and where those earnings arose, and it also authorizes the taxation of "income" including dividends, interest etc. However, the Treaty does not authorize the taxation of industrial and commercial profits of a non-resident where those profits were not earned through a permanent establishment in Canada. The guaranty fee falls into the latter category. The revenue received by the non-resident bank by reason of its guaranty of a Canadian lender represents industrial and commercial profits received from within Canada but

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not earned in an entreprise carried on through a Canadian permanent establishment. Laws enacted by Canada to redefine taxation procedures and mechanisms with reference to income not subjected to taxation by the Agreement are not, in my view, incorporated in the expression “laws in force” in Canada as employed by the Agreement. To read this section otherwise would be to feed the argument of the appellant, which in my view is without foundation in law, that subs. (2) authorizes Canada or Germany to unilaterally amend the tax Treaty from time to time as their domestic needs may dictate.

It is well to remind ourselves in analysing these statutes and the subtended tax Agreement that the international Agreement does not itself levy taxes but simply authorizes the contracting parties, within the terms of the Agreement, to do so.

As I have already mentioned, s. 3 of the ratifying statute of 1956 anticipates at least in part the problem with which the Court is today faced. There is, of course, no room for debate on the proposition that Parliament is supreme and can neither bind itself nor any successor of Parliament when acting within its constitutionally-assigned sovereign jurisdiction. Obviously it follows that s. 3 or any other part of the 1956 statute can be repealed or amended. The question is not that, but whether the collateral legislative action in connection with the *Income Tax Act* has the effect of amending the 1956 statute. The suggestion that it does have such an effect is startling. There are 26 concluded and 10 proposed tax conventions, treaties or agreements between Canada and other nations of the world. If the submission of the appellant is correct, these agreements are all put in peril by any legislative action taken by Parliament with reference to the revision of the *Income Tax Act.* For this practical reason one finds it difficult to conclude that Parliament has left its own handiwork of 1956 in such inadvertent jeopardy. That is not to say that before the 1956 Act can be amended in substance it must be done by Parliament in an Act entitled “An Act to Amend the

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Act of 1956”. But neither is the converse true, that is that every tax enactment, adopted for whatever purpose, might have the effect of amending one or more bilateral or multilateral tax conventions without any avowed purpose or intention so to do.

There is no doubt, in my view, that the effect of s. 3 is to make the operation of any other law of Parliament, including the *Income Tax Act,* subject to the terms of the 1956 Act and the

incorporated Agreement. The only exception to this result would be where Parliament has expressly set out to amend the 1956 statute. Then, of course, there is no conflict between the 1956 Act and "any other law". This interpretation has the necessary result of embodying in the Agreement, by reason of Article II(2), as definitions of the words not therein defined, the meaning of those words at the time the Agreement was adopted. Thus any legislative action taken for whatever reason which results in a change or expansion of a definition of a term such as "interest" does not prevail over the terms of the 1956 statute because of the necessary meaning of s. 3 thereof.

There may be a confession of this result, albeit inadvertent, in the action taken by the appellant in assessing these guaranty fees. In its claim the Crown, through the assessment procedure and in the statement of claim, has constantly asserted the right to recover from the respondent in an amount equal to 15 per cent of the guaranty fee remitted to the non-resident bank. The rate of 15 per cent is established in Article VII of the Agreement. However, s. 212(1), *supra,* enacted for the recovery of tax from non-residents, imposes a tax at the rate of 25 per cent. If the *Income Tax Act* had the effect in law, as is alleged in the case of the definition of the word interest, of amending the Agreement, then not only would Article III(5) be amended but also Article VII so as to increase the rate of taxation from 15 to 25 per cent. No explanation was advanced by counsel for the appellant for this apparent discrepancy between the assessment and the Act or, expressed conversely, between the requirements of the *Income Tax Act* and the demand made upon the respondent and through it upon the non-resident.

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What the position of the appellant amounts to is an assertion that Canada can simply amend the Agreement by the device of redefining the term interest. As has already been noted, interest in the ordinary commercial usage of that term simply means the payment of rent by a borrower for the use of the principal of the lender to whom the rent is paid. It may be that the money flow will be different than this simple definition would indicate by reason of directions or special circumstances, but essentially the payment is made by the payor for the use of the payee's principal. Here the respondent was not a borrower from the guarantor and it has made no payment to the guarantor for the use of the guarantor's principal. The consequence of the 1974 tax amendment therefore, as urged by the appellant, is simply a purported

exercise of a unilateral right to effectively amend the Agreement deliberately entered into and implemented by legislation by Canada in 1956. The Agreement provides, as for example in Article XXIII(2), for alterations to it by unilateral action but these are exceptional and explicit. That same Article establishes a procedure for termination by notice terminating the Agreement effective the 1st day of January next following the giving of notice. Subsection (2) provides a method for termination of rates established in Article VII, *supra,* and other Articles. This requires the giving of notice by one country to the other on or before the 30th day of June in any year so as to revise the rate effective the 1st of January following. No notice of termination appears in the record here. It is in lieu of all these procedures enacted by Parliament that the appellant directs our attention to the above sections of the 1974 *Income Tax Act* as producing the same result.

On this leg of the argument, therefore, I conclude that the 1956 statute has introduced into our domestic law the terms of the international Agreement and that properly construed that Agreement does not authorize the taxation by domestic law of the guaranty fee by Canada. I also reach the conclusion that the introduction of provisions relating to interest by the amendments of 1974 to the *Income Tax Act* of Canada evidences no intention by Parliament to amend the 1956 statute. I

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note also that this conclusion is in accord with that reached by Mahoney J. when considering the Canada-U.S. Convention in *Associates Corporation of North America v. The Queen,* [1980] 2 F.C. 377 aff'd [1980] 2 F.C. 382. In his reasons for judgment Mr. Justice Mahoney concluded [at p. 381]:

> The guarantee fees paid to the plaintiff are not interest within the terms of the Canada-US Tax Convention. Paragraph 214(15)(*a*) of the *Income Tax Act* deeming them to be interest is inconsistent with the Convention and, by virtue of section 3 of the Act that makes the Convention part of Canada's domestic law, paragraph 214(15)(*a*) cannot apply to guarantee fees subject to the Convention. The fees in issue were a component of the plaintiff's industrial and commercial profits which were not taxable by Canada since the plaintiff was a United States enterprise having no permanent establishment in Canada.

The Court was directed to a number of cases from the United Kingdom dealing with the relationship said to exist between legislatively-adopted treaties and domestic statutes

generally. Only a few of these authorities can be said to have any bearing on the issue raised in this appeal. I refer firstly to *Inland Revenue Commissioners v. Collco Dealings Ltd.,* [1962] A.C. 1 in which the House of Lords considered an amendment to United Kingdom income tax legislation which was intended to put an end to the practice of "dividend stripping", the paying of dividends out of profits accumulated before the date on which the shares were acquired. The precise issue before their Lordships was whether the opening words of the provision, "… a person entitled under any enactment to an exemption from income tax which extends to dividends … ", should be read to include a resident of Ireland whose dividends would otherwise be exempted by a U.K.-Irish Agreement. Their Lordships concluded, affirming the Court of Appeal and Vaisey J., that the plain words of the enactment extended to the exemption for Irish residents. Viscount Simonds, at p. 19, declared:

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> It would not, I think, be possible to state in clearer language and with less ambiguity the determination of the legislature to put an end in all and every case to a practice which was a gross misuse of a concession.

Similarly in *Woodend (K.V. Ceylon) Rubber and Tea Co. v. Commissioner of Inland Revenue,* [1971] A.C. 321, the Privy Council concluded that the Legislature of Ceylon had intended the expression "non-resident company" to apply so as to override any inconsistencies with a 1950 U.K. Agreement, holding that "the general words must receive their full meaning" (*per* Lord Donovan at p. 335). These cases add little to the analysis of the present appeal as the terms of the 1974 amendments to the Canadian *Income Tax Act* evidence no comparable intention by the Canadian Parliament to override the 1956 Agreement.

In the final analysis the appellant must fail because the 1956 statute, being the legislative adoption of the international tax Agreement, has not been amended by the income tax amendments of 1974 and accordingly Article III(1) of the Agreement prevents the application of the *Income Tax Act* to the guaranty fees paid by the respondent to the non-resident bank. Accordingly the appeal should be dismissed with costs.

Appeal dismissed with costs.

Solicitor for the appellant: R. Tassé, Ottawa.

Solicitors for the respondent: Blaney, Pasternak, Smela and Watson, Toronto.