The Estate of the late John N. Gladden (Plaintiff) v. Her Majesty the Queen (Defendant)

85 DTC 5188

Federal Court -- Trial Division

January 28, 1985

Tax conventions -- Deemed disposition on death -- Capital gains on deemed disposition of shares of privately owned Canadian corporations by U.S. citizen and resident -- Capital gains exempt as 'sale or exchange' of capital assets under Article VIII of Canada-U.S. Tax Treaty -- Income Tax Act, S.C. 1970-71-72, c. 63, s. 70(5).

At his death, the taxpayer, an American citizen and resident, owned shares in two privately controlled Canadian companies. The Minister took the position that there was a deemed disposition of the shares on the taxpayer's death and that the taxpayer was liable for capital gains tax on the deemed disposition. On appeal by the taxpayer's estate, the Tax Court of Canada (84 DTC 1242) found that there was a deemed disposition of the shares on death and that the resultant capital gains were not exempt from taxation by virtue of the relevant tax treaty. The taxpayer's estate further appealed to the Federal Court -- Trial Division.

Held: The estate's appeal was allowed. The Court found that capital gains were exempt as 'sale or exchange' of capital assets under the Canada-U.S. tax treaty. Canada had no capital gains tax when it entered the treaty. It could not unilaterally amend its tax legislation contrary

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to the treaty except by amending the statute which adopted the treaty. The words of a tax convention should be given a liberal interpretation with a view to implementing the true intentions of the contracting parties. Although neither state reserved the right to tax capital gains arising on deemed dispositions, the term 'sale or exchange', as used in the treaty, included a deemed disposition on death.

Counsel: J. Saunders for the plaintiff; J. Kennedy for the defendant. Solicitors: J. Saunders for the plaintiff; R. Tassé, Q.C., Deputy Attorney General for Canada, for the defendant.

Addy, J. There is no dispute as to the facts in this case.

Facts

The deceased, an American citizen and resident, died there during the 1977 taxation year. At the time of his death he owned shares in two privately controlled Canadian companies.

A capital gain of $75,387.50 was reported at the time of death on the basis of a deemed disposition of the shares pursuant to Section 70(5)(a) of the Income Tax Act. The estate claimed exemption from taxation pursuant to Article VIII of the Canada-U.S. Tax Convention. The Minister maintained the assessment claiming the tax was payable thereon and that the provisions of the Treaty were not applicable to the present case.

An appeal against the assessment was brought before the Tax Appeal Court [84 DTC 1242]. On the basis that the deceased had been married to Mary A. Gladden in California under the community of property regime of that state, the Tax Appeal Court held that the capital gain was taxable only on one-half of the value of the shares since the wife was fully entitled to her one-half interest. This part of the decision is now undisputed.

Issue

The issue before me involves the question of whether the capital gain on one-half of the total value of the shares is taxable or exempt.

Article VIII of the 1942 Canada-United States Convention and Protocol, which was the formal name of the Treaty, reads as follows:

ARTICLE VIII

Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

Section 70(5)(a) of the Income Tax Act provides as follows:

70(5) Depreciable and other capital property of deceased taxpayer. Where in a taxation year a taxpayer has died, the following rules apply:

(a) the taxpayer shall be deemed to have disposed, immediately before his death, of each property owned by him at that time that was a capital property of the taxpayer (other than depreciable property of a prescribed class) and to have received proceeds of disposition therefor equal to the fair market value of the property at that time;

The plaintiff argues that the intention of the parties was obviously to exempt non-residents of each country from capital gains tax which that country might impose. Canada, in fact, did not have a capital gains tax at the time but the wording of Article VIII is quite clear. I therefore fail to understand the finding of the Tax Court below to the effect that because Canada had no capital gains tax it was not and is not bound by Article VIII. After quoting the article textually, the learned Judge summarily rejected the argument with which I am dealing in the following terms: 'the parties could not have negotiated to avoid double taxation on a tax which did not exist in Canada.' It seems to be trite law that nobody can contract in anticipation of the possible occurrence of a future event.

Treaty Implications

It is important to note in reading Article VIII that neither country reserved the right to tax a gain arising out of a deemed disposition. There are no exceptions, exclusions, limitations or provisos in the Article or anywhere else in the Treaty which might affect restrictively its application.

The Treaty was adopted, approved and made part of the domestic tax laws of Canada by the Canada-United States of America Convention Act, 1943, 7 George VI C.21. It is obvious that since a Treaty is a contract, Canada cannot unilaterally amend its tax legislation contrary to the Treaty except by amending that particular statute which adopted the Treaty. Furthermore

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this general principle of law is emphasized and spelled out statutorily in section 3 of that Act which specifically provides that, should there be any inconsistency between any part of the Treaty and the operation of any other law of Canada the former shall prevail.

Case law

The case of The Queen v. Melford Developments, 81 DTC 5020 (F.C.A.) and 82 DTC 6281 (S.C.C.) is very much in point. Both divisions of the Federal Court, as well as the Supreme Court of Canada, held in favour of the taxpayers who were originally assessed on the basis that they had failed to pay non-resident's withholding tax on guarantee fees paid to a German bank. They, in turn, argued that they were exempt since industrial or commercial profits were exempted under the provisions of the Canada-Germany Tax Convention of 1956 and on the grounds that the guarantee fees had to be classified as such. The Minister argued that, pursuant to a 1974 enactment which provided that guarantee fees would be deemed to be interest, a non-resident withholding tax was payable. Section 3 of the Act adopting the Canada-German Treaty is identical to Section 3, which I have quoted supra, of the legislation adopting the Canada-U.S. Treaty. Urie, J., of the Federal Court of Appeal, had this to say regarding the inviolability of a tax treaty (refer p. 5024 of the report):

The paragraph (i.e. paragraph 5 of Article III which allowed Canada to tax interest) 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. Such a unilateral action would not be possible, in my view, because it would be in violation of the terms of a binding agreement freely entered into by sovereign states. Such an agreement can only be varied or amended by agreement of the parties not by the action of one party in changing its tax laws by the enactment of a section such as section 214(15) in 1974 some 18 years after the agreement was entered into.

On the same subject Estey, J., in the Supreme Court of Canada remarked (see pp. 6285-6286 of the above mentioned report):

. . .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 sub.(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.

. . .

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 twenty-six concluded and ten 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 Act of 1956'. But neither is the converse true, that is that every tax enactment, adopted for whatever purpose, might have the affect [sic] 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 Art. 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 of 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 . . .

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. (emphasis added)

The same result was arrived at on the same basis in the case of The Queen v. Associates Corporation of North America, 80 DTC 6140 (F.C.A). (Refer also: Doris Lillian Gadsden v. M.N.R., 83 DTC 127.) The next issue involves the interpretation which must be given to the

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Treaty interpretation

Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.

Article 31 of the Vienna Convention on the Law of Treaties (1969) to which Canada subscribed governs the general rule of interpretation to be applied. Paragraph 1 of that Article reads as follows:

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

Case law

The case of The Queen v. John Cruikshank, 77 DTC 5226, dealt with a resident of France who received a lump sum payment from a Canadian company to commute a pension. The Canada-France Treaty provided that pensions were exempt from tax where the person did not reside in the taxing state. The Minister argued that the payment was taxable because the ordinary dictionary or lexicon meaning of the word 'pension' does not include a lump sum payment. That argument of the Minister was categorically rejected by Gibson, J. of our Court who held that the word 'pension' should, for the purpose of the treaty, be given a wider meaning than its lexicon meaning. (Refer p. 5227 of the above mentioned report; see also William Vincent Saunders v. M.N.R., 54 DTC 524 (TRB)). A statement of the law as to the interpretation in these cases is to be found at p. 526 of the report. The passage was quoted with approval on two occasions by Trial Judges of the Federal Court, namely by Walsh, J. in Canadian Pacific Limited v. The Queen, 76 DTC 6120 at 6134, and by Grant, D.J. in Melford Developments v. The Queen, 80 DTC 6074 at 6076. The passage reads as follows:

[Tax convention liberally interpreted]

The accepted principle appears to be that a taxing Act must be construed against either the Crown or the person sought to be charged, with perfect strictness -- so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome.

(Refer also: Ezra Shahmoon v. M.N.R., 75 DTC 275 at 276.) The Courts of the United States, the other signatory of the Tax Convention in issue here, have come to the same conclusion as to the method of interpreting treaties of this nature. (Refer decision of U.S. Supreme Court in the case of in Re Ross, 140 U.S. 1891; The Great West Life Assurance Company v. U.S.A., U.S. Court of Claims No. 114-79T.)

I fully agree with and adopt the statement of David A. Ward in his paper on The Principles to be Applied in Interpreting Tax Treaties, which is reproduced at page 264 of the 1977 Canadian Tax Journal. The passage in question reads as follows:

. . .In interpreting and applying treaties, the courts have said they should be prepared to extend 'a liberal and extended construction' to avoid an anomaly 'which a contrary construction would lead to'. As the court has recognized that we cannot expect to find the same nicety of strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy, but rather to adopt more liberal terms.

Therefore, the weight of authority would appear to be against the type of strict interpretation of a tax treaty which would normally be applied to an exempting provision of fiscal legislation. The justification for this general rule of interpretation probably lies in the contractual nature of a tax treaty rather than in its formal ratification by Parliament as legislation. (emphasis added)

Article 32 of the Vienna Convention, supra, entitled 'Supplementary Means of Interpretation' provides:

Article 32

Supplementary Means of Interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

(a) leaves the meaning ambiguous or obscure, or
(b) leads to a result which is manifestly absurd or unreasonable.

(emphasis added)

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Analysis

As to the surrounding circumstances when the treaty was signed, Canada had no capital gains tax legislation and the U.S. legislation at the time used the terms 'sale or exchange'. This accounts for the reason why those very words were used in the treaty. There seems to be little doubt, however, that the general intention was to exempt non-residents of each of the contracting countries from capital gains taxes generally. With regard to paragraph (b) of Article 32 of the Vienna Convention, supra, regarding the avoidance of a result which might be manifestly unreasonable or absurd, to hold that a deemed disposition would, as claimed by the Minister, be taxable as a capital gain while a true sale or exchange would not, would be both unreasonable and absurd. Real commercial transactions would be taxable while artificially created ones would not. In the case at bar, for instance, it is abundantly clear that had the deceased disposed of the shares immediately before his death in consideration of payment of the full market value thereof, his estate would not have been taxable in any way on a capital gain. Yet, because he died and there is deemed to be a disposition of the shares, the result would be that his estate would be taxable although no real 'sale or exchange' or other disposition actually took place.

The estate was taxed in the United States on the shares on the basis of an estate tax liability and certain arguments were addressed to the question of whether taxation on the value of an asset pursuant to an estate tax or succession duty statute in one country can be considered double taxation when the incidence of the tax on the same asset arising out of the same event is based on a capital gain in the other country. There is no need, in my view, to determine this issue at all since, on a simple reading of Article VIII, it seems evident that double taxation is neither a condition nor a prerequisite for invoking the protection of the treaty. The non-resident can benefit from the exemption regardless of whether or not he is taxable on that capital gain in his own country. If Canada or the U.S. were to abolish capital gains completely, while the other country did

not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country. This in effect was the situation between the time the treaty took effect and Canada in fact first imposed a capital gains tax. During that period Canadians could benefit from Article VIII.

Article XVI provides for a procedure for a taxpayer to lodge a claim in his own state for a review of the question by both states but this need only be invoked by the taxpayer where the Convention does not specifically provide for exemption and the taxpayer feels that there is in fact double taxation. This Article does not in any way remove from this Court the jurisdiction of determining whether in a case such as the present one a non-resident is at law entitled to benefit from a specific exemption provided for in the treaty.

The defendant relied also on certain statements in the case of Holbrook R. Davis v. The Queen, 78 DTC 6374, where Decarie, J. made certain assertions regarding 'deemed dispositions' as they affect non-residents. The facts of the case, however, indicate clearly that the taxpayer was a Canadian resident and not a non-resident when the deeming provisions apply. The statement relied upon by the defendant therefore constitutes obiter dictum. When the case went to the Court of Appeal the statements were not relied upon in any way and the appeal was decided on the sole ground that the appellant taxpayer was in fact a resident of Canada at the time the provisions applied against him.

Appeal allowed

For the above reasons, the claim will be allowed with costs. The assessment will be set aside and the matter referred back to the Minister for re-assessment on the basis that the capital gains on the stocks in issue were not taxable for the year 1977.