



Interpreting and Applying Deeming Provisions of the Income Tax Act

Michael N. Kandev
mkandev@dwpv.com

John J. Lennard
jlennard@dwpv.com



DAVIES

Interpreting and Applying Deeming Provisions of the Income Tax Act

Michael N. Kandev and John J. Lennard*

PRÉCIS

Les dispositions déterminatives sont une caractéristique familière des textes législatifs canadiens, en général, et des lois, règlements et conventions fiscales, en particulier. Cet article se divise en deux parties. Dans la première partie, les auteurs font une analyse théorique de l'interprétation et de l'application des règles déterminatives. Ils traitent de la classification des règles déterminatives, de la force des présomptions qu'elles créent, de leur champ d'application et de leur incidence. Dans la deuxième partie de l'article, ils examinent d'un point de vue pratique la règle controversée sur les intérêts réputés du paragraphe 214(7) de la Loi de l'impôt sur le revenu. En particulier, les auteurs considèrent si l'intérêt réputé découlant de la conversion en actions d'une débenture d'un émetteur canadien serait des intérêts sur des créances participatives de sorte que la retenue d'impôt s'appliquerait malgré que le non-résident et l'émetteur canadien n'aient pas de lien de dépendance.

ABSTRACT

Deeming provisions are a familiar feature of Canadian legislative texts in general, and Canadian tax statutes, regulations, and treaties in particular. This article is divided into two parts. In the first part, the authors undertake a theoretical discussion of the interpretation and application of deeming rules. They discuss the classification of deeming rules, the strength of any presumption they create, their scope of application, and their effect. The second part of the article analyzes from a practical perspective the controversial deemed interest rule in subsection 214(7) of the Income Tax Act. Specifically, the authors consider whether any deemed interest arising on the conversion for shares of a debenture of a Canadian issuer would be participating debt interest, with the result that withholding tax would apply notwithstanding that the non-resident and the Canadian issuer are at arm's length.

KEYWORDS: STATUTORY INTERPRETATION ■ DEEMING PROVISIONS ■ TAX LEGISLATION ■ APPLICATION

* Of Davies Ward Phillips & Vineberg LLP, Montreal (e-mail: mkandev@dwpv.com; jlennard@dwpv.com). We would like to thank the external reviewers for this journal for their helpful suggestions and comments. Any errors and omissions remain our responsibility.

CONTENTS

Introduction	276
Interpretation and Application of Deeming Provisions	277
Classification	277
Deeming Rules That Create a Legal Fiction	279
Deeming Rules That Declare the Law	279
Deeming Rules That Declare Certain Facts as Established	281
Deeming Rules That Confer Discretion	281
Distinguishing the Different Types of Deeming Provisions	282
The Strength of the Presumption	283
Scope of Application	285
The Effect of a Legal Fiction	287
Does a Legal Fiction Supplant or Supplement Reality?	287
Is a Legal Fiction To Be Applied Restrictively or Broadly?	290
Conclusions	293
Deeming Provisions in Practice: Subsection 214(7)	295
Background	295
Classification of the Provision	297
Application of the Deemed Interest Rule	298
Scope of Subsection 214(7)	298
Can the Subsection 214(7) Deemed Interest Payment Be “Participating Debt Interest”?	298
Effect	302
Conclusion	302

INTRODUCTION

Deeming provisions are a familiar feature of Canadian legislative texts: in particular, the term “deem”¹ and its variants appear over 4,600 times in various statutes and over 1,900 times in regulations.² With 399 appearances in the Income Tax Act³ and 19 in the Income Tax Regulations, “deem” is also a fixture in Canadian income tax law.⁴

Deeming rules are typically thought of as creating legal fictions. Though this is the most common use of such provisions in the Act, it is not their only use. The purpose of this article is to consider, from a Canadian tax perspective, the theoretical and practical aspects of the different types of deeming rules.⁵

-
- 1 As discussed below, a deeming provision does not necessarily require the use of the word “deem” or any of its variants. See *infra* note 6.
 - 2 Canada, Department of Justice, “Deem” (www.justice.gc.ca/eng/dept-min/pub/legis/n8.html).
 - 3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.
 - 4 Deeming rules also appear 720 times in Canada’s tax treaties.
 - 5 It does not appear that the interpretation and application of deeming rules from a tax perspective has been discussed extensively in the literature. For a prior article on the subject, see Cindy Harvey, “Où la fiction s’arrêt-t-elle?” (2007) 55:1 *Canadian Tax Journal* 72-105. For a discussion

This article is divided into two parts. In the first part, we undertake a theoretical discussion of the interpretation and application of deeming rules, drawing on selected decisions from the case law. We begin by setting out a framework for the classification of deeming provisions according to their purpose and discuss certain difficulties that may arise in assigning a specific provision to a particular category. We then discuss the strength of any presumption created by a deeming provision, the scope of application of deeming provisions, and their effect.

In the second part of the article, we apply the concepts discussed in the first part in analyzing the controversial deemed interest rule in subsection 214(7). Specifically, we consider whether any deemed interest arising under subsection 214(7) on the conversion for shares of a debenture of a Canadian issuer would be “participating debt interest” under subsection 212(3), to the effect that the withholding tax under paragraph 212(1)(b) would apply notwithstanding that the non-resident and the Canadian issuer are at arm’s length. Our analysis employs different methods of interpretation in determining the effect of the relevant rules in part XIII of the Act, and we conclude that regardless of which method is used—whether strict, expansive, or contextual and purposive—such deemed interest should not constitute participating debt interest that is subject to Canadian withholding tax.

INTERPRETATION AND APPLICATION OF DEEMING PROVISIONS

This part of the article considers the interpretation and application of deeming provisions in the context of the Act. It discusses the classification of deeming rules, the strength of any presumption they create, their scope of application, and their effect.

Classification

While deeming provisions are used frequently in the Act and the regulations, the word “deem” and its variations are not defined for tax purposes.⁶ The *Concise Oxford Dictionary*, 8th ed., defines the verb “to deem” as “believe, consider, judge, or count, to be.” *Webster’s Ninth New Collegiate Dictionary* provides the following meanings: “to come to think or judge: consider; to have an opinion: believe.” These dictionary definitions, by themselves, are hardly helpful. Some synonyms, such as “believe,” suggest the consideration of something as true notwithstanding the impossibility of proving it to be so. Other synonyms, such as “judge” or “consider,” indicate the

of legal fictions in US tax law, see John A. Miller, “Liars Should Have Good Memories: Legal Fictions and the Tax Code” (1993) 64:1 *University of Colorado Law Review* 1-55.

6 Actually, a deeming provision does not necessarily require the use of the word “deem” or any of its variants. For example, in *R v. Verrette*, [1978] 2 SCR 838, at 847, the Supreme Court of Canada held that the word “is” as used in former section 170(2) of the Criminal Code (RSC 1970, c. C-34) means “shall be deemed to be.” Also, as discussed below, the word “presume” creates a deeming provision.

forming of an opinion based on reasoned weighting of evidence. Given the highly ambiguous ordinary meaning of the word “deem,” the context and purpose of its use are key to its understanding.⁷

In the legal context, deeming provisions are generally thought of as creating a fiction—that is, declaring that legislation is to be applied as if something were different from what it actually is. *Black’s Law Dictionary*, 9th ed., gives as the main definition of the verb “deem” “[t]o treat (something) as if (1) it were really something else, or (2) it had qualities that it does not have.” Similarly, in *Verrette*, Canada’s seminal case on deeming rules, Beetz J, speaking for the Supreme Court of Canada, noted:

A deeming provision is a statutory fiction; as a rule it implicitly admits that a thing is not what it is deemed to be but decrees that for some particular purpose it shall be taken as if it were that thing although it is not or there is doubt as to whether it is. A deeming provision artificially imports into a word or expression an additional meaning which they would not otherwise convey beside the normal meaning which they retain where they are used; it plays a function of enlargement analogous to the word “includes” in certain definitions; however, “includes” would be logically inappropriate and would sound unreal because of the fictional aspect of the provision.⁸

However, creating a legal fiction is only one possible function of a deeming provision. Sullivan classifies deeming rules into four broad categories according to their purpose:⁹

1. to create a legal fiction by declaring that something exists or has occurred regardless of the truth of the matter;
2. to declare the law;
3. to create a legal presumption by declaring that certain facts are to be taken as established; and
4. to confer discretion.

In the discussion that follows, we describe each category in further detail, and then comment on the complexity of determining the appropriate classification of certain deeming provisions of the Act.

7 This approach is consistent with the “one principle of [statutory] interpretation” affirmed by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at paragraph 40; also see *infra* note 71 and the accompanying text.

8 *Verrette*, *supra* note 6, at 845.

9 Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham, ON: LexisNexis Canada, 2008), at 85-91. Although Sullivan identifies functions in categories 2 and 4, she does not elaborate on these themes much further.

Deeming Rules That Create a Legal Fiction

The most common use of “deem” is to create a legal fiction.¹⁰ The Act contains a plethora of such deeming rules. The reason for using them is generally to give equal treatment to two transactions that are different in legal substance but analogous in economic effect.¹¹

For example, the effect of the deemed dividend rules in section 84 is that a dividend declared and paid in accordance with applicable corporate law is taxed in the same way as, for example, redemption proceeds or payments on reduction of capital to the extent that such proceeds or payments exceed paid-up capital (PUC). The logic behind the legal fiction of section 84 appears obvious: although a redemption or a reduction of capital is not technically the same as the declaration of a dividend, economically it is a distribution of corporate surplus (to the extent of any excess over PUC) and therefore equivalent to a dividend.

This logic is taken to the next level in the deemed dividend anti-avoidance rule in section 84.1.¹² In essence, section 84.1 aims to prevent the stripping of corporate surplus in certain cases where low PUC shares of a Canadian-resident corporation have been the subject of a non-arm’s-length transfer by a Canadian-resident taxpayer (other than a corporation). Where certain conditions have been met on such a non-arm’s-length transfer, subsection 84.1(1) may trigger an immediate deemed dividend to the transferor in respect of consideration other than shares. The concept of section 84.1 is that an indirect extraction of corporate surplus through a non-arm’s-length transfer, though legally not at all the same as a dividend, should be treated the same as a dividend for the purposes of the Act. We discuss this deeming rule in more detail later in this article.

Deeming Rules That Declare the Law

Deeming rules that declare the law do not aim at creating a fiction; rather, they establish an irrebuttable presumption regarding the meaning of a particular word or expression. Typically, the purpose of such a rule is to conclusively clarify the meaning of a term that may be particularly ambiguous or may imply a value judgment, and to eliminate any controversy over the application of a particular provision.

10 Ibid., at 69. While sovereign legislatures cannot change reality, they can declare it to be different from what it is or was, and such fictions must govern even in the face of irrefutable evidence to the contrary. See generally, regarding legal fictions, Gilles Létourneau, “Les fictions en droit public,” in Ysolde Gendreau, ed., *Les fictions du droit/Fictions in the Law* (Montréal: Éditions Thémis, 2001), at 14-15. See also Yan Thomas, “L’empire de la fiction romaine et ses limites médiévales” (1995) 21-22 *Droits—Revue française de théorie juridique* 17-63, at 19; Guillaume Wicker, *Les fictions juridiques : Contribution à l’analyse de l’acte juridique* (Paris: LGDJ, 1997), at 14; and Jean-Louis Bergel, “Le rôle des fictions dans le système juridique” (1988) 33:2 *McGill Law Journal* 357-86.

11 See Harvey, *supra* note 5, at 78-80. Harvey notes that this legislative technique is an effective way to adapt statutes to legal and commercial developments: *ibid.*, at 78.

12 See also section 212.1.

Take, for example, paragraph 251(1)(a), which states that, for the purposes of the Act, related persons are deemed not to deal with each other at arm's length. It may seem obvious, and certainly not fictitious, that related persons, such as a father and a child,¹³ do not deal with each other at arm's length. Conceivably, paragraph 251(1)(a) could have been drafted as a merely inclusive definition, which could provide that persons who do not deal with each other at arm's length include related persons. However, likely because the arm's-length notion is so important to the Act, and vagueness could potentially spur controversy, Parliament chose to conclusively declare that related persons are considered not to deal with each other at arm's length.¹⁴

Consider further the example of the deeming provision in subsection 247(4) as it relates to the transfer-pricing penalty in subsection 247(3). In general terms, subsection 247(3) states that a taxpayer is liable to a penalty for a taxation year if the total amount of the taxpayer's "reduced" transfer-pricing income and capital adjustments for the year exceeds the lesser of 10 percent of the taxpayer's gross revenue for the year and \$5 million. A taxpayer's transfer-pricing income and capital adjustments are reduced, *inter alia*, to the extent that they can reasonably be considered to relate to a transaction in respect of which the taxpayer made "reasonable efforts" to determine arm's-length transfer prices or arm's-length allocations and to use those prices or allocations for tax purposes. Whether a taxpayer has made such reasonable efforts is determined under the so-called contemporaneous documentation rule in subsection 247(4). Essentially, subsection 247(4) requires a taxpayer to document its transactions that are governed by subsection 247(2), failing which the taxpayer will be liable to the penalty in subsection 247(3). Technically, subsection 247(4) is drafted as a deeming rule that provides that a taxpayer is deemed not to have made reasonable efforts to determine and use arm's-length transfer prices or arm's-length allocations in respect of a transaction unless the taxpayer complied with the documentary requirements set out in paragraphs 247(4)(a) to (c).

This deeming provision in subsection 247(4) cannot be seen to create a legal fiction. Actually, it may be quite realistic to state that a taxpayer who has not complied with the contemporaneous documentation requirements has not made a reasonable effort to determine and use arm's-length transfer prices or arm's-length allocations in respect of a transaction. However, the expression "reasonable efforts" has an elusive meaning. Absent the irrebuttable presumption created by subsection 247(4), taxpayers and the Canada Revenue Agency (CRA) may not agree on what constitutes "reasonable efforts" in a particular case. To avoid such disagreements and unnecessary litigation, the Act therefore conclusively establishes threshold transfer-pricing documentation requirements for the purposes of the penalty in subsection 247(3).

13 Paragraph 251(2)(a).

14 If this were not the case, a father and a child could potentially argue that, though related by blood, they deal at arm's length, either because they are on bad terms or because their dealings are in a strictly commercial context.

A final example, in a tax treaty context, is the deeming rule in article 13(5) of the capital gains article of the Canada-Korea tax treaty.¹⁵ This provision states that gains from the alienation of shares forming part of a “substantial interest” in the capital of a company that is a resident of a contracting state may be taxed in that state according to the laws of that state. Article 13(5) goes on to state that for the purposes of that provision, a substantial interest is deemed to exist when the alienator, alone or together with associated or related persons, holds directly or indirectly 25 percent of the total shares issued by the company.¹⁶ Again, there is nothing fictitious in considering a 25 percent interest to be “substantial,” but given the value judgment involved in interpreting the meaning of this term, Canada and Korea have chosen to create an irrebuttable presumption about the requisite threshold percentage.

Deeming Rules That Declare Certain Facts as Established

Deeming rules that declare certain facts as established create a presumption that accepts something as fact without the benefit of evidence.¹⁷ The presumption created by such a deeming provision may be either conclusive or rebuttable. The latter type may be useful to deal with an evidentiary difficulty. The purpose of the former is rather to create a legal rule: since legal consequences attach to a set of facts, if the facts are conclusively presumed, the legal consequences follow automatically in all circumstances.¹⁸

An example of a rule that declares facts as established is subsection 244(15), which provides that an assessment is deemed to have been made on the day of mailing of the notice of assessment. This provision is considered in more detail below.

Deeming Rules That Confer Discretion

Statutory powers of all types are often exercisable when a designated holder of the power “deems” something. In this context, “deem” is employed to confer discretion and is synonymous with the words “consider” or “decide.”¹⁹

The Act contains a few examples of the word “deem” being used in this fashion. One instance is paragraph 149.1(15)(a), which states that the information contained

15 The Convention Between the Government of Canada and the Government of the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on September 5, 2006.

16 Interestingly, article 13(5) does not refer to the holding of “more than 25 percent” or “25 percent or more” of the total shares issued by the company, suggesting, on its face, that only a 25 percent interest is a substantial interest. Presumably the intention of the contracting states is that a 25 percent or greater interest would be a substantial interest.

17 Sullivan, *supra* note 9, at 89. In this respect, the meaning of “deem” here appears similar to “believe.”

18 *Ibid.*, at 91.

19 See *Black’s Law Dictionary*, 9th ed., according to which a second meaning of “deem” is “[t]o consider, think, or judge.”

in a public information return of a charity shall be made available to the public by the minister “in such manner as the Minister deems appropriate.”

Distinguishing the Different Types of Deeming Provisions

Among the four types of deeming provisions, the most easily distinguishable use of “deem” is to confer discretion. In this type of deeming rule, the legislator has clearly identified the authority that is to exercise the discretion—that is, to do the “deeming.” By contrast, the other types of deeming provisions are drafted in the passive voice, since it is understood that Parliament is the deeming authority.

The difference between deeming provisions that create a legal fiction and those that conclusively declare the law should, in theory, be easily distinguishable: whereas one declares the law to be different from reality, the other merely clarifies the reality of the law. In practice, however, the distinction may be far from obvious. Consider, for example, subsection 248(10), which states that, for the purposes of the Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series. In *OSFC Holdings Ltd.*,²⁰ Canada’s leading decision on this provision, the Federal Court of Appeal concluded that the deeming rule in subsection 248(10) creates a legal fiction. Specifically, the court regarded this rule as extending the meaning of “series” beyond the common-law interpretation of the term, and held that subsection 248(10) requires three things: first, a series of transactions within the common-law meaning;²¹ second, a transaction related to that series; and third, the completion of the related transaction in contemplation of that series. In reaching this conclusion, the court observed that subsection 248(10) is a deeming provision and that a deeming provision imports into a term a meaning that the term would not otherwise convey (that is, it creates a fiction). In this regard, the court relied on the Supreme Court’s decision in *Verrette* and held that the deeming nature of subsection 248(10) implies an enlargement of what the Federal Court of Appeal called “the common law series.” In *Canada Trustco*, the Supreme Court of Canada generally endorsed the interpretation of subsection 248(10) in *OSFC* as part of its guidance on the construction and application of the general anti-avoidance rule in section 245.²² Most recently, the Supreme Court adopted the approach to subsection 248(10), as

20 *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260.

21 On the basis of UK case law, the Federal Court of Appeal decided that “for there to be a series of transactions, each transaction in the series must be pre-ordained to produce a final result. Pre-ordination means that when the first transaction of the series is implemented, all essential features of the subsequent transaction or transactions are determined by persons who have the firm intention and ability to implement them. That is, there must be no practical likelihood that the subsequent transaction or transactions will not take place.” *Ibid.*, at paragraph 24.

22 *Canada Trustco*, supra note 7, at paragraphs 25-26.

developed in *OSFC* and as elaborated in *Canada Trustco*, in its ratio decidendi in *Coptborne*.²³

In none of the above decisions did the courts consider the possibility that the function of the deeming rule in subsection 248(10) may be other than to create a legal fiction. In this regard, arguably subsection 248(10) should rather be seen as declaring the law for the purpose of clarifying the meaning of the series concept in the Act. Under this conception, there is no “common-law” series or “deemed” extended series under the Act; there is just a single notion of series, which subsection 248(10) merely aims at conclusively clarifying.²⁴ This interpretation of subsection 248(10) supports the taxpayer’s position in *Coptborne*; however, the Supreme Court refused to accede to this view and instead chose to entrench the approach in *OSFC* and *Canada Trustco*.

According to Harvey, the difference between deeming provisions that create a legal fiction and those that presume certain facts as established is that the former is based on the certainty of the fictitious whereas the latter is based on the uncertainty of the true.²⁵ However, to the extent that a presumption of fact is not rebuttable, it becomes essentially indistinguishable from a legal fiction.²⁶ This is because, as previously noted, where facts are conclusively presumed, their legal consequences follow automatically and effectively result in a legal fiction.

Finally, the difference between deeming provisions that presume certain facts as established and those that declare the law should be, in principle, distinguished on the basis that the former declare certain *facts* to be true where the latter declare the *law* to be true. In practice, difficulties may arise in distinguishing questions of fact and questions of law.

The Strength of the Presumption

The strength of a deeming provision refers to whether any presumption it creates is conclusive or rebuttable. Presumptions of law are conclusive.²⁷ Factual presumptions

23 *Coptborne Holdings Ltd. v. The Queen*, 2007 TCC 481; aff’d. 2009 FCA 163; aff’d. 2011 SCC 63.

24 For detailed analysis of this argument, see Michael Kandev, Brian Bloom, and Olivier Fournier, “The Meaning of ‘Series of Transactions’ as Disclosed by a Unified Textual, Contextual, and Purposive Analysis” (2010) 58:2 *Canadian Tax Journal* 277-330. According to the authors, *ibid.*, at 326, “[a] series of transactions comprises two or more related transactions planned by the taxpayer (or the mind directing the taxpayer) as one logical whole and completed in a predetermined sequence and without genuine interruption with the intention of achieving a particular common objective, purpose, or result. An initial transaction will form part of a series if, at the time that the transaction is carried out, it is contemplated that the subsequent transactions constituting the series will be implemented, and the subsequent transactions are eventually carried out. Such contemplation will be considered to exist, on the basis of objectively ascertainable facts, either (1) where the series has been precontracted or has been agreed upon in principle so that there is no practical likelihood that the series will not be completed, or (2) where the taxpayer’s intention to complete any remaining transaction(s) is genuine and specific.”

25 Harvey, *supra* note 5, at 77.

26 Sullivan, *supra* note 9, at 89.

27 *Ibid.*, at 69.

may either be rebuttable or irrebuttable.²⁸ In this regard, according to the Supreme Court of Canada, where a rule deems certain facts to be established, “the words ‘deemed’ or ‘deeming’ do not always import a conclusive deeming into a statutory scheme. The word must be construed in the entire context of the statute concerned.”²⁹

This distinction was analyzed by the Tax Court of Canada in *Cabot*.³⁰ In this case, the taxpayer father claimed child tax benefits on the basis that he fulfilled primary responsibility for the care and upbringing of his children. The issue before the court was whether the presumption in section 122.6 that the female parent is the “eligible individual” is a rebuttable one. Rip J (as he then was) held in favour of the taxpayer on the basis that it is. As part of his analysis, he stated that

[t]he word “deemed” and the word “presumed” may have different meanings at different times and one may be rebuttable and the other may not be rebuttable depending on the particular wording of the statute.³¹

Further, to illustrate the contextual analysis required in determining the strength of a presumption, Rip J considered the distinction between subsections 244(14) and (15). In this regard, whereas the former “presumes” a notice to be mailed on the date of the notice, the latter “deems” an assessment to have been made on the day of mailing of the notice of assessment. Rip J viewed these provisions as follows:

The purpose of subsection 244(14) [which uses the word “presumed”] is to assist in identifying the date of mailing of a notice of assessment which, of course, is important for determining limitation periods for appeals. By and of itself, there is no indication that the presumption was intended to be conclusive or rebuttable. However, a finding that the presumption must be rebuttable is evidenced by the use of a different word [“deem”] in subsection 244(15).³²

This obiter comment in *Cabot* is consistent with the case law, which has held that subsection 244(14) establishes a rebuttable presumption³³ while subsection 244(15)

28 See article 2847(2) of the Civil Code of Québec, SQ 1991, c. 64, as amended: “A presumption concerning presumed facts is simple and may be rebutted by proof to the contrary; a presumption concerning deemed facts is absolute and irrebuttable.”

29 *St. Peter’s Evangelical Lutheran Church v. Ottawa*, [1982] 2 SCR 616, at 629. See also *St. Leon Village Consolidated School District v. Ronceray* (1960), 31 WWR 385 (Man. CA); and *Liampat Holdings Limited v. The Queen*, 96 DTC 6020 (FCTD).

30 *Cabot v. R.*, [1998] 4 CTC 2893 (TCC).

31 *Ibid.*, at 2899.

32 *Ibid.*

33 See, for example, *Hughes v. MNR*, 87 DTC 635 (TCC).

is conclusive.³⁴ However, for the rule in subsection 244(15) to operate, the onus is on the minister to demonstrate that the assessment was, in fact, mailed.³⁵

Scope of Application

The scope of application of deeming provisions is typically well defined:³⁶ some are made “for the purposes of this Act,” whereas others apply only to a specific part, division, subdivision, section, etc. However, when the scope of application of a deeming rule is not explicitly stated, interpretational difficulties arise. The Tax Court considered such a situation in *Cellard*³⁷ in determining the scope of application of the deemed cost rule in paragraph 44(1)(f). In this case, the taxpayer was paid an indemnity in respect of the expropriation of its sawmill by the Quebec government. Upon receipt of the indemnity, the taxpayer elected under subsection 44(1) to defer taxation on the capital gain from the disposition. The taxpayer then went on to construct a new sawmill, for which it claimed an investment tax credit (ITC) under subsection 127(9) in respect of the actual cost of construction. The minister disallowed the full tax credit on the ground that the deemed capital cost determined under paragraph 44(1)(f) applied throughout the Act, including for the purposes of calculating an ITC under subsection 127(9).

The court began by observing that the drafters of paragraph 44(1)(f) did not clearly delineate its application, such that it was impossible to determine on a plain reading of the Act whether the “cost of capital” calculated thereunder was applicable for the purposes of subsection 127(9). The court therefore proceeded to examine the historical context in which the ITC rules were enacted and determined that their main purpose was to stimulate economic growth, which the taxpayer’s project accomplished. Therefore, Tardif J found for the taxpayer and held that extending the scope of the deeming rule in paragraph 44(1)(f) to the ITC rules would lead to an absurdity.³⁸

34 See, for example, *Kushnir et al. v. MNR*, 85 DTC 280 (TCC). A similar deeming rule was also held to be conclusive in the goods and services tax context: see *Schafer v. R.*, [2000] GSTC 82 (FCA). These and other decisions notwithstanding, a proper textual, contextual, and purposive analysis of subsection 244(15) should, in our view, mandate that the presumption contained therein be rebuttable, particularly in the context of protecting a taxpayer’s right to object to an assessment under subsection 165(1). Indeed, if the effect of subsection 244(15), read with subsection 248(7) (which deems a thing sent to have been received), is to conclusively deem a taxpayer to have received an assessment, then a taxpayer who has never actually received an assessment is denied the substantive right to object, and the underlying purpose of subsection 165(1) is frustrated.

35 See, for example, *Aztec Industries Ltd. v. The Queen*, 95 DTC 5235 (FCA). For a discussion, see Robert G. Kreklewetz and Simon Thang, “Assessments Sent to Wrong Address Were Not Issued at All” (2007) 7:1 *Tax for the Owner-Manager* 5-6.

36 This is not surprising in light of the typically extraordinary effect of deeming provisions, particularly legal fictions.

37 *Gaston Cellard Inc. v. The Queen*, 2005 DTC 699 (TCC). See also Harvey, supra note 5, at 80.

38 *Cellard*, supra note 37, at paragraphs 54-56.

Even when the scope of application of a deeming rule is specifically delineated, interpretational issues may arise. For example, in *Settled Estates*,³⁹ a deeming provision made explicitly “for the purposes of the Act” was nonetheless considered inapplicable to a specific section of the Act, because a contrary intention was gathered from the context. In this case, the Supreme Court of Canada considered whether a corporation controlled by an estate could be a “personal corporation” as defined in subsection 68(1) of the 1952 Act.⁴⁰ This term required that the corporation be controlled by an individual resident in Canada or “by such an individual and one or more members of his family who were resident in Canada.” The court held that the word “individual” in paragraph 68(1)(a) referred to a natural living person and did not include an estate. This is because the context of the word “individual” clearly contemplated someone capable of having a family. As a result, notwithstanding the fact that subsection 63(2) of the 1952 Act (now subsection 104(2)) provided that “for the purposes of the Act” an estate shall be deemed to be, in respect of the estate property, an individual, the context of paragraph 68(1)(a) did not allow a corporation controlled by an estate to qualify as a “personal corporation.”⁴¹

Conversely, there may also be situations where a deeming provision is applied beyond its stated limited scope. For example, in a recent technical interpretation,⁴² the CRA was asked whether the arm’s-length test of subparagraph 212(1)(b)(i) should be applied at the partner or the partnership level, considering the deeming rule in paragraph 212(13.1)(b). The latter provision states that where a person resident in Canada pays or credits an amount to a partnership (other than a Canadian partnership within the meaning assigned by section 102), the partnership is deemed to be “a non-resident person” in respect of that payment for the purposes of part XIII of the Act, other than section 216. In its response, the CRA first noted that paragraph 251(1)(c) provides that it is a question of fact whether persons not related to each other are at a particular time dealing with each other at arm’s length. It also noted paragraph 251(1)(a), which provides that related persons are deemed not to deal with each other at arm’s length. The CRA then extended the deeming rule in paragraph 212(13.1)(b), through the intermediary of subparagraph 212(1)(b)(i), beyond its explicit scope to deem a partnership to be a person⁴³ for the purposes of the related-party rules in subsection 251(2), which is in part XVII of the Act. Hence, the CRA concluded that if, for example, the payer were a corporation and the corporation were controlled by the partnership that receives the payment, the entities would be deemed not to be dealing at arm’s length because of paragraph 251(2)(b).

39 *Settled Estates Ltd. v. MNR*, 60 DTC 1128 (SCC).

40 Income Tax Act, RSC 1952, c. 148.

41 This decision is consistent with section 15(2) of the Interpretation Act, RSC 1985, c. I-21, as amended.

42 CRA document no. 2009-0340031E5, July 21, 2010.

43 Notably, paragraph 212(13.1)(b) deems the partnership to be a “non-resident person,” not merely a “person.”

The Effect of a Legal Fiction

The appropriate effect of a deeming rule that creates a legal fiction can be a difficult determination. Two specific and interrelated issues are especially problematic:

1. Does a legal fiction supplant or merely supplement reality? For example, if a dog is deemed by law to be a parrot, can the dog and the deemed parrot co-exist within the scheme of the law, or does the deemed parrot replace the dog for the purposes of the law?
2. Is a legal fiction to be applied restrictively, or should it be read beyond its explicit terms by imagining other legal fictions? In this regard, if a legal fiction can be taken beyond its explicit effect, two further questions arise:
 - a. Can the legal fiction be extended only to its *necessary* logical consequences and incidents? For example, if a dog is deemed by law to be a parrot, given that all parrots have beaks,⁴⁴ can we assume that the deemed parrot has a beak, even though the law does not explicitly deem this to be so?

Or

- b. Can the legal fiction also be extended to various *possible* scenarios? For example, if a dog is deemed by law to be a parrot, given that some (though not all) parrots have blue feathers, can we assume that the deemed parrot has blue feathers, even though the law does not explicitly seem this to be so?

We consider these matters next.

Does a Legal Fiction Supplant or Supplement Reality?

In *Verrette*, a criminal law case, the Supreme Court of Canada held in favour of the Crown on the basis that a legal fiction merely supplements reality when it stated that “[a] deeming provision artificially imports into a word or expression an *additional meaning* which they would not otherwise convey *beside the normal meaning which they retain where they are used.*”⁴⁵ *Verrette* dealt with the application of former section 170 of the Criminal Code to a go-go boy who performed in the nude. The issue considered by the court was whether section 170(2), which for the purposes of section 170 deemed a person to be nude if such person was clad to offend against public decency or order, supplanted the ordinary meaning of the word “nude” as used in section 170(1) (the position argued by the accused), or merely supplements it (the position asserted by the Crown).

A deeming provision in the Act in respect of which the statement in *Verrette* is true is paragraph 251(5)(b). Simplistically, this provision states that a person who has a right to acquire shares in a corporation is deemed to have the same position in relation to the control of the corporation as if he owned the shares. This rule has been interpreted to the effect that the actual ownership of shares and the deemed

44 We are not ornithologists, but we understand that all parrots have beaks.

45 *Verrette*, supra note 6, at 845 (emphasis added).

ownership coexist. In the seminal case on this point, *Viking Food*,⁴⁶ the Exchequer Court had to interpret former paragraph 139(5d)(b), the predecessor of paragraph 251(5)(b). The appellant corporation argued that it was no longer under the control of the actual owners of its shares, but was rather under the control of their grandchildren, to whom the owners had granted the right to acquire their shares. Unlike the grandparents, the grandchildren did not control any other corporations, and thus the appellant would effectively cease to be associated with the other corporations controlled by the grandparents. Finding that the legal fiction of paragraph 139(5d)(b) did not supplant reality, Jactett P (as he then was) stated:

[I]t seems improbable that Parliament intended that [paragraph 139(5d)(b)] would have the unexpressed effect of artificially deeming a person to have ceased to control a company whose issued shares all belonged to him merely because he had granted an option to someone else to buy such shares.⁴⁷

To the contrary, in the context of other deeming rules, the legal fiction was considered to supplant reality. For example, in *Terrador Investments*, the Federal Court of Appeal held that an amount deemed to be a dividend paid and received necessarily bars other possible characterizations of the amount:

The “deemed dividend” being said by the Act to have been “paid” and “received,” it cannot at the same time be a “doubtful debt” or “bad debt.” What is deemed to have been paid cannot also be said to be due. The taxpayer cannot have its cake and eat it, too. Once it elects to treat proceeds of disposition as paid dividends rather than as cash and promissory notes, the proceeds find their way into its income through paragraph 12(1)(k). The proceeds of disposition cannot then make their way into the taxpayer’s income as a reserve for doubtful debts nor as bad debts. Paragraphs 20(1)(l) and (p) of the Act cannot come into play because it cannot be said that the debts reflected in the promissory notes have not been included as such in the taxpayer’s income.⁴⁸

The difficulties involved in determining whether a legal fiction supplants or supplements reality are exemplified by the conflicting approaches of the Tax Court and the Federal Court of Appeal in *La Survivance*.⁴⁹ This case dealt with the effects of the deemed control provision in subsection 256(9). The taxpayer, a public company, sold all of its shares in a subsidiary to a purchaser that was a private corporation in

46 *Viking Food Products Ltd. v. MNR*, 67 DTC 5067 (Ex. Ct.). See also *The Queen v. Alroy Industries Ltd.*, 76 DTC 6220 (FCTD).

47 *Viking Food Products*, supra note 46, at 5071.

48 *Terrador Investments Ltd. et al. v. The Queen*, 99 DTC 5358, at paragraph 19 (FCA); leave to appeal to the Supreme Court of Canada refused (2000), 258 NR 195. More recently, in *Mills Estate v. Canada*, 2011 FCA 219, leave to appeal to the Supreme Court of Canada requested, the court made a similar determination with respect to the mechanical application of the deemed dividend rule in paragraph 84.1(1)(b).

49 *La Survivance v. The Queen*, 2005 TCC 245; rev’d. 2006 FCA 129.

an arm's-length transaction. This disposition resulted in a loss, which the taxpayer claimed as a business investment loss pursuant to paragraph 39(1)(c). In light of subsection 256(9), which deems control of a corporation to have been acquired at the beginning of the day on which control was actually acquired, the taxpayer argued that its subsidiary was deemed, for the purposes of subparagraph 39(1)(c)(iii), to have been a small business corporation (SBC) (and therefore a Canadian-controlled private corporation [CCPC]) at the time it was sold because the purchaser would notionally have acquired the subsidiary at the beginning of the day.

The Tax Court ruled in favour of the minister to the effect that the taxpayer's actual control and the purchaser's deemed control under subsection 256(9) co-existed between the beginning of the date of change of control and the time on that date when the change actually occurred:

Subsection 256(9) establishes that this control is deemed to have been acquired at the commencement of that same day, nothing more. It does not establish that the person who held legal or effective control of Les Clairvoyants, namely La Survivance, simultaneously ceased to possess such control. Nothing, moreover, in subsection 256(9) supports the conclusion that La Survivance would be deemed to have disposed of the shares in Les Clairvoyants before the actual moment of their disposition during the day of July 5, 1994; accordingly, at the time when the disposition occurred, La Survivance still had legal or effective control of Les Clairvoyants.⁵⁰

Dussault J went on to explain his position by pointing out the apparent “incongruity” in the taxpayer's claim, which essentially would lead to the conclusion that control was deemed to have been transferred even though it could not in fact be exercised:

[It would be] incongruous [if La Survivance would be] able to claim a [business investment loss] following the disposition of shares in a corporation deemed to be a CCPC and an SBC, and doing so on the basis that [the acquiror] . . . was a private corporation, when La Survivance could neither hold nor dispose of such shares since it was itself at all relevant times a corporation deemed to be a public corporation which controlled the corporation whose shares were disposed of.⁵¹

The Tax Court's decision was overturned by the Federal Court of Appeal on the basis that the legal fiction created by subsection 256(9) supplanted the actual control exercised by the taxpayer. Noël JA found that Dussault J erred in his analysis of the subsection 256(9) deeming rule when he concluded that the purchaser was deemed to have acquired control of the subsidiary at the commencement of the date of sale, but the taxpayer was not affected by the same fiction. The Court of Appeal stated that the Tax Court's interpretation was not in line with the ordinary meaning

50 Ibid. (TCC), at paragraph 36.

51 Ibid. (TCC), at paragraph 40.

of subsection 256(9), whereby the deemed control was intended to affect both the person acquiring control and the person relinquishing control:

The result seems incongruous only if we choose to ignore the fiction. It is not if we treat the fiction as truth. If that is done, it is not the appellant but [the acquiror] that controlled [the subsidiary] at the time when the appellant disposed of its shares, and there is nothing incongruous in [the subsidiary] being thereby treated as a CCPC and a COSB [sic: SBC] since such was its status under the Act.⁵²

Consequently, the Court of Appeal ruled that the taxpayer was deemed by subsection 256(9) to have relinquished control of the subsidiary at the commencement of the date of sale. The subsidiary was therefore an SBC and a CCPC when the taxpayer disposed of its shares, and the taxpayer was therefore entitled to claim a business investment loss.

Significantly, after *La Survivance*, subsection 256(9) was amended to exclude from its application the determination of whether a corporation is an SBC and a CCPC.⁵³

Is a Legal Fiction To Be Applied Restrictively or Broadly?

Another difficult issue regarding the application of a legal fiction is whether it is to be applied restrictively or, instead, taken beyond its explicit limits by imagining other legal fictions?

In certain cases, courts have given effect to the implicit inevitable consequences and incidents of deeming rules. As stated most famously by Lord Asquith in the House of Lords decision in *East End Dwellings*,

[i]f you are bidden to treat an imaginary state of affairs as real, you must surely, unless prohibited from doing so, also imagine as real the *consequences and incidents* which, if the putative state of affairs had in fact existed, *must inevitably have flowed from or accompanied it*. . . . The statute says that you must imagine a certain state of affairs; it does not say that having done so, you must cause or permit your imagination to boggle when it comes to *the inevitable corollaries of that state of affairs*.⁵⁴

In *Derlago*,⁵⁵ the Federal Court Trial Division adopted the above approach. In this case, the taxpayer acquired a house and rented it to a tenant for a number of years, until he decided to demolish the house and construct a new dwelling, which he then used as his personal residence. The minister assessed the taxpayer's income on the basis that the taxpayer was deemed by paragraph 45(1)(a) to have disposed of the property for its fair market value at the time the house was demolished. The

52 Ibid. (FCA), at paragraph 78.

53 SC 2009, c. 2, section 78(2).

54 *East End Dwellings Co. Ltd. v. Finsbury Borough Council*, [1952] AC 109, at 132-33 (HL) (emphasis added).

55 *Derlago v. The Queen*, 88 DTC 6290 (FCTD); aff'g. 86 DTC 1503 (TCC).

taxpayer appealed the assessment, contending that even though he was deemed to have disposed of the property, he was *not* deemed to have received any proceeds of disposition. As a result, he was entitled to a reserve equal to the full amount of the deemed proceeds of disposition. In rejecting this contention, Martin J noted:

If I am to deem that the plaintiff sold his property in 1980 for a specific sum of money, I would assume, in the absence of any provision to the contrary, that he received the proceeds at the time of the disposition. . . . This indicates to me, in this fictional world of taxation, that Parliament must have intended the deemed proceeds to have been received by the plaintiff because it provided for the expenditure of the proceeds by the plaintiff immediately after their creation.⁵⁶

Similarly, in the recent decision in *Bagtech*,⁵⁷ the Tax Court adopted a broad interpretation of the notional “particular person” in paragraph (b) of the definition of a CCPC in subsection 125(7).⁵⁸ The issue in this case was whether the taxpayer corporation was a CCPC for the purposes of the refundable investment tax credit for research and development in section 127.1. During the relevant taxation years, an aggregate of more than 50 percent of the taxpayer’s voting shares were held by non-residents of Canada. The taxpayer argued that the notional particular person in paragraph (b) of the CCPC definition must be considered to be bound by the corporation’s unanimous shareholders’ agreement, which did not allow non-residents to exercise legal control over the corporation. The Tax Court agreed.⁵⁹ Bédard J began by noting that paragraph (b) of the CCPC definition creates a legal fiction and by citing *Verrette*. He then held that the necessary effect of this legal fiction is that the “particular person” is deemed to have the same rights and obligations as those of the actual non-resident shareholders of the corporation. In this regard, he noted section 146(3) of the Canada Business Corporations Act,⁶⁰ which provides that a purchaser or transferee of shares subject to a unanimous shareholders’ agreement is deemed to be a party to the agreement. On this basis, Bédard J stated that it would be very difficult to defend the hypothesis that the notional particular person may not be considered a party to the corporation’s unanimous shareholders’ agreement. He went on to reject the Crown’s contentions and certain previous statements by the CRA. Bédard J agreed strongly with the approach of the Federal Court of Appeal in *La Survivance* and concluded that the notional “particular person” in paragraph (b) of the definition of a CCPC must be seen as bound by the corporation’s unanimous shareholders’ agreement.

56 Ibid. (FCTD), at 6291.

57 *Price Waterhouse Coopers Inc. agissant ès qualité de syndic à la faillite de Bioartificial Gel Technologies (Bagtech) Inc. c. La Reine*, 2012 CCI 120 (12 April 2012).

58 Notably, this provision does not use the word “deem” or one of its variants.

59 *Bagtech*, supra note 57, at paragraphs 30-43.

60 RSC 1985, c. C-44.

Bagtech, *Derlago*, and *East End Dwellings* seem to indicate that extending a legal fiction beyond its explicit limits is a natural and logical consequence. Significantly, these cases do not seem to allow a deeming provision to result in consequences that are merely possible.

Contrary to the expansive interpretations in *East End Dwellings*, *Derlago*, and *Bagtech*, deeming provisions have also been applied restrictively. In *La Survivance*, the Tax Court's decision was based on the view that "[t]o the extent that a deeming provision has precisely the effect of distorting reality, . . . it must be interpreted strictly and its scope limited to what it clearly expresses."⁶¹

Another instance of restrictive construction of a deeming rule is the Federal Court of Appeal's decision in *Bryce*.⁶² In this case, the taxpayer unsuccessfully argued that payments for the benefit of his former spouse made by him to a third party rather than directly to her were made deductible as "alimony or other allowance" by virtue of the deeming provisions of former section 60.1. The Court of Appeal held "with considerable reluctance" that, while this rule deems such amounts to have been paid directly to the former spouse, it does not go so far as to deem such payments to be an "allowance," which was also required for such payments to be deductible under former paragraph 60(b). In this regard, the court felt bound by its previous decision in *Pascoe*,⁶³ to the effect that for an amount to be an "allowance" it must be at the complete discretion of the recipient. Since the amounts at issue were committed directly to the mortgagee and other specific third parties, the court considered that they were not at the complete disposal of the former wife. In other words, the court refused to assume that by deeming the amounts to have been paid directly to the former spouse, Parliament must implicitly have intended to treat them as a deductible allowance under paragraph 60(b).⁶⁴

Another example of a strict interpretation of a deeming provision is the well-known and controversial CRA position on the deemed dividend rule in paragraph 84.1(1)(b).⁶⁵ As previously noted, if certain conditions are met where low PUC shares of a Canadian-resident corporation are transferred by a Canadian-resident taxpayer (other than a corporation) to a non-arm's-length purchaser corporation, paragraph 84.1(1)(b) deems a dividend "to be paid to the taxpayer by the purchaser corporation and received by the taxpayer from the purchaser corporation." Regarding this

61 *La Survivance*, supra note 49 (TCC), at paragraph 36.

62 *The Queen v. Bryce*, 82 DTC 6126 (FCA); rev'g. 80 DTC 6304 (FCTD).

63 *The Queen v. Pascoe*, 75 DTC 5427 (FCA).

64 It is not clear from the decision in *Bryce* whether the court merely adopted a strict reading of section 60.1 or rather felt that being an "allowance" is not "a natural and logical consequence" of section 60.1 and paragraph 60(b). Note that *Bryce* is only of academic interest because the *Pascoe* jurisprudence was subsequently reversed by the Supreme Court of Canada in *Gagnon v. The Queen*, 86 DTC 6179, and the relevant provisions at issue in these cases have since been substantially amended.

65 See Harvey, supra note 5, at 81ff.

deeming rule, in a 2002 technical interpretation,⁶⁶ the CRA stated that a dividend deemed paid under section 84.1 is not eligible for a subsection 83(2) election as a capital dividend and cannot trigger a dividend refund and refundable tax to the purchaser corporation.⁶⁷ The reason invoked was that while section 84.1 deems the dividend to have been paid and received, it does not deem the dividend to be payable to a shareholder of any class of shares of the purchaser corporation's capital stock, as required by subsection 83(2). Accordingly, the CRA stated that it does not intend to take a permissive administrative position and will not go beyond the explicit limits of the legal fiction created by paragraph 84.1(1)(b).⁶⁸ This is despite the notion that deeming a dividend to be paid to, and received by, the transferor necessarily implies a distribution by the purchaser corporation to the transferor.

Conclusions

Admittedly, the above discussion and selected court decisions do not provide clear answers as to how to interpret and apply deeming provisions. To the contrary, our analysis highlights the difficulties that courts have had in interpreting deeming provisions and illustrates the differing approaches developed as a result. Generally speaking, when courts interpret deeming rules, they appear to follow one of three paths:

1. *Strict approach.* According to this approach, a court should give a deeming rule a restrictive reading to reflect Parliament's purported aversion to distorting reality. For example, this approach was adopted by the Federal Court of Appeal in *Bryce* and by the Tax Court in *La Survivance*.
2. *Expansive approach.* According to this approach, a court has to give full effect to a legal fiction by taking it to its necessary logical conclusion, imagining an assumed situation as real even if it leads to the creation of other legal fictions. For example, this approach was followed by the Federal Court Trial Division in *Derlago* and by the Tax Court in *Bagtech*.
3. *Purposive approach.* According to this approach, whether a deeming provision should be given a strict or expansive interpretation depends on its object and purpose in relation to the object and purpose of the provision to which it is sought to be applied. For example, in *Cellard*, the Tax Court considered the purpose of the ITC rules in order to decide whether the deemed cost provision in paragraph 44(1)(f) extended to those rules.⁶⁹

66 CRA document no. 2002-0128955, September 26, 2002. For comment, see Elisabeth Atsaidis and John Jakolev, "The Scope of Fiction" (2002) 10:11 *Canadian Tax Highlights* 83.

67 In CRA document no. 2006-0183851E5, May 30, 2007, a qualification was introduced to the effect that this is the result unless the transferor was already a shareholder of the transferee corporation.

68 This position was recently confirmed in CRA document no. 2011-0414731E5, January 4, 2012.

69 See *supra* note 38.

In a sense, the previous discussion reverts to and reinforces the statement at the beginning of this section that, in isolation, the word “deem” is highly ambiguous and unclear. Thus it supports our assertion that the proper interpretation and application of a deeming provision is a function of the context and purpose of that provision.

Arguably, there are two main contextual questions that provide the initial indicia to the nature and function of a deeming rule:

1. *Who* does the deeming? If the rule is expressed as a declaratory statement in the passive voice, it is implicit that the deeming power is exercised by Parliament. If, on the other hand, the rule is expressed as a power exercised at the discretion of a specified authority, this signifies that Parliament has chosen to confer that power on such authority.
2. *What* is being deemed? This question has two aspects: it looks to the output of the deeming, but necessarily compares it with the input.

Beyond the context of a deeming rule, however, it is the object and purpose of the rule that should determine its proper interpretation and application. While the Canadian tax cases considered above have not explicitly adopted this thinking, it is the approach favoured in the United Kingdom. Most notably in the *Metrolands* case, which dealt with the effects of a deeming rule on a taxpayer’s liability to pay a development tax assessment, the Chancery Division of the UK High Court of Justice stated:

When considering the extent to which a deeming provision should be applied, the court is entitled and bound to ascertain for what purposes and between what persons the statutory fiction is to be resorted to. It will not always be clear what those purposes are. If the application of the provision would lead to an unjust, anomalous or absurd result then, unless its application would clearly be within the purposes of the fiction, it should not be applied. If on the other hand, its application would not lead to any such result then, unless that would clearly be outside the purposes of the fiction, it should be applied.⁷⁰

This approach is clearly consistent with the principles of tax construction endorsed in *Canada Trustco*:

The interpretation of a statutory provision must be made according to a *textual, contextual and purposive analysis* to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play[s] a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. *The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.*⁷¹

70 *IRC v. Metrolands Ltd.*, [1981] 2 All ER 166, at 181 (Ch. D.); aff’d. [1982] 2 All ER 557 (HL).

71 *Canada Trustco*, supra note 7, at paragraph 10 (emphasis added).

Against the theoretical backdrop of the above-mentioned analysis, we consider next a practical example: the interpretation of the deemed interest rule in subsection 214(7) and its possible application to convertible debentures issued by Canadian corporations.

DEEMING PROVISIONS IN PRACTICE: SUBSECTION 214(7)

Background

Subsection 214(7), which is contained in part XIII of the Act, applies where a non-resident person has at any time assigned or otherwise transferred to a person resident in Canada a bond, debenture, bill, note, mortgage, hypothecary claim or similar obligation issued by a person resident in Canada. For this purpose, subsection 214(14) provides that a redemption or cancellation of an obligation held by a non-resident person is deemed to be an assignment of the obligation by the non-resident person.

If the application criteria of subsection 214(7) are met, the amount, if any, by which the price for which the obligation was assigned or otherwise transferred at that time exceeds the price for which the obligation was issued, is deemed, for the purposes of part XIII, to be a payment of interest on the obligation made by the person resident in Canada to the non-resident person at that time. If such interest is considered to be “participating debt interest” as defined in subsection 212(3), it will be subject to withholding tax under paragraph 212(1)(b).

The deeming rule in subsection 214(7) does not apply where the obligation is an “excluded obligation,” as defined in subsection 214(8), or the assignment or other transfer is one referred to in paragraph 214(7.1)(b). Subsection 214(8) lists three types of excluded obligations:

1. obligations that would be covered by the exclusions in former subparagraphs 212(1)(b)(iii) (foreign currency obligations) and (vii) (the so-called 5/25 exemption) as they read in 2007;
2. public issue securities; and
3. so-called shallow discount obligations.

The exclusion in respect of paragraph 214(7.1)(b) merely allows the rule in that provision to operate in priority to subsection 214(7).

A particular concern with subsection 214(7) has been that it may give rise to part XIII withholding tax on interest upon the conversion by a non-resident holder of convertible debentures issued by an arm’s-length Canadian-resident issuer.⁷² Specifically, it is unclear whether

⁷² For a discussion of the issue, see, for example, Gabrielle M.R. Richards, “Canada Revenue Agency Revises Its Position on Convertible and Exchangeable Debt” (2009) 11:3 *Corporate Structures and Groups* 627-30; David W. Glicksman and Geneviève C. Lille, “Convertible Debt Obligations—The Canada Revenue Agency Provides Some Comfort on ‘Traditional’

- an amount under subsection 214(7) arises when a Canadian issuer of convertible debentures issues to a non-resident shares in the capital of the issuer having fair market value in excess of the principal of the obligation in consideration for the cancellation of the obligation, and
- any deemed interest under subsection 214(7) would be “participating debt interest,” to the effect that part XIII withholding tax would apply notwithstanding that the non-resident and the Canadian issuer are at arm’s length.⁷³ In this regard, “participating debt interest” is defined to mean

interest . . . that is paid or payable on an obligation, other than a prescribed obligation, all or any portion of which interest is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.⁷⁴

In our view, there are strong arguments that the amount paid on conversion of a debenture into shares is the principal amount of the debt from which the issuing

Convertible Debentures” (2009) 16:1 *Corporate Finance* 1747-49; and Paul K. Tamaki and Lisa Eastwood, “Convertible Debt: A Legislative Fix Needed Quickly” (2009) 16:1 *Corporate Finance* 1750-52. For a fuller discussion of the historical and legislative background to the 2008 reforms and the problems arising thereunder, see also the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, “Re: Convertible Debentures,” submission to Phil Jolie and Mark Symes, directors, Income Tax Rulings Directorate, Canada Revenue Agency, May 10, 2010 (herein referred to as “the joint committee report”).

73 Assuming, of course, that the deemed interest would not qualify as “fully exempt interest,” as defined in subsection 212(3), or as an “excluded obligation,” as defined at subsection 214(8). Some tax commentators have suggested that the conversion premium may in fact qualify as an “excluded obligation”: see, for example, the joint committee report, *supra* note 72, at 8. An analysis of this argument is beyond the scope of this article.

74 Subsection 212(3). As pointed out in the joint committee report, *supra* note 72, before the amendment of paragraph 212(1)(b) in 2007, the CRA took the position that withholding tax would apply to index linked interest payments in which the particular stock index chosen was influenced by the inclusion in the index of the shares of the issuing corporation, corporations related to the issuing corporation, or a corporation whose primary business was substantially similar to that of the issuing corporation: see CRA document nos. 2000-0046375, November 22, 2000; 2001-0096655, October 9, 2001; and 2000-0011015, May 16, 2000. In addition, the CRA took the position that interest payments that fluctuate on the basis of a formula that attempts to measure whether the issuer’s stock price outperforms or underperforms the short-term money market index would be subject to withholding tax, since they would be “computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion”: CRA document no. 9915455, July 21, 1999. However, significantly, the definition of “participating debt interest” does not refer to interest computed by reference to share price while it does refer to interest computed “by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.”

corporation is relieved by virtue of the share issuance.⁷⁵ This amount would be reflected by the addition to the stated capital for the issued shares of an amount equal to the principal amount of the debentures. On this basis, the amount paid (or the transfer price on a conversion of a debenture) is the principal amount of the debenture such that mathematically the amount of deemed interest under subsection 214(7) should be nil. Nonetheless, we proceed on the assumption that a positive amount of deemed interest may result under this rule. Hence, the following discussion focuses only on the issue of whether such deemed interest is “participating debt interest.”

Classification of the Provision

Subsection 214(7) creates a legal fiction. The provision is worded in the passive voice and does not confer a discretion on an identified authority. It also does not presume certain facts as established, since what constitutes interest is a question of law. Subsection 214(7) deems the amount, if any, by which the price for which the obligation was assigned or otherwise transferred exceeds the price for which the obligation was issued, to be a payment of interest. The provision creates a legal fiction because the input amount determined thereunder would not have the legal character of interest. The classic definition of “interest” is found in the 1947 Supreme Court of Canada decision in *Reference as to the Validity of Section 6 of the Farm Security Act, 1944 of the Province of Saskatchewan*, where Rand J defined the term broadly to include “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.”⁷⁶ Clearly, a gain on the sale or redemption of an obligation is not interest in these terms.

75 See *Teleglobe Canada Inc. v. R*, 2002 FCA 408. See also Monica Biringer, “Leveraged Buyouts and Private Equity: Selected Issues in Debt-Financing the Acquisition,” in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 11:1-23, at 11:9.

76 [1947] SCR 394, at 411; aff’d. [1949] AC 110 (PC). This definition was subsequently narrowed by the addition of two requirements: (1) that the payment accrue on a day-to-day basis (*Attorney General (Ontario) v. Barfried Enterprises*, [1963] SCR 570); and (2) that interest must be calculated with reference to a principal sum (*Re Balaji Apartments Ltd. and Manufacturers Life Ins. Co.* (1979), 100 DLR (3d) 695 (Ont. HCJ)). However, these limitations seem to have been rejected in *The Queen v. Sherway Centre Limited*, 98 DTC 6121 (FCA). In *Sherway Centre*, regarding the first requirement, the court held that the appropriate interpretation to be given to daily accrual of interest is that each holder’s entitlement to interest must be ascertainable on a daily basis. Regarding the second requirement, the court held that *Balaji Apartments* should not be read as limiting the deductibility of payments that, while not directly related to the principal amount, nonetheless are clearly related to that amount; indeed, *Balaji Apartments* should be limited to similar facts where it is clear that the payment in question is an addition to stipulated interest on the loan.

Application of the Deemed Interest Rule

Scope of Subsection 214(7)

Where the conditions for its application are met in respect of an obligation, subsection 214(7) deems a payment of interest on the obligation “for the purposes of this Part” (that is, part XIII). Therefore, this deeming rule is applicable to the charging provision in paragraph 212(1)(b) and the related definition of participating debt interest in subsection 212(3). The following discussion focuses on the effect of subsection 214(7) in particular in respect of the definition of participating debt interest.

Can the Subsection 214(7) Deemed Interest Payment Be “Participating Debt Interest”?

As discussed above, courts have adopted one of three interpretive approaches in determining the effect of a deeming rule. Arguably, as explained below, all three approaches should yield the same result here: the deemed interest payment under subsection 214(7) should *not* be participating debt interest as defined in subsection 212(3).

STRICT APPROACH

For interest that is paid or payable on an obligation to be participating debt interest, subsection 212(3) requires that all or any portion of such interest must be “contingent or dependent on the use of or production from property in Canada” or must be computed “by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.” Under a strict approach, because subsection 214(7) only deems the payment of an arithmetic amount of interest and does not deem any other elements in respect of such payment that are relevant in applying the definition in subsection 212(3), such deemed interest payment should not be participating debt interest.

EXPANSIVE APPROACH

Even if an expansive approach is applied, it is not clear that the subsection 214(7) deemed interest payment may be participating debt interest. On the basis if the case law discussed previously, this approach would give full effect to subsection 214(7), but only to the extent of the necessary and logical extensions of the deemed interest payment. In this regard, the deemed interest payment is not necessarily participating debt interest. Hence, even a court that applied a broad reading to the deeming rule in subsection 214(7) may not be willing to assume characteristics of the interest that are possible while not essential and that subsection 214(7) does not explicitly deem.

PURPOSIVE APPROACH

Finally, the deemed interest payment under subsection 214(7) should not be participating debt interest on a contextual and purposive reading of the relevant rules. In this regard, it is relevant to examine the context and purpose of (1) the withholding tax

charge on interest in paragraph 212(1)(b), (2) the exemption denial rule in respect of participating debt interest, and (3) the deemed interest provision in subsection 214(7).

Part XIII imposes a withholding tax of 25 percent (which may be reduced under an applicable treaty) on certain listed items of Canadian-source income, including dividends, interest, and royalties that are paid or credited, or deemed to be paid or credited, to an actual or deemed non-resident of Canada. The charging provision of part XIII is section 212 and paragraph 212(1)(b) deals specifically with interest.

Before 2008, this rule imposed withholding tax on *all* interest paid or credited to a non-resident person, *except* the types of interest specifically listed in subparagraphs 212(1)(b)(i) to (xii). The best-known and most widely used of these exemptions was the 5/25 exemption in former subparagraph 212(1)(b)(vii).⁷⁷ This exemption applied if interest was payable by a corporation resident in Canada to a non-resident with whom the corporation dealt at arm's length, and under the terms of the obligation or any agreement relating thereto, the corporation could not be obliged to repay more than 25 percent of the principal amount of the loan within five years from the date of issue of the obligation, except in certain limited situations.⁷⁸ Apparently, the policy rationale behind the withholding tax exemption in former subparagraph 212(1)(b)(vii) was "to provide Canadian businesses with access to foreign capital markets for medium- and long-term debt."⁷⁹

Effective January 1, 2008, the withholding tax charge in paragraph 212(1)(b) was completely rewritten to limit its application only to

interest that

- (i) is not fully exempt interest, and is paid or payable to a person with whom the payer is not dealing at arm's length, or
- (ii) is participating debt interest.⁸⁰

77 See generally Robert A. Kopstein and Janette Y. Pantry, "Subparagraph 212(1)(b)(vii) Withholding Tax Exemption," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 15:1-48.

78 The specified situations were (1) in the event of a failure or default under the terms of the obligation or agreement; (2) if the terms of the obligation became unlawful or were changed by virtue of legislation or by a court, statutory board, or commission; (3) if the lender exercised a right to convert or exchange the loan for a prescribed security; and (4) in the event of the person's death.

79 Kopstein and Pantry, *supra* note 77, at 15:3. See Canada, Department of Finance, 1975 Budget, Highlights and Supplementary Information, June 23, 1975, at 21. See also J. Scott Wilkie, "Structuring International Debt Issues: A Canadian Perspective" (1987) 35:1 *Canadian Tax Journal* 1-49, at 5.

80 The March 16, 2011 draft amendments to the Act propose to amend subparagraph 212(1)(b)(i) to add the requirement that the interest be paid or payable "in respect of a debt or other obligation to pay an amount to a person with whom the payer is not dealing at arm's length." See Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, March 16, 2011), at clause 3.

Significantly, whereas former paragraph 212(1)(b) applied to all interest except certain listed types of interest, the scope of the new rule was effectively reversed since, a priori, it applies only in strictly limited circumstances and thereby exempts all other types of interest. Hence, the purpose of substantially amending paragraph 212(1)(b) seems to have been to materially expand the ability of Canadian businesses to access foreign debt financing. Arguably, this should generally inform the interpretation of both the exemption denial rule in respect of participating debt interest and the deemed interest rule in subsection 214(7).

Regarding the participating debt interest restriction, the old withholding tax exemption was, and the new one remains, subject to this limitation. As noted above, participating debt interest is defined in subsection 212(3) to mean interest

that is paid or payable on an obligation, . . . all or any portion of which interest is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

This definition is not new but reflects the text of the exemption denial contained in the postamble of former paragraph 212(1)(b). The policy underlying this exemption denial is not entirely clear,⁸¹ but it has been suggested that the effect of this rule is to “[discourage] taxpayers from abusing the subparagraph 212(1)(b)(vii) exemption by *disguising profit distributions as interest*.”⁸² Presumably the same policy underlies the current rule, since the test for determining whether an amount is participating debt interest is identical to the test under the old rule. Thus, the policy considerations should not differ in respect of the definition of participating debt interest; that is, the policy continues “to preclude an exemption from withholding tax where the payment of ‘interest’ is a *disguised distribution of earnings*.”⁸³

Regarding these descriptions of the policy underlying the definition of participating debt interest, arguably the premium on the conversion of a convertible debenture should not be taxed as participating debt interest because it is not a disguised distribution of earnings. Contrary to participating interest paid by the debtor, the issuance of shares in the capital of the debtor does not result in an outflow or “distribution” of its profits to the creditor and does not result in a tax deduction to the debtor.⁸⁴ Quite

81 P. Mark Meredith, “Current Problems and Future Directions in Derivatives Taxation,” in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 18:1-21, at 18:18: “The policy basis for hampering the access of Canadian corporations to international financing in this manner is not apparent.”

82 Kopstein and Pantry, *supra* note 77, at 15:30 (emphasis added).

83 Biringer, *supra* note 75, at 11:9 (emphasis added).

84 In *Sherway Centre*, *supra* note 76, the Federal Court of Appeal concluded that participating interest payments that did not formally accrue from day to day were deductible under paragraph 20(1)(c). In this regard, participating interest depletes both the debtor’s earnings and

the opposite: the practical effect of the conversion of the debt into shares is that the debtor is able to retain and preserve its earnings, while allowing the creditor to obtain cash flow from third parties by selling the debtor's shares into the market.

Against this background, section 214 contains a variety of subsidiary rules intended to police the charging provision in section 212. Among them is the deemed interest rule in subsection 214(7). This provision is considered to target long-term, deep-discount debt obligations issued by Canadian residents⁸⁵ and seeks, from a policy standpoint, to prevent the avoidance of withholding tax that might otherwise be applicable to interest, in the case of a non-resident holder of such obligations, if the obligations were issued at a reasonable rate of interest.⁸⁶ This indicates that the premium on converting a debenture into the issuer's shares should not be caught by subsection 214(7). Convertible debentures typically are not structured as deep-discount debt obligations. To the contrary, they are generally issued at par or, at most, at a shallow discount and, while outstanding, typically provide for a market rate of non-participating interest. In fact, before 2008, most convertible debentures were set up to comply with the exemption contained in subparagraph 212(1)(b)(vii). If the debenture satisfied the conditions of the 5/25 rule, the debenture itself was an excluded obligation pursuant to paragraph 214(8)(a), and subsection 214(7) would not apply to a conversion premium, whether or not such amount was seen to give rise to deemed interest under the latter provision. Conversely, if the 5/25 exemption did not apply, any conversion premium would, if considered to give rise to a subsection 214(7) amount, be subject to part XIII withholding tax, as regular interest would. Accordingly, prior to 2008, the potential imposition of withholding tax on a conversion premium was not necessarily linked to whether the premium was caught by the preamble to former paragraph 212(1)(b). In fact, withholding tax would be

Canada's tax base. By comparison, even if a conversion premium were deemed to be interest under subsection 214(7), the ambit of this rule does not extend to part I and therefore paragraph 20(1)(c) does not operate. Furthermore, the decision of the Supreme Court of Canada in *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46, created uncertainty about whether a conversion premium on a convertible debenture was deductible under paragraph 20(1)(f). The decision in *Tembec Inc. v. The Queen*, 2007 TCC 395; aff'd. 2008 FCA 205, which relied on *Imperial Oil*, provides support for the position that paragraph 20(1)(f) is not available in respect of the conversion premium arising on the conversion into common shares of convertible debentures issued by a taxpayer. In *Tembec*, a loss on the fluctuation of the taxpayer's convertible debentures, when converted, was denied on the basis that the "principal amount" cannot fluctuate: "It is at the time the obligations are issued that it must be determined whether or not they are issued at a discount" (supra (TCC), at paragraph 38). See Andrew S. McGuffin and Pooja Samtani, "Federal Court of Appeal Ruling May Lead to Review of Exchangeable Debt" (2008) 11:1 *Corporate Structures and Groups* 599-601. For exchangeable debentures, the CRA has reversed its view that paragraph 20(1)(f) applies, effective for debentures issued after 2009. On exchange, the issuer of the debentures is not entitled to any deduction or capital loss for the appreciation in principal amount over face value: CRA document no. 2009-0347251C6, November 24, 2009. See also Richards, supra note 72.

85 Original issue discounts are dealt with in the deductibility rule in paragraph 20(1)(f).

86 See McCarthy Tétrault LLP, ed., *Canada Tax Service* (Toronto: Carswell) (looseleaf).

imposed to the extent that the conversion premium was deemed to be interest under subsection 214(7). In this regard, it seems that Parliament had no broad-based policy issues that would have caused convertible debentures to be generally subject to withholding tax; if it had such concerns, convertible debentures would never have specifically benefited from the 5/25 rule in the first place. Therefore, the fact that paragraph 214(8)(a) was not correspondingly expanded when the withholding tax in paragraph 212(1)(b) was limited should not have the perverse effect of broadening Canada's part XIII taxing rights, since this would go against the policy of the relevant provisions and hamper the ability of Canadian businesses to access foreign debt capital.

Effect

In light of the preceding discussion, there is a strong argument based on the relevant rules in part XIII—whether those rules are given a strict, an expansive, or a contextual and purposive reading—that if the conversion of a debenture into shares of the issuer gives rise to a subsection 214(7) deemed interest payment, such interest should not constitute participating debt interest that is subject to Canadian withholding tax.

CONCLUSION

The purpose of this article has been to consider the proper interpretation and application of deeming provisions in the Act from a theoretical perspective and in the context of a practical example.

The first part of the article provided a general analysis of deeming rules in the Act and highlighted the following main points:

- Deeming provisions may be classified in four broad categories. While typically thought to create a legal fiction, deeming rules can also be used to declare the law, to create a factual presumption, or to confer discretion. The different types of deeming rules may be distinguished from each other by first identifying who does the deeming and what is being deemed and then identifying the context and purpose of the deeming.
- Deeming rules may have different strengths in that the presumption they create may be either conclusive or rebuttable. Presumptions of law are conclusive, whereas factual presumptions may either be rebuttable or irrebuttable, depending on their context and purpose.
- The scope of application of a deeming provision is typically, though not always, specified. Whether or not this is the case, the issue of whether a deeming rule applies to another provision should be determined on the basis of an analysis of the context and purpose of the deeming provision and the provision to which it is sought to be applied.
- The effect of a deeming rule that establishes a legal fiction is generally determined in terms of whether the thing being deemed supplants or merely

supplements reality, and whether the rule is to be applied restrictively or should be read beyond its explicit terms by imagining and assuming other legal fictions. The case law on point seems to have adopted diverging interpretive approaches: some courts have applied a strict reading, while others construe deeming rules broadly in order to give effect to their necessary and logical incidences. In our view, the most appropriate approach is to give either a narrow or a broad effect to a deeming provision as determined by a textual, contextual, and purposive interpretation of the rule.

In light of the theoretical discussion summarized above, the controversial deemed interest rule in subsection 214(7) should not, in our view, be extended to give rise to participating debt interest that would result in Canadian withholding tax, since such a result would clearly be inconsistent with the text, context, and purpose of the relevant provisions of the Act.

