

CORPORATE TAX LITIGATION

An overview of the Canadian tax dispute resolution process, the litigation of transfer pricing disputes and other issues in international tax litigation

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The Canadian Tax Dispute Resolution Process

The Audit and Appeals Process

The Canadian tax system relies on self-assessment by the taxpayer. The mandate of the Canada Revenue Agency (CRA) is to administer tax programs and legislation and to ensure that taxpayers comply with their tax reporting and payment obligations. An audit is often the first step in what can be a prolonged and thorough investigation by the CRA into the business of a taxpayer, whether a resident or non-resident of Canada.

In order for the CRA to properly conduct an audit, it enjoys broad statutory powers to examine the books, records, documents and even the premises of Canadian taxpayers, as well as to compel the production of certain foreign-based information in order to verify a taxpayer's compliance with domestic tax rules. An audit may result in an assessment of the taxpayer's liability to tax, interest or penalty.

A taxpayer who disagrees with an assessment may file a notice of objection with the CRA describing why the assessment is incorrect in fact or law. After reviewing the objection, the CRA will generally either confirm or vary the assessment.

Recourse to the Courts

If dissatisfied with the outcome of the objection process, a taxpayer may proceed to trial before a

judge of the Tax Court of Canada who will decide the matter by way of trial. Judgments of the Tax Court may be appealed to the Federal Court of Appeal. Where a Tax Court judge has committed an error of law, or an error of fact that is "palpable and overriding," a three-judge panel of the Court of Appeal may set aside the decision of the Tax Court.

The unsuccessful party in the Federal Court of Appeal may apply for leave to appeal to the Supreme Court of Canada. Based on written submissions, three judges of the court decide whether the case involves a question of "public importance" and merits a hearing. The court generally hears only a few tax cases in any particular year. As a practical matter, most significant tax cases end at the Federal Court of Appeal.

Other Judicial Remedies

Where the conduct of the CRA is abusive or the Minister of National Revenue has not followed proper procedure in denying a taxpayer discretionary relief (and there is no assessment of tax, interest or penalty), the Federal Court may be asked to apply a range of extraordinary remedies either to prevent the minister from engaging in illegal acts or compel him to act in accordance with the law.

The Competent Authority Mechanism (Mutual Agreement Procedure)

When cross-border tax disputes arise, an impor-

tant dispute resolution mechanism (apart from the domestic procedures described above) is the mutual agreement procedure (MAP) under a tax treaty between Canada and the relevant foreign jurisdiction. MAP requests are made by the taxpayer to the relevant “competent authorities” (the tax authority of each state) who then initiate negotiations with a view to resolving the dispute in a manner that satisfies both states. In principle, an agreement under the MAP avoids double taxation — a result that usually satisfies the taxpayer as well.

The CRA releases an annual report on its Mutual Agreement Procedure Program reviewing the statistics on the cases submitted by taxpayers to the CRA as Canada’s competent authority. The purpose of the MAP process is to ensure that taxpayers are not taxed by two states in respect of the same income in a manner inconsistent with the tax treaty between those states. The CRA’s most recent report, covering April 1, 2007, to March 31, 2008 (the report period), discloses that the vast majority of cases accepted by the CRA relate to transfer pricing.

There are two types of MAP requests: negotiable and non-negotiable. Negotiable cases involve a request by a taxpayer that requires discussions with another tax administration. Non-negotiable cases involve an issue being resolved by the taxpayer and the competent authority and do not involve another tax administration. From 2007–2008, the CRA accepted a total of 275 cases, 71 of which were negotiable. Of those 71 cases, 54 related to double taxation caused by transfer pricing adjustments. Although these numbers have remained consistent with the previous two reports, the number of completed cases dropped significantly from 45 in the previous year to just 28 during the report period. In total, 49 of the negotiable cases were completed compared to 65 in the previous year. An obvious result of this decreasing efficiency is a corresponding increase in backlogged cases. This has occurred despite the fact that the Competent Authority Services division of the CRA has grown considerably during this same period (from 37 to 48 employees).

During the year prior to the report period, 42 of the 65 completed cases (65 percent) involved the United States. During the report period, 36 of the 49 completed cases (73 percent) involved the United States.

The target set by the CRA to resolve a negotiable MAP case is 24 months. In the year prior to the report period, the average time to complete a

Canadian-initiated MAP case was 25.86 months and the average time to complete a MAP case initiated by another state involving a Canadian taxpayer was 24.07 months. However, there has been a dramatic change during the report period as the timing for CRA-initiated MAP cases dropped to an average of 20.69 months, but cases not initiated by the CRA took an average of 37.76 months to resolve.

Of the 49 negotiable MAP cases that were completed during the report period, approximately 8 percent could not be resolved in a manner that avoided double taxation. Three cases (6 percent) provided no relief to the Canadian taxpayer and one case (2 percent) provided only partial relief. These statistics are comparable to those of the previous year.

In cases where subsequent taxation years are assessed in respect of the same or similar issues involved in a MAP process, the CRA offers an Accelerated Competent Authority Procedure, which allows the later taxation years to be reviewed at the same time.

The Possibility of Mandatory Arbitration

While the possibility of submitting tax treaty issues to a voluntary arbitration procedure has been considered internationally for quite some time, it has rarely been fully implemented by any state and has never been applied under Canada’s tax treaties. However, the Fifth Protocol to the Canada-United States Income Tax Convention (which entered into force on December 15, 2008) implements a mandatory and binding arbitration procedure that has not been fully tested in practice in any jurisdiction. Under this arbitration procedure, the arbitration board must choose between the position of one state or the other (also known as “baseball arbitration”).

The stated purpose of mandatory arbitration is to simplify and streamline the MAP procedure by obligating the competent authorities to resolve issues quickly (within two years). The idea is that no case would ever actually proceed to arbitration since the risk of an adverse arbitration decision should provide the necessary incentive for the competent authorities to be reasonable, prudent and efficient in their handling of MAP cases.

The Litigation of Transfer Pricing Disputes

Transfer pricing has emerged as a key issue for tax authorities around the world and is a major issue currently on the Canadian cross-border tax litiga-

tion scene. At its core, transfer pricing is the practice of determining the appropriate price at which a corporation in one state sells goods or services to a corporation in another state with whom it is not dealing at arm's-length. Governments are concerned that by manipulating the transfer price, a multinational enterprise may attempt to shift profits to lower tax jurisdictions. Accordingly, states with a relatively high overall tax rate seek to ensure that parties use an appropriate transfer price in order to protect their own tax base.

In this regard, the CRA has been granted broad statutory powers to adjust transfer prices in a manner consistent with an arm's-length benchmark and, under certain circumstances, has the power to recharacterize transactions in order to achieve that result. However, an adjustment by one state may result in double taxation unless the other state makes a corresponding adjustment. Accordingly, transfer pricing disputes often involve not only the taxpayer and the CRA but also the tax administration of at least one other state as well.

As noted above, transfer pricing rules rely on an arm's-length standard — the transfer pricing benchmark adopted by the Organisation for Economic Co-operation and Development (OECD). This principle states that the price agreed to between non-arm's-length parties should reflect the market price between parties who are dealing at arm's-length. Depending on the nature of the good or service being transferred, the OECD has set out a hierarchy of methods that may be used to determine the appropriate transfer price. The method most favored by the CRA and the OECD is the “comparable uncontrolled price” (CUP) method, which establishes the transfer price based on comparable transfer prices observed in the market between parties dealing at arm's-length. In the absence of a comparable uncontrolled price, a number of other methods of arriving at an appropriate transfer price may be used.

Current Transfer Pricing Litigation

In recent years, the CRA has sought to challenge an increasingly wide range of transfer pricing arrangements. In fact, since transfer pricing has become such a high priority for the CRA (encouraged by recommendations in recent reports of the Auditor General of Canada), we are seeing, and will likely continue to see, more transfer pricing cases being heard by the courts.

For example, the Tax Court recently delivered its

decision in *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324, in which the taxpayer, GlaxoSmithKline Inc. (Glaxo Canada) was reassessed by the CRA for allegedly paying too high a price for certain products purchased from a related non-resident. Glaxo Canada is a wholly owned subsidiary of Glaxo Group Ltd., a UK corporation, which is a wholly owned subsidiary of another UK corporation, Glaxo Holdings PLC.

During the relevant period, Glaxo Canada was manufacturing and selling the drug Zantac. The active ingredient in Zantac is ranitidine, which was manufactured by an affiliate in Singapore and purchased by Glaxo Canada from Adechsa S.A., another affiliate located in Switzerland. The transfer price was established by Glaxo Holdings PLC, while Adechsa administered the transfer pricing. During this same period, generic drug companies were purchasing ranitidine at a far lower cost.

Glaxo Canada argued that the price it paid for ranitidine closely mirrored the price paid by independent third parties in comparable circumstances. Glaxo Canada also argued that the amounts paid were reasonable in the circumstances and that its business model and circumstances were not comparable to those of the generic companies purchasing ranitidine. In applying the arm's-length principle, the Tax Court held that the price paid by the generic drug companies was indeed the relevant “comparable” and that Glaxo Canada had therefore overpaid for the ranitidine. The excess payment was characterized as a dividend paid by Glaxo Canada to Glaxo Group, which was subject to Canadian withholding tax at a rate of 10 percent. This decision is under appeal to the Federal Court of Appeal.

Another major transfer pricing case, *General Electric Capital Canada Inc. v. The Queen*, was heard by the Tax Court in the summer of 2009 and is currently under reserve. In contrast to the sale of goods issue considered in *GlaxoSmithKline*, the *GE Capital* case deals with the question of either (a) whether a guarantee fee arrangement in respect of commercial paper and debentures issued by a Canadian subsidiary of a US parent ought to have been entered into in light of the fact that the guarantor was the parent of the subsidiary and would have been perceived by the market as standing behind its subsidiary in any event (the Crown's view), or (b) whether the amount of the guarantee fee (100 basis points) would have been reasonable in the circumstances if the parties had been dealing with one another at arm's-length (the taxpayer's view). It will be interesting to see

which “theory of the case” the Tax Court adopts.

Other Issues in International Tax Litigation

Permanent Establishment

Two recent Tax Court decisions involving the interpretation of the term “permanent establishment” have generated significant international attention: *Knights of Columbus v. The Queen*, 2008 TCC 307, and its sister case *American Income Life Insurance Company v. The Queen*, 2008 TCC 306 (*AILIC*). These cases address the fundamental issue of a state’s ability to tax the business profits of a non-resident enterprise under a bilateral income tax convention where a non-resident carries on business in that state.

The *Income Tax Act* provides that any non-resident carrying on business in Canada is required to pay income tax on the profits attributable to its Canadian business activities. However, under its tax treaties, Canada has agreed not to tax a non-resident’s business profits unless the non-resident has a “permanent establishment” in Canada. Generally, tax treaties contemplate two different types of permanent establishments: (a) a “geographical permanent establishment” (i.e., a fixed place of business through which the business of the non-resident is carried on); and (b) a “dependent agent permanent establishment” (i.e., a person who has, and habitually exercises, the authority to enter into contracts on behalf of the non-resident).

Both *Knights* and *AILIC* involved insurance companies based in the United States who sold insurance products to Canadians through the assistance of commission-based Canadian sales agents. The agents would solicit insurance applications from Canadians and submit those applications to the US insurance companies for consideration. Sale agents generally worked out of home offices and visited the homes of prospective applicants to solicit insurance applications.

In both cases, the Crown argued that the Canadian sales agents constituted “dependent agent permanent establishments” of the US insurance companies for purpose of the Canada-United States Income Tax Convention on the basis that the agents solicited and received applications that were routinely approved by the insurance companies in the US. Alternatively, the Crown argued that an agent’s home office was a “geographical permanent establishment” of the US insurance companies primarily on the basis that the agents carried on activities of significant importance

to the business of the insurance companies through these premises.

The Tax Court found in favor of the taxpayers on all issues. The court found that the agents did not constitute “dependent agent permanent establishments” on the basis that the US insurance companies concluded all contracts of insurance in the US. Furthermore, the court concluded that the US insurance companies did not have sufficient control or disposal over the home offices to constitute them as “geographical permanent establishments.” In this respect, the court found that the agents carried on their own agency businesses through such locations and did not carry on the business of the US insurance companies.

Treaty Shopping

Because Canada has entered into tax treaties with certain countries and some of those treaties are more favorable than others, there is an incentive for certain non-residents to select the most favorable Canadian tax treaty when structuring their investments and to attempt to situate themselves within the scope of certain tax treaties.

The CRA has expressed a pronounced aversion to any cross-border structure that even remotely suggests treaty shopping. However, to date, the CRA’s record at trial has been poor. In this respect, the CRA has thus far been unable to demonstrate that “treaty shopping” offends Canada’s general anti-avoidance rule (the GAAR) or that there is some sort of inherent anti-abuse rule in Canada’s treaties. In *The Queen v. MIL (Investments) S.A.*, 2007 FCA 236, aff’g 2006 TCC 460, the Federal Court of Appeal rejected the CRA’s assertion that treaty shopping should be considered abusive under Canada’s legislation-based anti-avoidance rules or a treaty-based anti-abuse rule.

Generally speaking, in the absence of a specific treaty-based anti-avoidance rule, Canadian courts have been reluctant to find that taxpayers have “abused” a treaty merely by utilizing the benefits that the treaty offers. Undoubtedly, the judicial boundaries of “abusive” transactions in the context of tax treaties will continue to be tested by both taxpayers and the CRA in the coming years.

The CRA has also tried to attack the availability of treaty benefits through definitional means. For example, one important term that has been included in most international tax treaties is “beneficial owner.” Generally, in order for a non-resident to benefit from treaty-reduced rates of withholding tax

in respect of interest, dividend or royalty payments, the non-resident must be the “beneficial owner” of the income received from Canada. The “beneficial owner” requirement prevents a person resident in a third state from routing those payments through an agent or nominee who is resident in another state that has a favorable treaty with Canada in order to access the reduced treaty rates.

The CRA has (unsuccessfully) attempted to characterize the “beneficial owner” requirement as a broad anti-abuse rule that could even apply in relatively “plain vanilla” cross-border holding company structures. In *Prévost Car Inc. v. The Queen*, 2008 TCC 231, aff’d at 2009 FCA 57, the CRA contended that a Dutch holding company (Dutchco) was not the “beneficial owner” of dividends paid by its wholly owned Canadian subsidiary (Prévost Car) on the basis that Dutchco acted as a mere “conduit” in respect of the dividends. The underlying basis for the CRA’s position was that Dutchco routinely paid all of the dividends it received, in turn, to its own shareholders: a corporation resident in Sweden (Volvo) and a corporation resident in the United Kingdom (Henlys). As such, the CRA asserted that Dutchco could claim no legal ownership of the dividends and was, therefore, not entitled to the reduced rate of Canadian withholding tax under the Canada-Netherlands income tax treaty.

The Tax Court disagreed with the Crown, noting that the “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend received. The Tax Court concluded that Dutchco owned the shares of the Canadian subsidiary on its own account and that the dividends on those shares were therefore the property of Dutchco. In this respect, the dividends were an asset of Dutchco and were available to its creditors. There was no predetermined or automatic flow of funds to Volvo and Henlys.

Accordingly, Dutchco was the “beneficial owner” of the dividends upon their receipt from its Canadian

subsidiary and was therefore entitled to the benefit of the 5 percent withholding tax rate under the treaty. The Federal Court of Appeal upheld the Tax Court’s decision, refusing to adopt the ambiguous and flexible meaning of “beneficial owner” put forward by the CRA, which could threaten the viability of numerous international holding company structures. The Court of Appeal instead endorsed a more practical meaning that, in its view, provides greater “certainty and stability” for taxpayers.

The *Prévost* decision has significant international consequences; the term “beneficial owner” is common in most tax treaties around the world. Whether the CRA decides to desist from further attack based on the notion of “beneficial ownership” remains to be seen. We understand that other “beneficial owner” cases dealing with other types of payments (i.e., royalties) are currently pending before the Tax Court, the determination of which may turn on the ability of the CRA to factually distinguish such cases from *Prévost*.

In light of the results in *MIL* and *Prévost*, Canada may feel obliged to include specific anti-avoidance rules, also referred to as “limitation on benefit” (LOB) provisions, in future tax treaties. Such comprehensive LOB provisions are commonly used by other states, most notably the United States. Moreover, the OECD has increasingly endorsed such rules to combat perceived treaty abuses and has encouraged member states to pursue such provisions in treaty negotiations.

In the past, Canada had resisted these types of rules, but the recent expansion of the comprehensive LOB provision in the Fifth Protocol to the Canada-United States Income Tax Convention may very well indicate a change in direction in this regard. Previously, the LOB provision applied only to Canadian residents — now, the provision may apply to deny treaty benefits to US residents who fail to satisfy its strict requirements. There is sure to be much future cross-border tax litigation around this new LOB provision as well.

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