tax notes international
Volume 81, Number 7 ■ February 15, 2016

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Canadian Transfer Pricing Decision In *Marzen*: Points of Interest

by Nathan Boidman

Reprinted from *Tax Notes Int'l*, February 15, 2016, p. 601

taxanalysts®

For more *Tax Notes International* content, please visit www.taxnotes.com.

PRACTITIONERS' CORNER

Canadian Transfer Pricing Decision in *Marzen*: Points of Interest

by Nathan Boidman

Nathan Boidman is with Davies Ward Phillips & Vineberg LLP in Montreal.

In this article, the author reviews *Marzen Artistic Aluminum*, a Canadian transfer pricing case involving sales of Canadian products into U.S. markets. He focuses on novel issues raised by the parties' use of a Barbados subsidiary in the operating structure and the separate question of the decision's possible effects on the implementation in Canada of any of the action 8-10 recommendations under the OECD's base erosion and profit-shifting project.

Copyright 2016 Nathan Boidman.

The transfer pricing decision handed down January 29 by Canada's Federal Court of Appeal (FCA) in *Marzen Artistic Aluminum Ltd* (2016 FCA 34) regarding service fees paid by a Canadian corporation to its low-taxed Barbados subsidiary is noteworthy for several reasons, examined below after a brief outline of the facts and the judgment.

The Facts

The taxpayer, a Canadian corporation (Canco), developed and manufactured windows in Canada and had established a U.S. sister corporation (USco) to purchase and resell them to the California high-rise market. Canco, with the assistance of a Barbados consultant (a former Canadian lawyer and businessman) who was in the business of establishing low-taxed international business corporations in Barbados, established a Barbados subsidiary (Barbco), engaged the consultant as its managing director, and entered into a marketing and sales services agreement (MSSA) with Canco.

Barbco was to render sales, marketing, and support services in the U.S. to and for Canco. But because, as written at paragraph 23 of the judgment, Barbco ''was essentially an empty shell with no personnel, no assets and no risk,'' it had to obtain the services and functions of the California-based employees of USco in order to provide those services to Canco and did so under a personnel secondment agreement (PSA) with USco. Barbco paid cost plus 10 percent to USco under the PSA, which amounted to C $2.1 million and C $2.8 million in 2000 and 2001, respectively. There were also two subsidiary contracts between the parties.

In those two years, Canco sold windows to USco at ''the same price they were sold [by USco] in the United States'' (paragraph 6 of the judgment). And Canco paid fees to Barbco under the MSSA equal to C $4.2 million in 2000 and C $7.8 million in 2001 — in other words, at markups of C $2.1 million and C $5 million in those years. Barbco paid its managing director and his management company C $32,500 in each of those years and was positioned to pay dividends to Canco (received without Canadian tax by Canco under the foreign affiliate rules[1]) of C $2 million in 2000 and C $5.3 million in 2001.

---

[1] *See* sections 95 and 113 of the Income Tax Act (Canada).

For more *Tax Notes International* content, please visit www.taxnotes.com.

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The Government Attack

The minister of national revenue (part of the Canada Revenue Agency) disallowed, as a deductible expense, the portion of the fee paid by Canco to Barbco exceeding the amounts that Barbco had paid to USco under the PSA, which is essentially the amount of profit Barbco made from the arrangement. That disallowance arose under Canada's basic arm's-length-based transfer pricing rule, section 247(2)(a) and (c) of the Income Tax Act (Canada).

The minister also assessed a penalty under ITA section 247(3) equal to 10 percent of the amount denied for 2001. Paragraph 219 of the Tax Court of Canada's (TCC) judgment shows the penalty as C $502,519 (10 percent of C $5,025,190). That arises if the denial exceeds the lesser of C $5 million or 10 percent of the taxpayer's gross revenue, which was C $54.4 million, and the taxpayer has not made reasonable efforts to use arm's-length prices.

A taxpayer is deemed, under section 247(4) ITA, not to have made reasonable efforts if it has not prepared prescribed contemporaneous documentation. Here the government asserted that the documents submitted were not in compliance, and thus the penalty was assessed.

The Judgments

In a 2014 decision,[2] the TCC upheld the government's assessments, except for reducing them by the amounts of C $32,500 paid by Barbco to the managing director and his management company. Now the FCA decision has upheld that judgment, dismissing the taxpayer's appeal.

The two courts found that Canco would not have paid a third party more than the costs Barbco incurred because, in the courts' view, Barbco added no value to that stemming from the efforts (and related costs to Barbco) of the seconded employees and the managing director and his management company. Therefore, those costs represented the arm's-length price for the services and an orthodox transfer pricing method that could be arrived at through an internal comparable uncontrolled price approach (even though Barbco and USco were commonly controlled). The latter was adopted in preference to a transactional net margin method approach that the taxpayer advocated, at paragraphs 55 and 58 of the FCA judgment.

As discussed below, the critical finding of fact was that the consultant/managing director did not — contrary to the central thesis of the taxpayer's expert witness and position — turn, through his efforts on behalf of Barbco, the activities of the seconded employees of USco into a much more valuable service through a synergistic process that the witness argued reflected a virtual ''amalgam'' of the efforts or inputs of Barbco and USco.[3] This was rejected both factually and on the basis that the OECD transfer pricing guidelines require a separate entity approach, although it may accept a blended or bundled transaction approach.[4]

Regarding the section 247(3) penalty, although the TCC agreed that the documentation did not meet the requirements of section 247(4), it appears that it became inapplicable once the TCC reduced the assessments by $32,500 because that seemed to bring the adjustment under the requisite threshold — and that would be consistent with the fact that the FCA judgment does not deal with the penalty.

Points of Interest

The Oddities of the Arrangements

It appears that nowhere in either judgment does the court deal with some obvious oddities of the arrangement, which makes it difficult to systematically analyze the judgments in any normal or orthodox fashion.

To start with, both judgments note, without comment, the clearly odd fact that USco took no markup or profit margin on the purchase of windows from Canco and then sale to its U.S. customers. As noted above, the FCA stated in paragraph 6 and the TCC wrote in paragraph 51 that ''the Appellant supplied Window Products at a cost equal to SWI's [USco's] sale price to US customers, thus resulting in no profit being recognized by SWI.'' Would that attract an attack under U.S. transfer pricing law? Or would the 10 percent markup for the seconded employees charged by USco to Barbco under the PSA be asserted as a sufficient proxy for a distributor's margin on buying and reselling?[5]

Or was USco to be considered an agent, not a distributor, not only raising separate U.S. tax questions (none of which the two Canadian courts discussed or had reason to discuss) but leading directly to the next oddity?

Was it odd, as a pure business matter, that if USco was acting as a principal or distributor, Barbco was providing U.S. marketing and selling services to Canco (which, on this hypothesis, was selling to USco) as opposed to USco? In particular, if USco was selling as principal, wasn't it the party that required the marketing and selling services? On the other hand, returning

[2]*Marzen Artistic Aluminum Ltd v. The Queen* (2014 TCC 194).

[3]*See* paras. 24 and 26 of the FCA judgment.

[4]Paragraphs 1.6, 1.42, and 1.43 of the OECD transfer pricing guidelines.

[5]Query whether Canco could have claimed an offset, under ITA section 247(10), from the government's attack on the service fee payment on the basis of overcharging USco for the window products. That rule, intended to net overreporting intercompany transaction income against underreporting, requires the concurrence of the government.

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.

to the prior question, if USco was acting as an agent for Canco, it would make perfect business sense that Barbco would be under contract — as it was — to provide marketing and selling services to Canco. These questions do not seem to have surfaced in either of the two judgments.

An oddity raised was why — if he was the driving force, as the taxpayer contended, and was the effective creator of the alleged enhanced value of the services rendered by Barbco — the consultant/managing director was paid a paltry C $32,500 per year for his efforts, which brought such profitability to Barbco. The taxpayer tried to square this circle by asserting that the consultant was, somehow, being compensated separately by Canco. But no specifics were established by the taxpayer, and this was certainly a key factor in the courts' conclusions.

A related important factor (not oddity) is that the courts accepted the contention that the consultant did provide a fundamentally very valuable service but that it was provided to Canco before Barbco was established and therefore could not be seen to be provided by Barbco (paragraph 24 of the FCA judgment). Canco had met up with the consultant when it was not doing well trying to develop markets in the state of Washington. The consultant strongly suggested that Canco look for markets in Southern California and look for specific Canadian developers doing projects there, and upgrade its marketing and selling programs. That proved to be very valuable advice, but as noted, it was from the consultant to Canco and not to Canco on behalf of Barbco, which was brought into the Canco sphere only later.

Implication for BEPS

There may be a faintly discernible relationship between these judgments and the base erosion and profit-shifting crusade.[6]

The October 5 reports of the OECD's work in BEPS actions 8-10 regarding transfer pricing are seen by some as making substantial changes to the OECD transfer pricing guidelines.[7] To what extent will that affect Canada's approach, absent legislative change, to section 247(2), which sets out the principle of arm's-length pricing, but contains no detailed rules and leaves to the courts to ultimately decide its application, if taxpayers and the CRA cannot agree? The absence of detailed rules leads to the question of how Canadian courts view the role of the OECD transfer pricing guidelines.

In 2012 the Supreme Court of Canada, in its first decision on transfer pricing,[8] stated unequivocally that the OECD's transfer pricing guidelines are not law per se in Canada but that they are useful in determining an arm's-length price. This was dutifully noted in both judgments (paragraph 18 in the FCA judgment and paragraph 177 in the TCC judgment). But the concern is that the lower courts may be paying lip service to the first part of the Supreme Court's formulation. In *Marzen*, this is seen in two ways. First, the TCC says, "Canadian courts have *endorsed* the use of the OECD Guidelines" (emphasis added). Second, both judgments are replete with references to and reliance on the transfer pricing guidelines as if they were law.[9] As noted, this is potentially very troubling regarding the BEPS transfer pricing work.

Common Sense in Transfer Pricing

In this writer's view, an often overlooked judicial statement on transfer pricing that gets to its essence and comprises its heart and soul is the following: "Transfer pricing is largely a matter of facts and circumstances coupled with a high dose of common sense." See Justice Robert Hogan in his landmark decision in *General Electric Capital Canada Inc.*[10] regarding intercompany guarantee fees.

Accordingly, it was nice to see the judge in the TCC decision in *Marzen* relate the government's view of the role of common sense in considering that there was a basic inconsistency between the taxpayer's claim that the consultant/managing director had effectuated a major increase in the value of the services provided by the seconded employees and the nominal fees Barbco paid to the consultant and his management company. At paragraph 171:

> use common sense in the assessment of the evidence. Mr. Csumirk [the Consultant] and Mr. Martini [the owner of Canco] were experienced and successful in their respective business endeavours. If Mr. Csumirk, on behalf of SII [Barbco], was really performing the crucial marketing services attributed to him under the Appellant's argument, why would he have done so for nothing more than a managing director's annual stipend? Common sense dictates that he would not have. Accepting the Appellant's contention, then, that Mr. Csumirk was to be paid personally for his efforts under the side deal with Mr. Martini/the Appellant, it defies common sense that Mr. Martini would also have bound the Appellant to pay SII for the same services under the MSSA.

[6]For the Canadian standpoint, see Nathan Boidman and Michael Kandev, "BEPS: A Spent Force or Radical Change?" *Tax Notes Int'l*, Dec. 7, 2015, p. 837.

[7]*See, for example*, Jens Wittendorff, "BEPS Actions 8-10: Birth of a New Arm's-Length Principle," *Tax Notes Int'l*, Jan. 25, 2016, p. 331.

[8]*Canada v. GlaxoSmithKline Inc.* (2012 SCC 52).

[9]*See, for example,* paras. 55 and 58 in the FCA judgment and paras. 186-191, 194, and 208 in the TCC judgment.

[10]2010 DTC 252, at para. 273.

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.

Avoiding CFC Attribution of the Service Income

The statutory underpinning of the taxpayer's plan (aside from the unsuccessful attempt to comply with transfer pricing law) was that Canco presumably qualified for an exception to a general controlled foreign corporation rule that attributes service income of a controlled foreign affiliate[11] that arises from services to the Canadian parent or a Canadian affiliate.[12] The exception, provided by section 95(3), is when the service is ''performed in connection with the purchase or sale of goods.'' However, did the odd fact pattern, discussed above, put that exception in doubt?

Concluding Comments

The foregoing indicates at least two things. First, *Marzen*, because of its rather unusual and complex arrangements, raises some novel questions and issues. Second, the scope of Canadian transfer pricing law is already wide, calling into question whether absent statutory amendment, the BEPS initiatives will affect that scope. ◆

[11]A controlled foreign affiliate is a nonresident corporation in which a Canadian resident has a direct or indirect 10 percent interest in any class of shares and that is controlled by that person alone or together with other persons, or by other persons.

[12]*See* ITA sections 95(2)(b) and 91.

(C) Tax Analysts 2016. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.