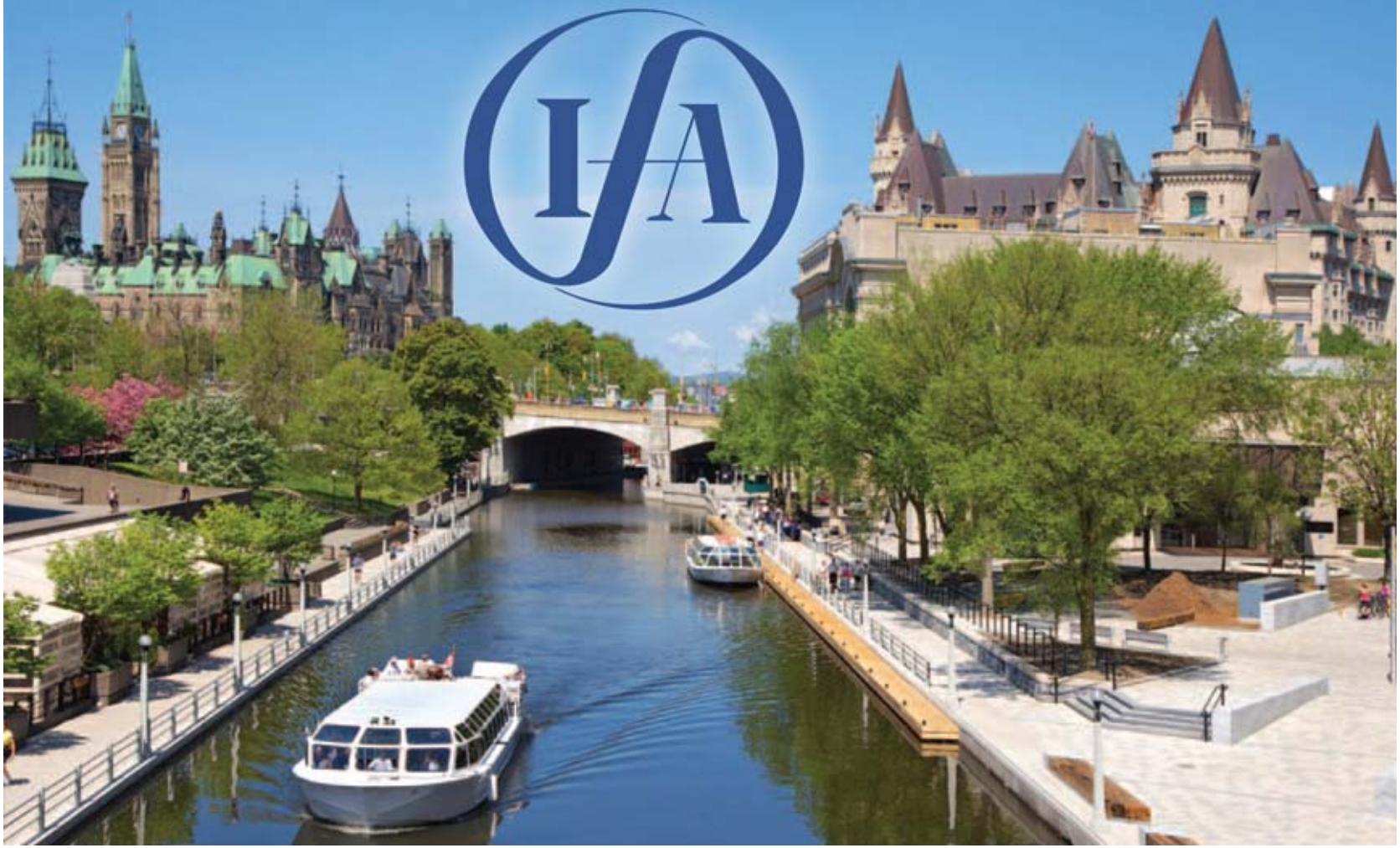


Recent Cases

Justice Campbell Miller, *Tax Court of Canada*
François Barette*, Fasken Martineau LLP*
Mark Brender, *Osler Hoskin & Harcourt LLP*

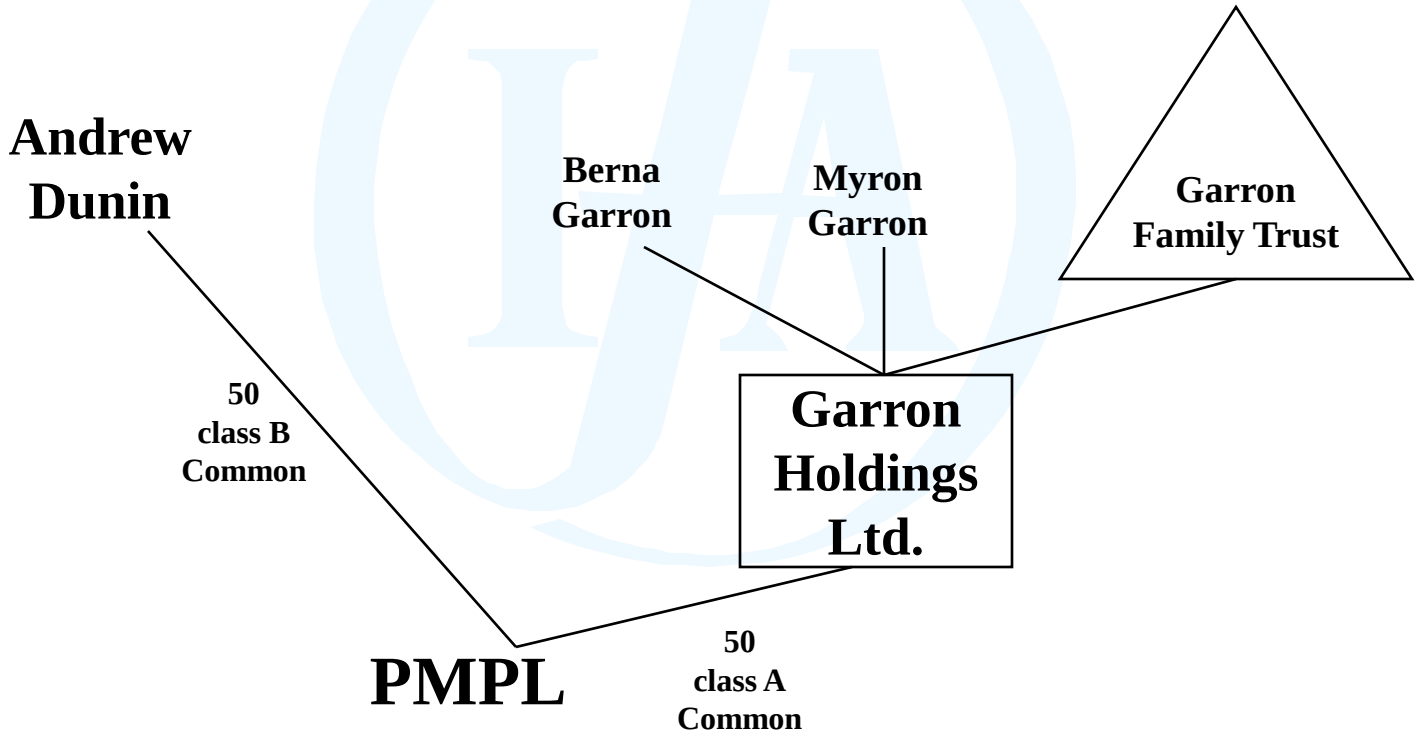
International Fiscal Association (Canadian Branch)
May 18, 2012,
Ottawa, Canada

Recent Cases - Agenda

- Trust Residence
  - *Garron Family Trust* (SCC)
- Beneficial Ownership
  - *Velcro Canada* (TCC)
- Transfer Pricing
  - *GlaxoSmithKline* (SCC appeal heard January 13, 2012)
- Subsection 95(6)
  - *Lehigh Cement* (TCC hearing held April 23, 2012)
- GAAR
  - *Copthorne Holdings* (SCC)

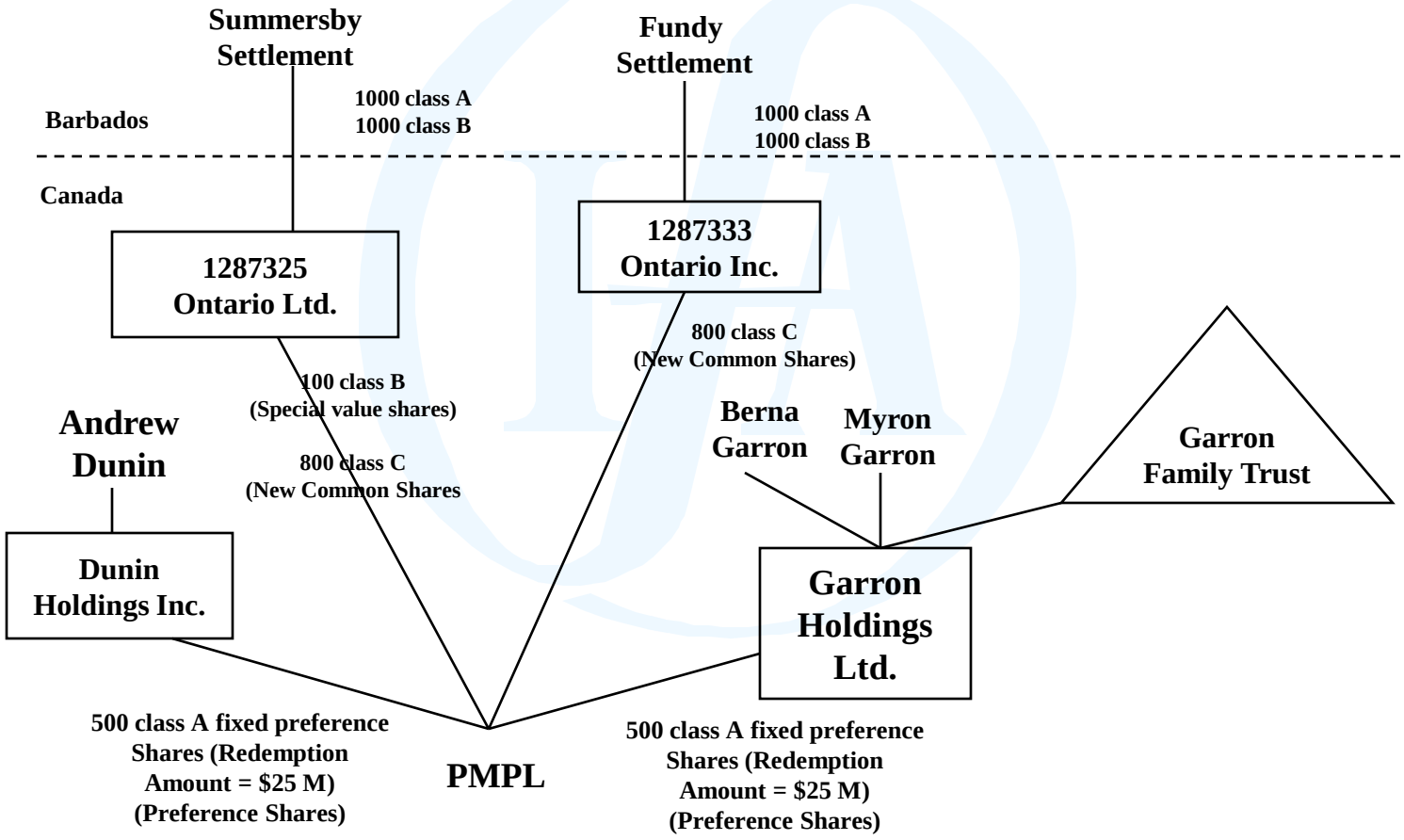
Garron Family Trust v. The Queen (TCC)

Corporate Structure Prior to April 6, 1998



Garron Family Trust v. The Queen (TCC)

Corporate Structure as at April 6, 1998



Garron Family Trust v. The Queen (TCC)

Issues

1. Are trusts resident in Canada under general principles ?
2. Are trusts resident in Canada by virtue of section 94 ?
3. Does 75(2) apply to other Appellants, i.e., the alternative assessment ?
4. Does GAAR apply ?
5. Should sale proceeds be reallocated by virtue of section 68 ?

Garron Family Trust v. The Queen (TCC)

Issue 1

- Does not accept the view that residence of trustees is always the deciding factor in determining the residence of a trust and rejects obiter of Gibson, J. in *Thibodeau Trust* case
- Must look to central management and control
- Reason for rejecting obiter is that one cannot always assume trustees comply with their fiduciary obligations
- Not expected that St. Michael would have decision making authority. Its role was to execute documents as required and provide administrative services. See basis for conclusion in ¶s 196-210
- Concluded trusts are resident in Canada

*Garron Family Trust v. The Queen (*TCC)

Issue 2 – does s. 94 apply ?

- 1998 reorganization resulted in a movement of share rights attributable to existing equity from former holders of common shares of PMPL to new common shareholders - per Kieboom – transfer of property
- But no transfer – transfer of property from Mr. Garron or Mr. Dunin
- Mr. Garron was not a shareholder of PMPL. GHL transferred property on the share recapitalization
- Mr. Dunin was a shareholder of PMPL and first step was a transfer of his shares of PMPL to his holding company. This is an indirect transfer of a property interest in PMPL

Garron Family Trust v. The Queen (TCC)

- But Woods, J. gave restrictive meaning to the words "directly or indirectly" in s.94 because otherwise it could lead to considerable uncertainty
- Woods, J. concluded that a s.94 deemed resident is not a resident for treaty purposes because a s.94 deemed resident is taxed on a source basis not on unlimited scope as in the case with a person resident under general principles

Garron Family Trust v. The Queen (TCC)

Issue 3 – Does 75(2) apply?

- Article XIV(4) of Treaty takes precedence over 75(2)

Garron Family Trust v. The Queen (TCC)

Issue 4 – Does GAAR apply?

- Minister asserts it is an abuse of the Treaty to avoid s.94
- Woods, J refers to 1977 Commentary re OECD which suggests that treaties should be amended to take into account domestic tax avoidance legislation
- If Trusts are resident only in Barbados, then the Treaty contemplates that Article XIV(4) will apply to them. It does not matter that the trusts have few connections with Barbados, i.e., asset, contributions and beneficiaries are resident in Canada
- Woods, J. rejects the argument that Article XIV(4) should be restricted to situations involving double taxation

Garron Family Trust v. The Queen (FCA)

- CRA emboldened by the decision is asserting that trusts are resident in Canada under the common law test.
- However, FCA noted some of the factors considered by Woods, J considered in isolation would not be sufficient to locate residence of trust anywhere but the residence of the trustee.
- The fact that the beneficiaries have the right to appoint a protector plus the power to replace the trustee is a common safeguard in a trust indenture.
- The fact that the beneficiaries took it upon themselves to advise the trustee and even urge the trustee, however strongly, to undertake a particular transaction is not sufficient by itself.

Garron Family Trust v. The Queen (FCA)

- Some normally neutral facts, such as the existence of a protector and reliance on advisors.
- Use of established trust company.
- August 27, 2010 draft legislation amending the ITCIA provides that notwithstanding the provisions of a tax treaty, a section 94 trust will be resident in Canada and not another country.
- FCA held that there is no misuse/abuse of the Barbados Treaty. Exemption flows from the terms of the Treaty under which Canada agreed not to tax capital gains.

Garron Family Trust v. The Queen (SCC)

- S.C.C. dismisses taxpayer's appeal.
- A trust resides where "its real business is carried on" (*De Beers*), which is where the central management and control of the trust actually takes place.
- Raises similarities between trusts and corporations which justifies application of central management and control test (holding, acquisition and disposition of assets; management of business; distribution of income, etc).
- Rejects the argument that management and control test cannot apply on the basis that a trust is not a person like a corporation:
  - trusts are deemed to be individuals under the ITA.

Garron Family Trust v. The Queen (SCC)

- Rejects argument that the ITA links the trust to the trustee under subsection 104(1), such that the residence of the trust must be the residence of the trustee:
  - This linkage is not a principle of general application for all purposes;
  - The context of subsection 104(1) does not suggest a rule that the residence of the trust must be the residence of the trustee;
  - Subsection 104(2) distinguishes the trust from the trustee in respect of trust property.
- S.C.C. does not consider sections 94 or 245, but notes that it "should not be understood as endorsing the reasons of the Federal Court of Appeal on those matters".

Velcro Canada Inc. v. The Queen (TCC)

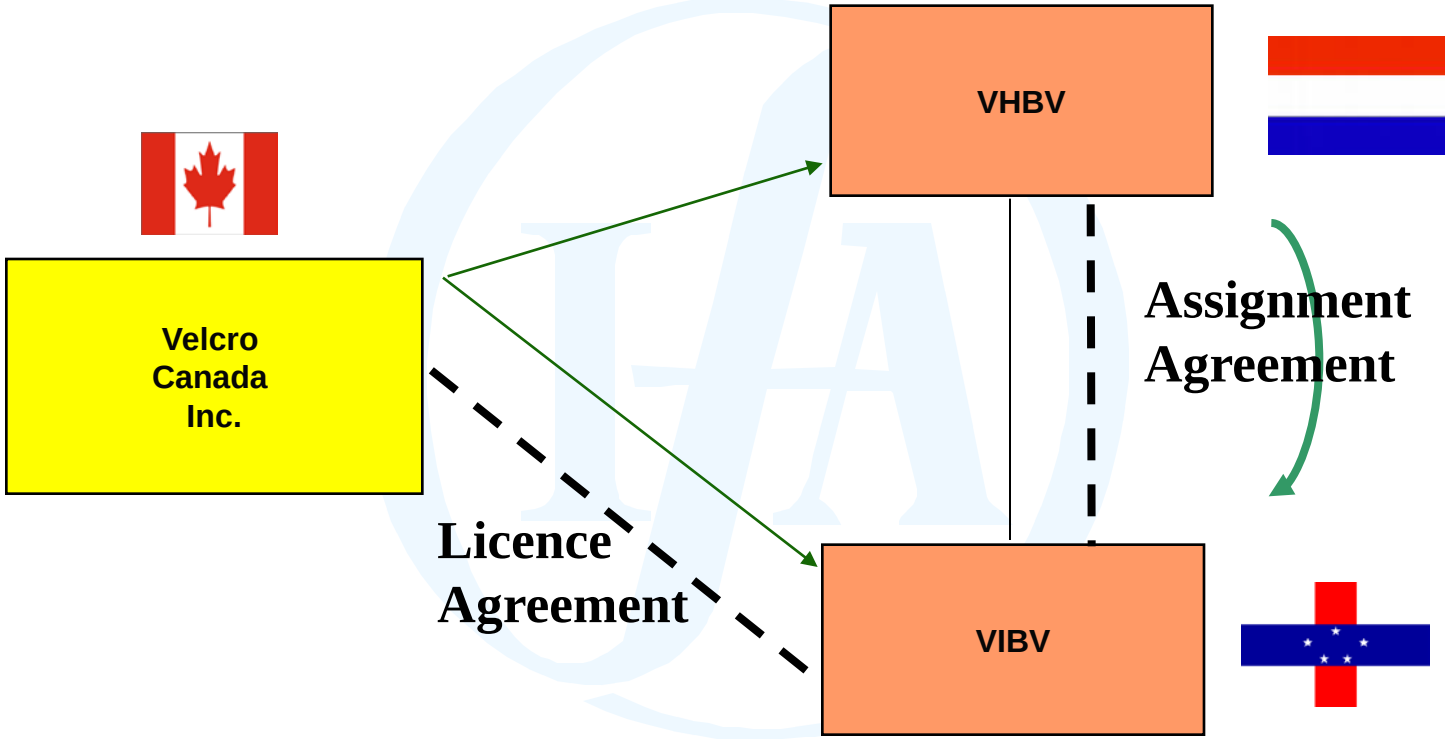
- Velcro Industries BV (VIBV), a resident of the Netherlands, owned IP under license to Velcro Canada
- From 1987 to October 1995, Velcro Canada paid royalties to VIBV and withheld Canadian tax at 10% under the CDA-NethTreaty
- In 1995 VIBV assigned all of its rights in the IP to Velcro Holdings BV (VHBV), a resident of the Netherlands. Under the assignment agreements,
  - VHBV was assigned the right to grant licenses of VIBVs' IP to Velcro Canada, and receive royalties from Velcro Canada.
  - Ownership of the IP remained with VIBV.
  - VHBV agreed to pay to VIBV an arm`s length amount, determined to be 90% of the royalties received from Velcro Canada, within 30 days of receiving royalty payments from Velcro Canada.

Velcro Canada Inc. v. The Queen - Facts

Some important factual elements:

- As part of a reorganization of the Velcro group, VIBV changed its residency to the Netherlands Antilles
- VHBV's affairs were In large part managed by an arm's length management company
- BOD of VHBV met as needed, no scheduled meetings and no meeting minutes kept. All resolutions were by unanimous consent
- Royalties were intermingled and moved with other monies flowing in and out of VHBV accounts
- Unrestricted flow of funds between CAD-US-Dutch currency accounts
- co-mingling of royalties with general funds of VHBV
- Royalty in-flows and outflows were of differing amounts; royalties did not move in an automated fashion

Velcro Canada Inc. v. The Queen



CRA: VHBV not "Beneficial Owner"

Velcro Canada Inc. v. The Queen

CRA's Position:

- VIBV rather than VHBV was the beneficial owner of the royalties from Velcro Canada between 1996 and 2004, thereby disentitling VHBV to the reduced royalty rate under the Treaty.
- Specifically, CRA asserted that VHBV:
  - did not beneficially own the royalties;
  - was an agent or conduit; and
  - did not exercise the "incidences of ownership" as required by *Prévost.*

Velcro Canada Inc. v. The Queen

Taxpayer's Position:

- Holdings was the beneficial owner of the royalties and, consequently, entitled to the reduced rate of withholding tax under the Treaty.
- Relied on the test for "beneficial owner" in *Prévost* and the application of Art. III, section 2 of the Treaty.

Velcro Canada Inc. v. The Queen

TCC Decision:

- Justice Rossiter, for the Tax Court of Canada…
  - OECD Model Convention, Commentary & Conduit Report – later commentaries can act as guides
  - "beneficial ownership test" in *Prévost*
  - Four elements to beneficial ownership
    - (a) possession; (b) use; (c) risk; and (d) control
    - *«the Court is not likely to pierce the corporate veil unless the corporation has no discretion with regard to the use and application of the funds»*

Velcro Canada Inc. v. The Queen

TCC Decision:

- The taxpayer was the beneficial owner of the royalties:
  - **Possession** – exercised *dominion* over the royalties
    - Legal right to receive funds, exclusive possession and control, funds intermingled with other accounts, invested at sole discretion, no automatic flow of funds
  - **Use** – discretion to use the funds
  - **Risk** – currency fluctuations, creditors, no priority, no indemnification
  - **Control** – to exercise power or influence over

Velcro Canada Inc. v. The Queen

TCC Decision:

- Beneficial owner of the royalties – no predetermined flow of funds
  - Contractual obligation to pay certain amount of monies, but not specific monies
  - No automated flow of specific monies because VHBV had discretion with respect to use
- Court places much emphasis on the co-mingling of assets:
  - *"VHBV did have an obligation to pay a certain amount of money which was equivalent to 90% of the royalties received. The funds paid were not necessarily the same funds as the royalty payments received because the original payments were co-mingled with other assets of Holdings. The funds paid to Velcro Industries were not necessarily in the same dollar because the funds were converted from Canadian dollars to U.S. dollars or to Dutch currency, it may have been a different amount because of the currency exchange."*

Velcro Canada Inc. v. The Queen

TCC Decision:

- **No agency** – no ability to affect Velcro Industries' legal position
- **Not a nominee** – no indication that VHBV was required to act in a limited way
- **Not a conduit** – "`For the Court to find that VHBV was a conduit, there would have to have been no discretion with respect to the funds

Velcro Canada Inc. v. The Queen

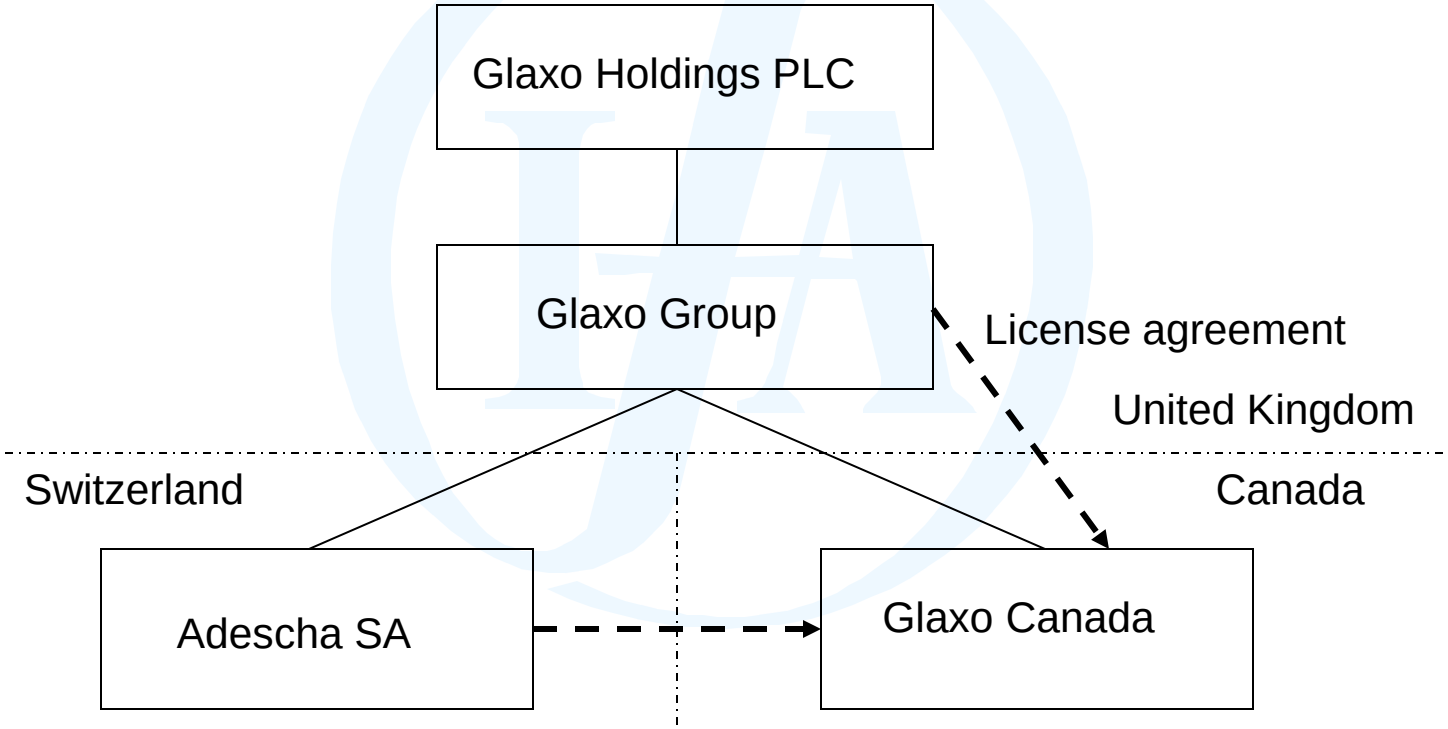
- The limited discretion which VHBV did exercise over the funds prevented the Court from piercing the corporate veil.
- Corroborated Justice Rip's statement in *Prévost* that a court is not likely to pierce the corporate veil unless the corporation has '*absolutely no discretion*' with regard to the user and application of the funds. At para 55:

> «The person who is the beneficial owner is the person who enjoys and assumes all the attributes of ownership. Only if the interest in the item in question gives that party the right to control the item without question (e.g. they are not accountable to anyone for how he or she deals with the item) will it meet the threshold set in Prévost. »

- The Crown did not appeal the decision to the FCA

The Queen v. GlaxoSmithKline Inc.

Corporate structure



Issue: transfer price of active pharmaceutical ingredient

The Queen v. GlaxoSmithKline Inc.

- Glaxo Canada purchased active pharmaceutical ingredient (ranitidine) from Adechsa SA for $1512 - $1,651 per kilogram.
- Same ingredient purchased by generic companies from third parties for $194 - $304 per kilogram.
- Minister reassessed under subsection 69(2) ITA (now subsection 247(2) ITA) on the basis that the price paid by the generic companies was the correct transfer price.
- Part XIII assessment followed in respect of amount re-characterized as a deemed dividend (subsections 56(2), 212(2) and 214(3) ITA.
- Glaxo Canada was also party to a license agreement with Galaxo Group, pursuant to which it paid Glaxo Group a 6% royalty on its net sales of certain drugs in exchange for various rights and support.

The Queen v. GlaxoSmithKline Inc. (TCC)

- The issue was whether the price paid by Glaxo Canada for ranitidine represented the fair market value of the ingredient.
- The T.C.C. held that it did not and determined that the reasonable price for Glaxo Canada to pay would have been the highest price paid by the generic companies for ranitidine (subject to an upward adjustment to take into consideration a difference between the ingredients).
- The excess amount was considered to be a benefit that Glaxo Canada desired to have conferred on Adechsa SA for purposes of subsection 56(2) and was thus subject to Part XIII withholding tax.

The Queen v. GlaxoSmithKline Inc. (TCC)

- Three principal areas of dispute between the Minister and Glaxo Canada:
  - Whether the supply agreement and the license agreement should be considered together;
  - The meaning of “reasonable in the circumstances” in subsection 69(2) ITA;
  - The impact of the differences in good manufacturing practices (“GMPs”) and health, safety and environmental standards (“HSEs”).

The Queen v. GlaxoSmithKline Inc. (TCC)

- The T.C.C. concluded, based on the *Singleton* case, that the supply and license agreements covered separate matters and the license agreement should not impact the determination of the arm's length price for ranitidine. The business circumstances and strategies of the Glaxo group were not relevant for the transfer pricing issue.
- The T.C.C. also rejected Glaxo Canada's argument that its GMPs and HSEs rendered its ranitidine incomparable with the ranitidine used by the generic companies, noting that the ranitidine used by both was chemically equivalent.

The Queen v. GlaxoSmithKline Inc. (TCC)

- The T.C.C. concluded, after reviewing various transfer pricing methodologies, that the comparable uncontrolled price (“CUP”) method was the preferred method and that the generic companies were an appropriate comparator.

The Queen v. GlaxoSmithKline Inc. (FCA)

- The F.C.A. first examined the issue of whether both the supply and license agreement should be considered in determining the transfer price.
- It found that the T.C.C. erred in concluding that the license agreement was not a relevant consideration:
  - The *Singleton* decision is of no relevance to a transfer pricing issue;
  - The T.C.C. misunderstood the test set out in subsection 69(2) ITA – all relevant circumstances which an arm's length purchaser would have to consider must be taken into consideration in determining whether the price paid by Glaxo Canada would have been "reasonable in the circumstances" if the parties were dealing at arm's length.

The Queen v. GlaxoSmithKline Inc. (FCA)

- On the basis of *Gabco Limited v. Minister of National Revenue* (68 DTC 5210), the test "requires an inquiry into those circumstances which an arm's length purchaser, standing in the shoes of the appellant, would consider relevant in deciding whether it should pay the price paid by the appellant to Adechsa for its ranitidine".
- The license agreement had to be taken into account, as it was central to Glaxo Canada's business reality.
- The license agreement gave rise to a number of considerations and circumstances that an arm's length purchaser would have had to consider in deciding the price it was willing to pay.

The Queen v. GlaxoSmithKline Inc. (FCA)

- The appeal was allowed and the matter was returned to the T.C.C. for rehearing and reconsideration in light of the F.C.A.'s decision.
- The S.C.C. granted leave to appeal and the appeal was heard on January 13, 2012 (SCC 33874). Judgment has been reserved.

Recent Cases - Subsection 95(6)

- Overview of 95(6)
- Decided
  - *Univar* (2005, TCC)
- Recently Heard
  - *Lehigh Cement* (heard by TCC on April 26, 2012)
- In the pipeline
  - *Imperial Tobacco (notice of appeal filed)*

Subsection 95(6)

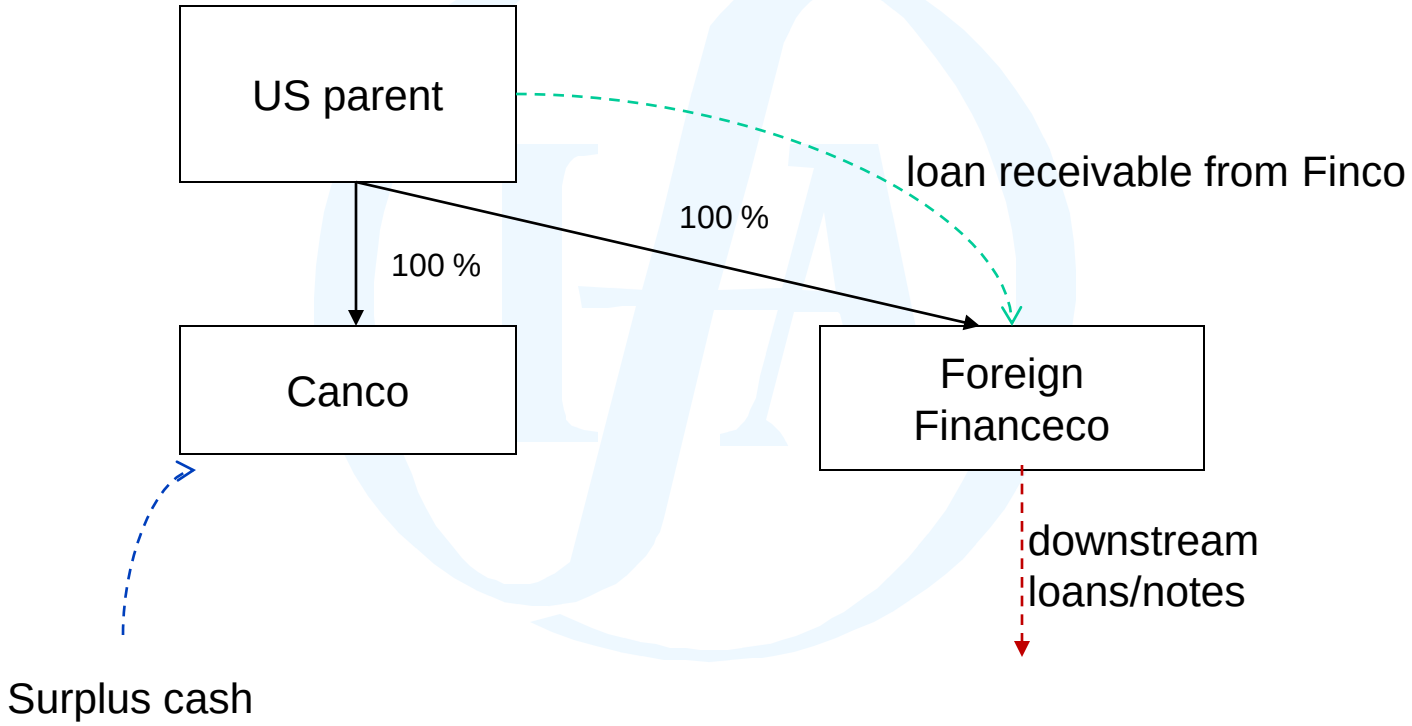
- Subsection 95(6)
  - Specific anti-avoidance rule aimed at preventing the avoidance of tax by means of the acquisition or disposition of shares or rights to acquire shares
- Generally understood purpose of paragraph 95(6)(b)
  - Prevent taxpayers from artificially obtaining “foreign affiliate” status through acquisition of shares of a foreign corporation for a nominal amount or for a transitory period of time, thereby gaining access to exempt surplus dividends
  - Prevent taxpayers from manipulating shareholdings in order to avoid “controlled foreign affiliate” status and thereby avoiding FAPI rules
  - Paragraph 95(6)(b) should not apply where an investment has real economic substance

Subsection 95(6)

- CRA Income Tax Technical News #36
  - CRA's General Comments on 95(6)(b)
    - Words of paragraph 95(6)(b) are broad and could apply to a wide range of transactions
    - To ensure consistency in application, all reassessments involving paragraph 95(6)(b) will be reviewed at CRA Headquarters

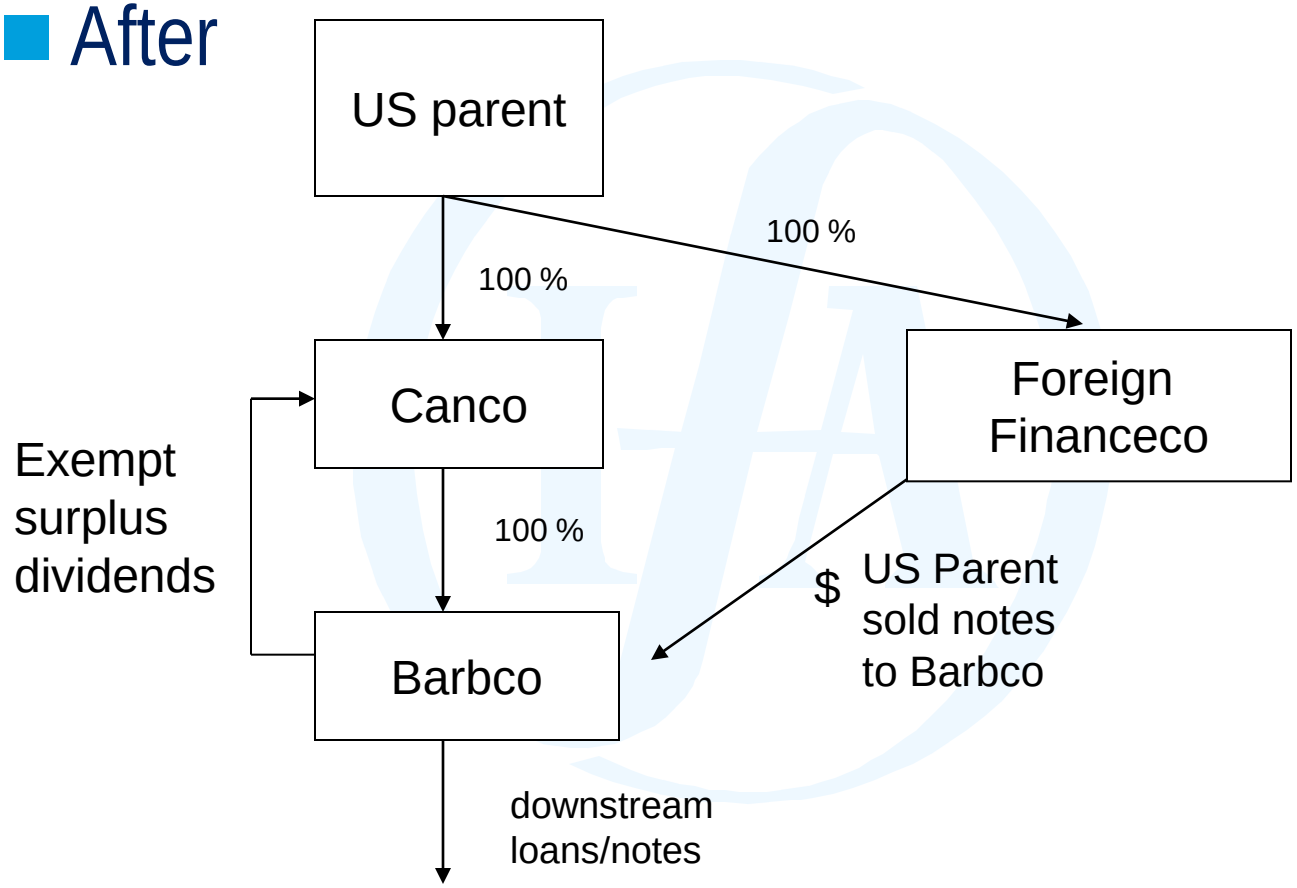
Univar Canada Ltd. v. The Queen (TCC)

Before



Univar Canada Ltd. v. The Queen (TCC)

- After



Univar - CRA's Arguments

1. Subsection 95(6) applies:
   - shares of Barbco were acquired for principal purpose of avoiding Canadian tax;
   - Barbco shares are deemed not to have been acquired by Canco; and
   - Barbco no longer a foreign affiliate of Canco therefore paragraph 113(1)(a) deduction not available.
2. Alternatively, GAAR applies:
   - Dividends paid by Barbco to Canco should be characterized as interest income to Canco

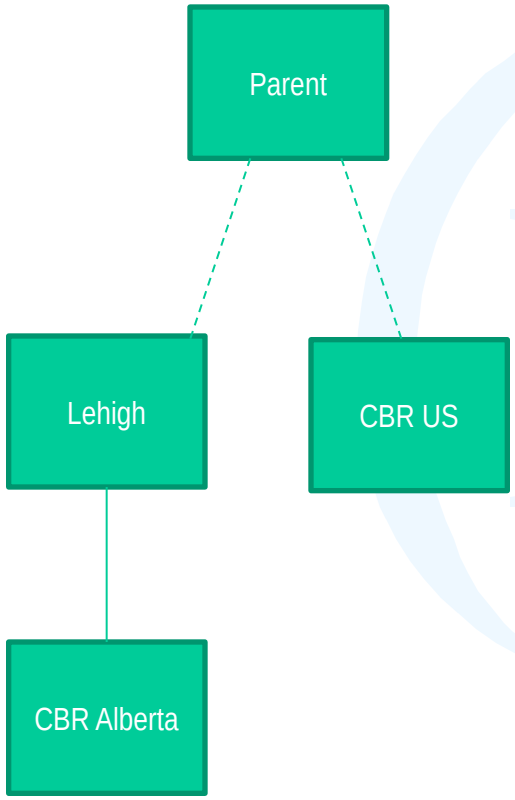
     or
   - Canco should be denied the paragraph 113(1)(a) deduction.

Univar Canada Ltd v. The Queen (TCC)

- Tax Court of Canada - Justice Bell
  - Taxpayer was successful
  - Court held that neither GAAR nor 95(6)(b) applied
  - Court focused solely on the share acquisition in question, not the series of transactions involved
  - No avoidance, reduction or deferral of “tax otherwise payable” or a “tax benefit”
  - Evidence indicated that there was no alternative transaction contemplated by the taxpayer against which to measure the tax, or lack thereof, resulting from the transaction actually undertaken
  - Little guidance with respect to scope of para. 95(6)(b)

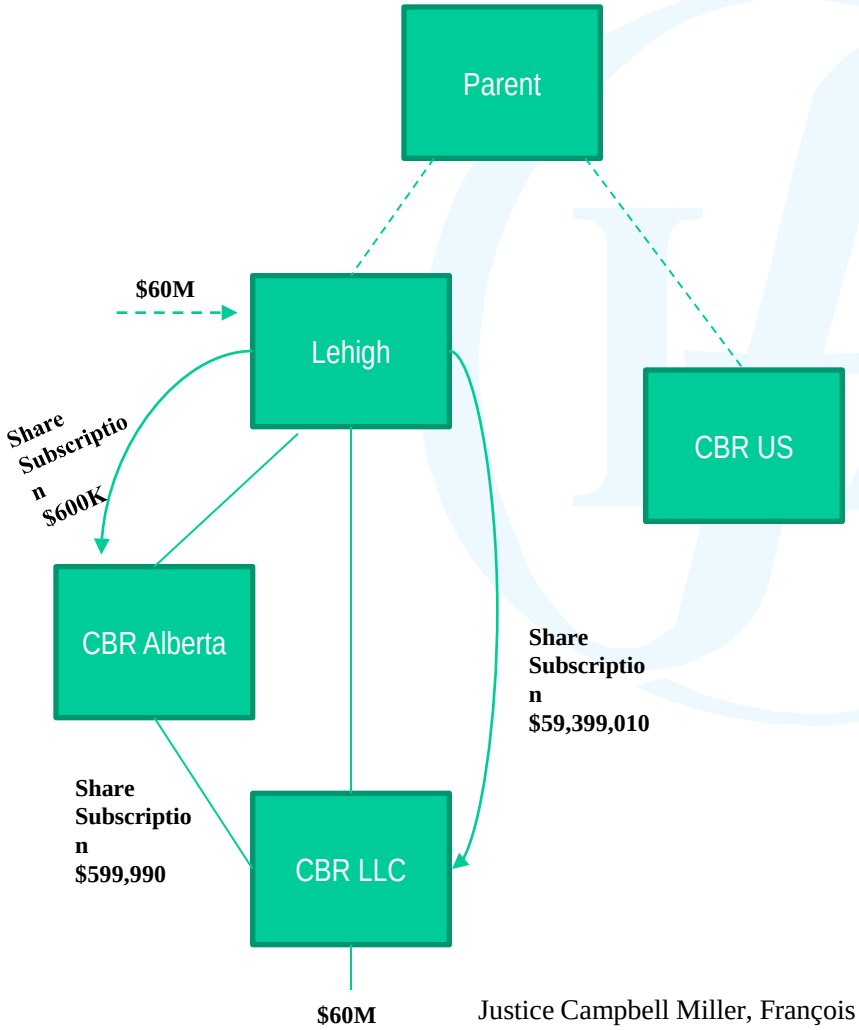
Lehigh Cement - Case Heard April 26, 2012

Facts (Simplified Structure)



- Lehigh is an indirect Canadian sub of a German publicly traded company
- CBR Alberta is a wholly owned subsidiary of Lehigh
- CBR US was related to Lehigh

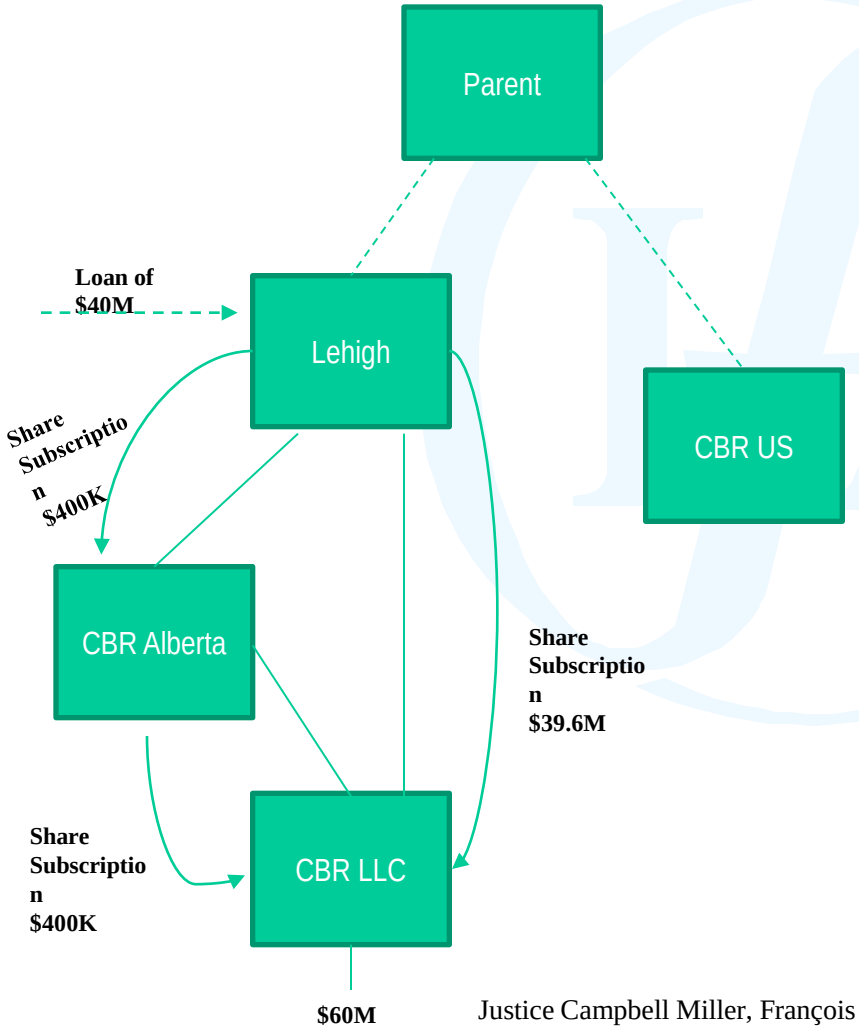
Lehigh - Facts



- On July 10, 1995

1. Lehigh borrowed $60M from Citibank Canada.
2. $600,000 of which was used to acquire shares of CBR Alberta.
3. Lehigh and CBR Alberta formed CBR LLC.
4. Lehigh subscribed for shares of CBR LLC in the amount of $59,399,010.
5. CBR Alberta subscribed for shares CBR LLC in the amount of $599,990.

Lehigh - Facts



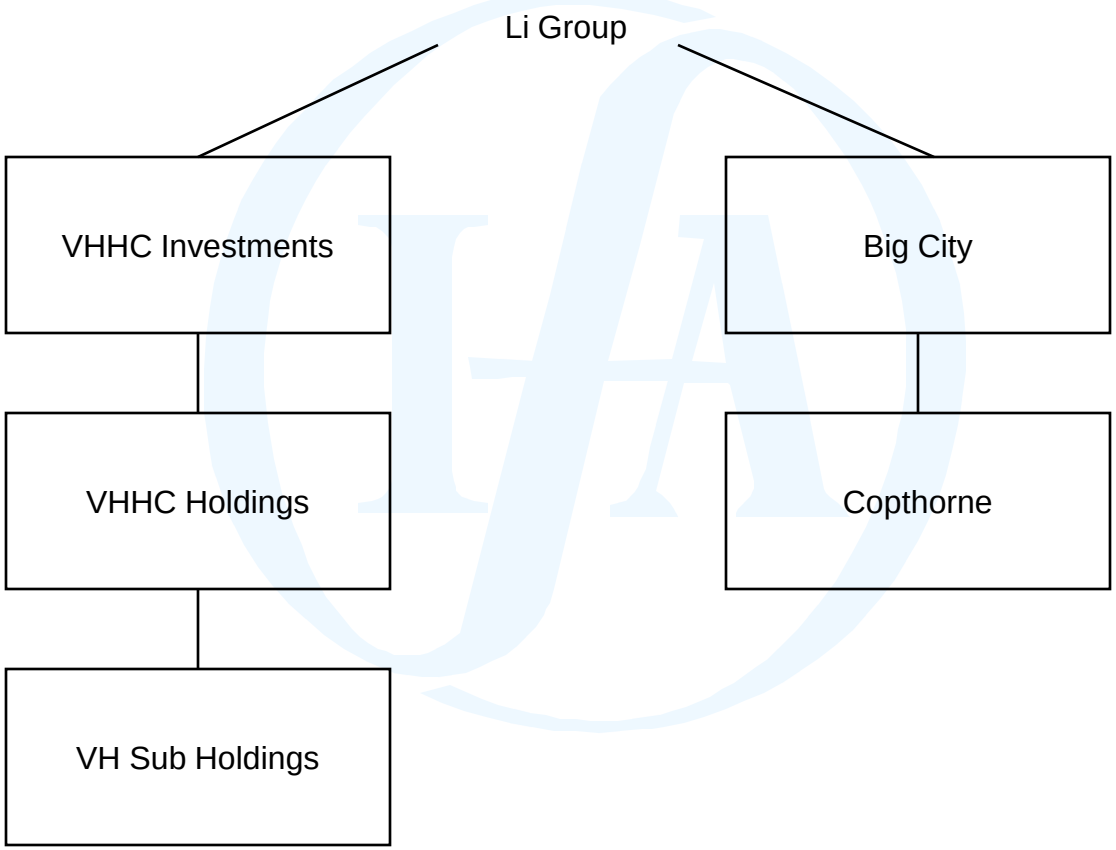
- On December 22, 1995

1. Lehigh borrowed $40M from Banque Brussels Lambert.
2. Lehigh used $400,000 to subscribe for shares of CBR Alberta.
3. Lehigh and CBR Alberta invested $39.6M and $400,000 respectively in shares of CBR LLC.

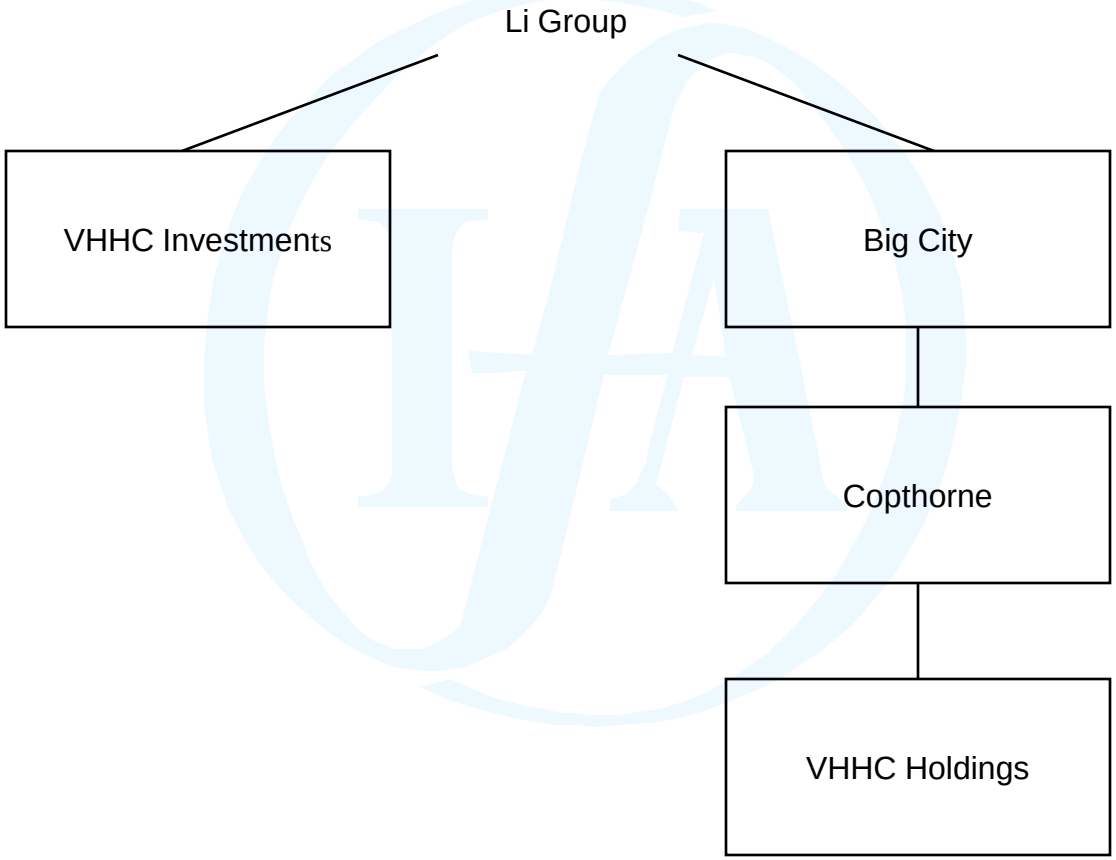
Copthorne Holdings Ltd. v. Canada (SCC)

- Preservation of paid-up capital
- CRA successful in TCC
- CRA prevailed in FCA
- CRA prevailed in SCC
- Important decision for the notion of “series of transactions”

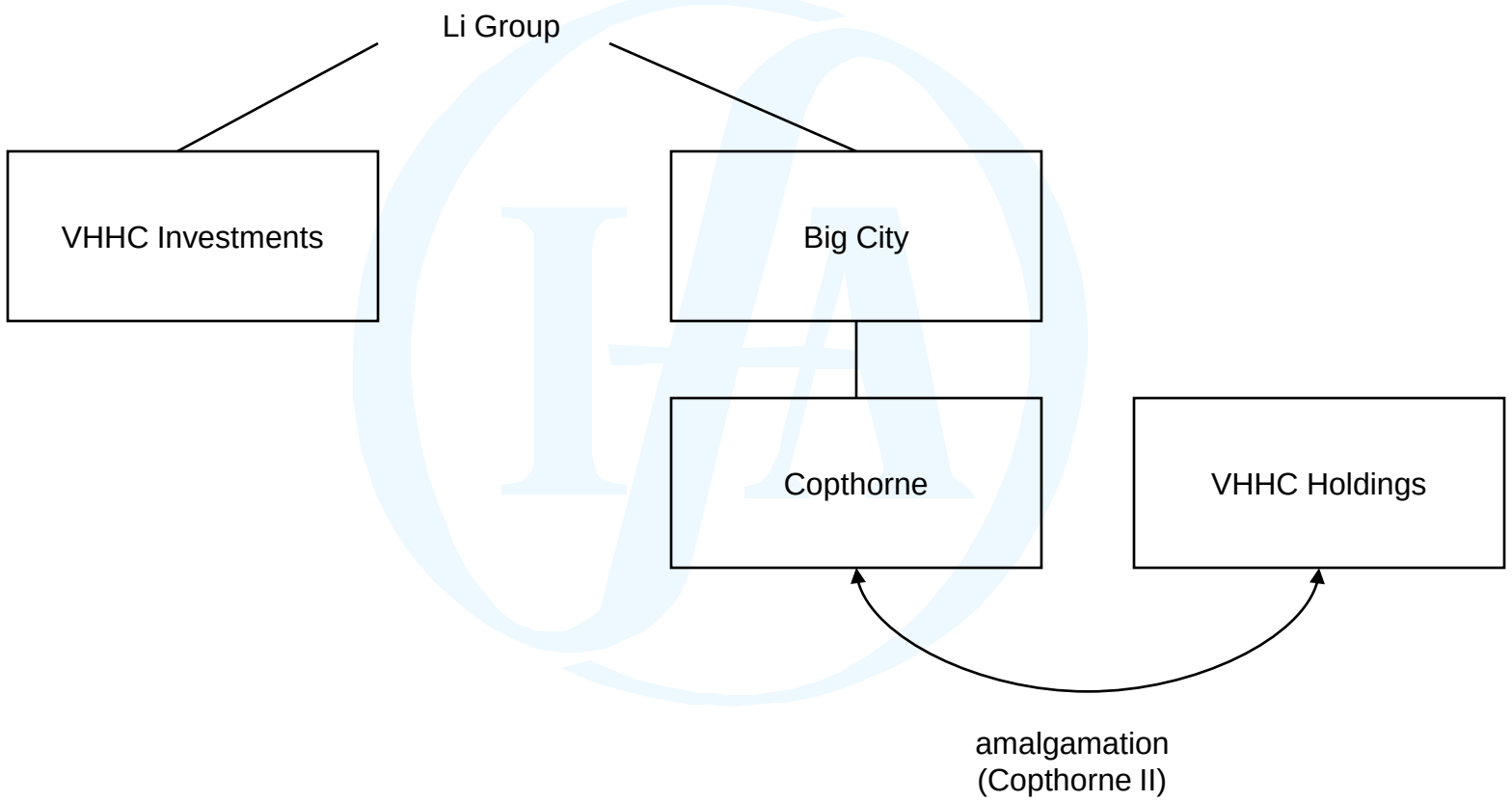
Copthorne, SCC - Pre-transactions



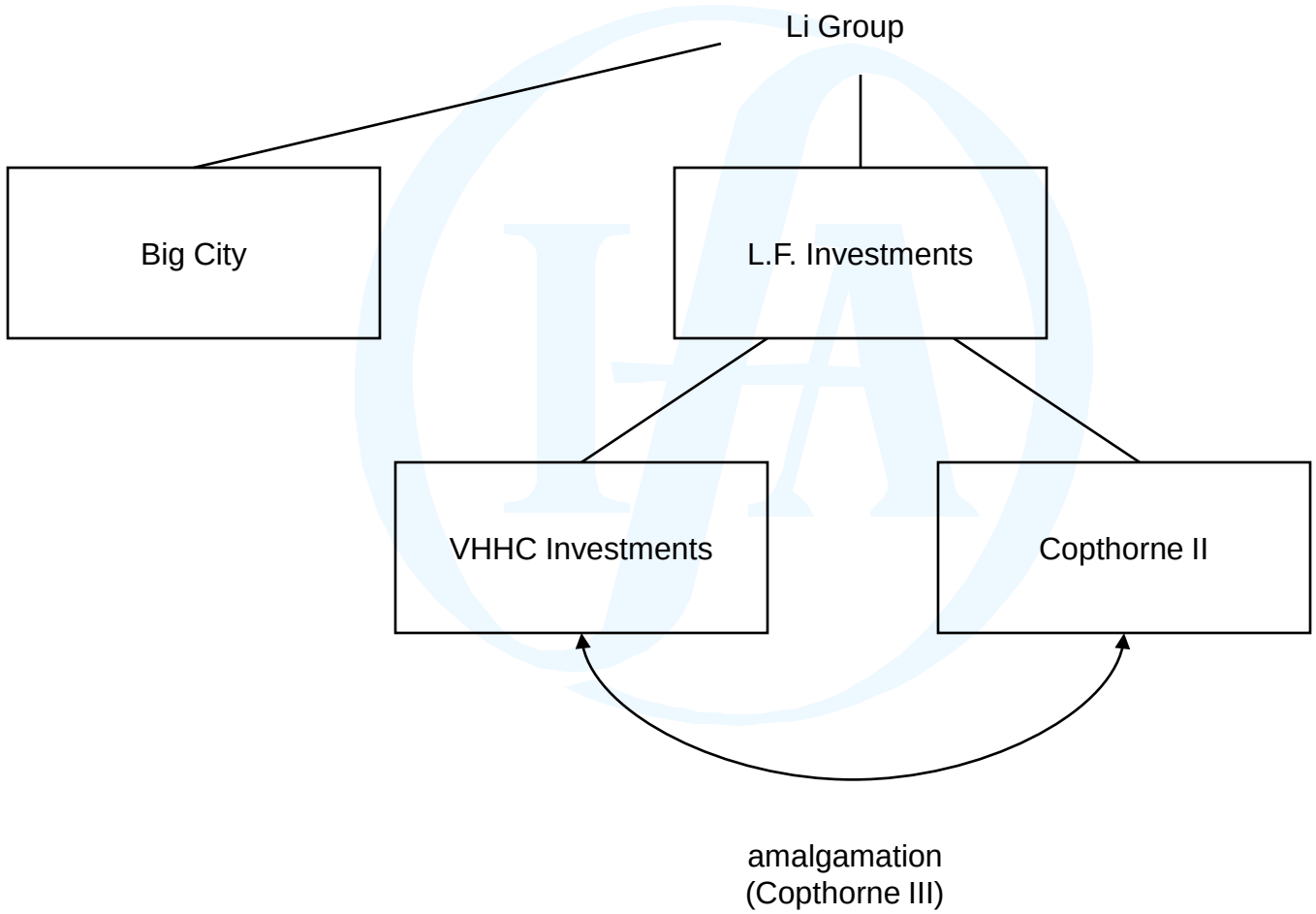
Copthorne, SCC – Step 1



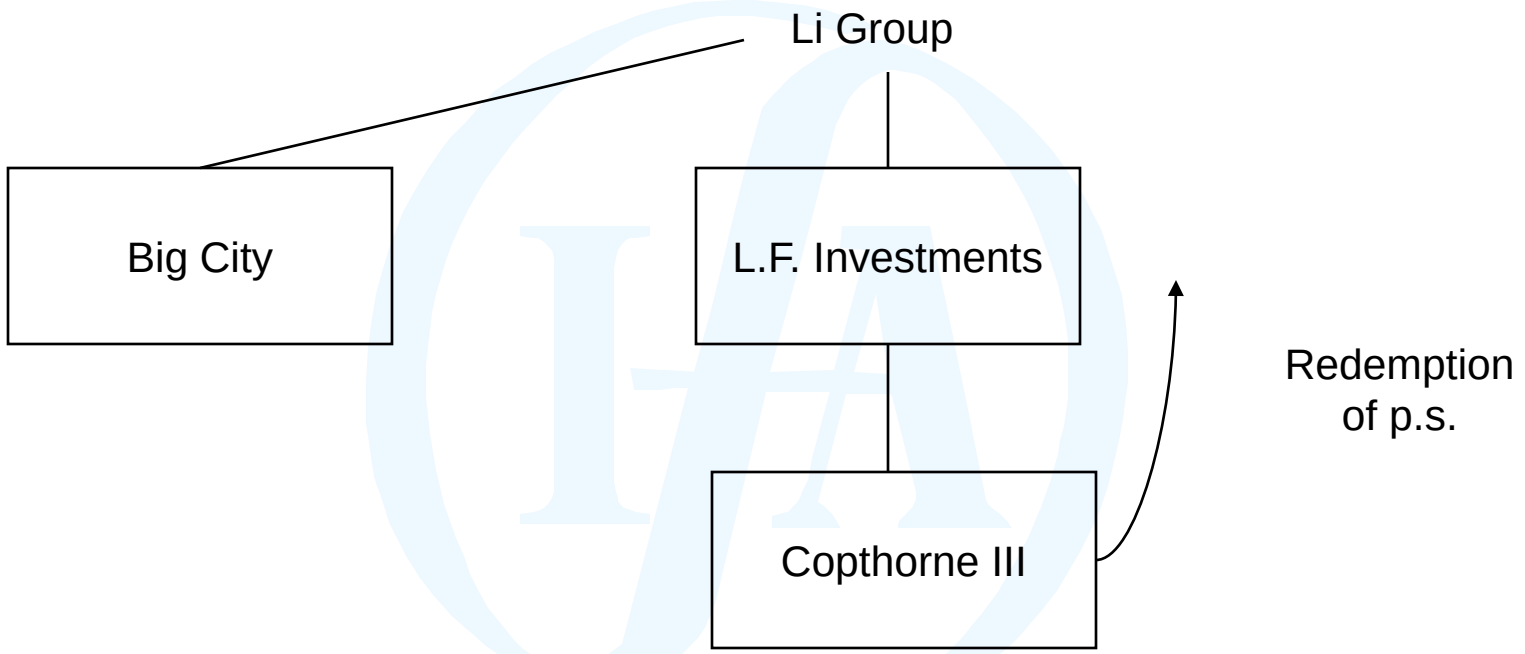
Copthorne, SCC – Step 2



Copthorne, SCC – Step 3



Copthorne, SCC – Post-transactions



Copthorne, SCC

- Issues

  (1) was there a series?

  (2) which transactions make up the series?

  (3) whether the tax benefit results from the series?

Copthorne, SCC

- Tax benefit realized from the redemption of preferred shares
- Question: Whether the redemption of preferred shares part of the series
- Common law definition of a series expanded by subsection 248(10) of the ITA
- 248(10) ITA deems a “related transaction” completed “in contemplation of” a series to be part of the series

Copthorne, SCC

- SCC followed its decision in *Canada Trustco* that 248(10) can apply either prospectively or retrospectively.
- Arguably, that interpretation of 248(10) is not consistent with the French version of 248(10).
- “related transactions or events completed in contemplation of the series” / “opérations et événements liés terminés en vue de **réaliser** la série”

Copthorne, SCC

- Three observations

  (1) The verb “réaliser”

  (2) “en vue de” usually indicates a purpose

  (3) “en vue de” in consideration of future events as opposed to “au vu de” in consideration of past events

- French version: 248(10) does not allow “backward-looking” contemplation

Copthorne, SCC

- Question: Whether any transaction within the series an avoidance transaction?
- SCC ruled that a vertical amalgamation would have accomplished taxpayer's purpose

Copthorne, SCC

- Question: Whether the avoidance transactions a misuse or abuse of the ITA.

- Three categories of abuse transactions under GAAR:

  (1) Transaction achieves an outcome the provision was intended to prevent;

  (2) Transaction defeats the underlying rationale of the provision;

  (3) Transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose.

Copthorne, SCC

- SCC ruled that the sale of VHH Holdings to Big City defeated the underlying object of 87(3) ITA

- SCC rules that 87(3) ITA payments not taxable as deemed dividend, only if payments reflect “tax-paid funds”

- What are “tax-paid funds”
  - Shareholder borrows to subscribe for shares
  - Shareholder is a non-resident
  - Shareholder is a loss corporation or is tax exempt
  - “Dollars on which Government of Canada has no claim”

Thank You