Recent Cases

The topic of the session is recent notable U.S. and Canadian cases dealing with international tax matters. The moderator of this session was Jack Bernstein from Aird and Berlis LLP, and the speakers were Brett Anderson from Felesky Flynn LLP, Joan Arnold from Pepper Hamilton LLP, Michael Hirschfeld from Dechert LLP, and Barbara Worndl from Aird and Berlis LLP.

The speakers presented the following cases:

1. The Tax Court of Canada's decision in *McKesson Canada Corporation v. Her Majesty the Queen*, 2013 TCC 404.

2. The United States Court of Appeals for the Eighth Circuit's decision in *WFC Holdings Corp.* v. US, No. 11-3616 (8th Cir. Aug. 22, 2013).

3. The Federal Court of Appeal's decision in *Lehigh Cement Limited v. Her Majesty the Queen*, 2014 FCA 103.

4. The United States Tax Court decision in *Sergio Garcia v. the Commissioner of Internal Revenue*, 140 T.C. 141.

Another Federal Court of Appeal decision in *Swirsky v. Her Majesty the Queen,* 2014 FCA 36, was included in the presentation materials for the session but was not discussed during the session.

McKesson Canada Corporation

Barbara Worndl reviewed the facts and decision in the *McKesson* case, and highlighted the main points of interest in the Tax Court's decision. *McKesson* is a lengthy decision by the Tax Court of Canada ("TCC") that was released on December 13, 2013. The trial was conducted between October 2011 and February 2012. The Tax Court ruled against McKesson Canada ("MC").

McKesson dealt with transfer pricing adjustments under section 247 of the *Income Tax Act* (the "Act") and the limitation period in Article 9(3) of the Canada/Luxembourg Tax Convention. The court was asked to determine whether the discount rate of 2.206% applied to the face amount of receivables that MC sold to its Luxembourg parent company ("MIH") was reasonable, and whether the withholding tax on the secondary transfer pricing adjustment was statute-barred. Barbara noted that MC did not need the money it obtained from factoring its accounts receivable with MIH, and that the transaction was mainly motivated by a desire to reduce MC's tax in Canada.

Barbara believed that the Tax Court judge made a negative inference from the fact that MC did not call anyone from MC to testify. Only an executive from McKesson US was called to testify, and the Tax Court did not find the executive's testimony to be particularly credible. Joan Arnold added comments on the manner in which Canadian and US courts rely on expert testimony and submissions in transfer pricing cases. Joan referred to a US case where the court held that a taxpayer cannot reasonably rely on the opinion of an expert that was involved in planning a transaction, and whose fee was dependent on the transaction.

Barbara highlighted that the transfer pricing adjustments were made under paragraphs 247(2)(a) and (c) which do not allow the court or Canada Revenue Agency ("CRA") to re-characterize the transactions. In addition, she highlighted that the secondary transfer pricing adjustment was subject to Part XIII withholding tax under the Act.

The main points of note were:

- The Tax Court followed the Supreme Court of Canada's decision in GlaxoSmithKline even though that case was decided under the former transfer pricing provision in section 69 of the Act. The Tax Court stated that the current transfer pricing provisions in section 247 are equivalent to former section 69 despite different wording. All the facts, circumstances, and transactions have to be taken into account when determining an arm's length transfer price.

- OECD guidelines are informative but not determinative. The Tax Court stated that a court must apply the law as written in the Act, and not the OECD guidelines.

- The perspective of both parties in a transaction must be considered in determining the reasonableness of a transfer price or an arm's length transfer price.

- Other arm's length transactions are comparable only if these transactions are similar, or if there are differences, adjustments can be made to take into account these differences.

- If a taxpayer's transfer price is within a reasonable range, then that price is acceptable.

- Tax Court says that morality in irrelevant, and a taxpayer's tax liability should only be determined in reference to the Act.

- A transfer pricing report should be impartial.

- The Tax Court developed its own range of acceptable transfer prices which was below MC's discount rate. The Tax Court did not award MC the rate at the highest end of the range because the court felt that this would simply encourage taxpayers to overreach. Since CRA's discount rate estimate was within the Tax Court's range, the court used CRA's discount rate.

On the Part XIII withholding tax issue, the Tax Court held that the withholding tax was not statute barred. The treaty did not apply in this case since it was not a transfer pricing adjustment. The failure to withhold provision is an enforcement provision. Thus, the treaty was not applicable. Barbara mentioned that MC is appealing this ruling to the Federal Court of Appeal ("FCA").

In response to a question posed by Michael Hirschfeld, Barbara stated that the Tax Court and CRA accepted that MC satisfied the contemporaneous documentation requirement, and did not assess a penalty.

WFC Holdings Corporation

Michael Hirschfeld presented and reviewed the decision in *WFC Holdings Corp.* in the context of the use of objective guidelines and subjective judgments. According to Michael, the jurisprudence in the US recognizes that every taxpayer has the legal right to plan their dealings or transactions to minimize tax. According to Michael, the reliance on objective rules in tax law has been undercut by a series of cases. Courts have been rejecting tax plans based on objective rules if the underlying transactions lack economic substance. This economic substance doctrine has been codified by the US Congress in section 7701(o). According to Michael, there is confusion over the interaction of the economic substance doctrine and objective rules, and whether the former take precedence over the latter or vice versa.

Michael stated that *WFC Holdings Corp.*, which is being appealed to the US Supreme Court, is an interesting case because the lower court focused primarily on the economic substance doctrine and ruled against Wells Fargo because the court found that the deal lacked economic substance. Even though there were legitimate business and regulatory reasons for Wells Fargo to proceed with the deal, the court held that economic substance took precedence over all other considerations. The lower court disaggregated the deal into three separate components, and found that one of the components offended the economic substance doctrine. Michael stated that there is still some confusion on when and how the economic substance doctrine may be applied. Hence, there is great interest in having the US Supreme Court take up the appeal.

Michael stated that the economic substance test is the functional equivalent of Canada's General Anti-Avoidance Rule ("GAAR"). Jack Bernstein indicated that there have been value shifting court cases and decisions in Canada that were similar to *WFC Holdings Corp.* Jack is of the opinion that such value shifting cases can be successfully attacked using GAAR in Canada.

Michael then provided an overview of tax litigation cases involving FBAR and disclosure of overseas assets.

Michael noted that there are a plethora of rules governing and regulating tax preparers. However, these rules do not regulate the competency of tax preparers. The Internal Revenue Service ("IRS") previously tried to introduce competency requirements on tax preparers but these competency requirements were not implemented due to successful legal challenges by tax preparers. The IRS is now proposing a voluntary certification procedure.

Jack then asked Michael if US tax authorities can ask CRA to collect FBAR penalties from US taxpayers living in Canada under the US/Canada tax treaty. Michael stated that the FBAR and associated penalties is not part of the internal revenue code even though the IRS is given the power to collect the penalties. Hence, Michael does not believe that the US/Canada tax treaty gives IRS the power to ask CRA to collect FBAR penalties.

Lehigh Cement Limited

Brett Anderson discussed both the TCC and FCA decisions in *Lehigh*. Even though the taxpayer prevailed in both courts, each court adopted different reasons and had fundamentally different interpretations of subsection 95(6). The FCA narrowed the application of paragraph 95(6)(b) whereas the TCC applied that anti-avoidance provision more broadly.

Paragraph 95(6)(b) is an anti-avoidance rule that may deem a foreign affiliate ("FA") shares not to have been issued for certain purposes. If the rule applies in respect of shares of a foreign corporation on which dividends were paid and included in the shareholder's income, the shareholder cannot deduct those dividends received as having been paid on shares of an FA.

Brett mentioned that tax practitioners generally prefer the FCA's decision. Brett then went through the transactions, and the consequences of those transactions, from *Lehigh* and later discussed the FCA's decision.

Brett asked Joan if the US has a re-characterization rule similar to the rule in subparagraph 95(2)(a)(ii) of the Act which deems passive income to be active business income of a FA. Joan indicated that the answer depends on the year and time. There is a rule, 954(c)(6), under the US Subpart F rules which states that interest, royalty, or dividend from a company to a related company, which would normally be Subpart F income, may actually be active income by allowing the company to look through the chain of transactions. However, this rule has expired and needs to be renewed by the US Congress. Joan expects the US Congress to bring back this rule in the Fall of 2014.

In reference to the FCA's decision, the court made a comment that Brett thought was interesting in relation to the earlier discussion of *WFC Holdings Corp.* Essentially, the FCA said that the CRA used an economic substance or reality test that has been rejected in Canadian courts. In Canada, economic reality does not override legal form.

Brett also highlighted the FCA's concern that a broad reading of paragraph 95(6)(b), as advocated by CRA, would encompass a large number of transactions. In response, CRA claimed that it would apply paragraph 95(6)(b) only selectively and when the tax avoidance is unacceptable. Brett commented that CRA's approach would violate the principle that tax laws be consistent, predictable, and fair; a principle that Canadian courts generally uphold. Canadian courts are loath to give CRA too much discretion.

Sergio Garcia

Joan Arnold presented and reviewed the decision in *Sergio Garcia.* Sergio Garcia, a resident of Switzerland, is a golfer who signed an endorsement deal in the US. This case dealt with the classification and taxation of that endorsement income as royalty income or service income. Sergio Garcia was paid a flat endorsement fee for a variety of duties including public appearances, wearing certain branded clothes during tournaments, and image rights. If the fee paid to Sergio Garcia was a royalty for the right to use an intangible property, then that royalty would be exempt from US withholding tax under the US/Switzerland tax treaty. On the other hand, a service fee would be taxable in the US.

Sergio Garcia's duties and obligations under the endorsement deal are difficult to classify. Joan mentioned the example of wearing golf products during a tournament. In this case, Joan argued that the wearing golf products during a tournament by Sergio Garcia can be classified as both the exploitation of intellectual property and provision of service.

Joan also discussed the manner in which the court allocated the endorsement fee between royalty income and service income. The court rejected the allocations put forward by Sergio Garcia and IRS. Instead the court allocated 65% as service income and the remaining as royalty income.

Joan noted that Sergio Garcia did not make the argument that he did not have a permanent establishment in Canada. Joan felt that Sergio Garcia should have raised this argument as he may be entitled to relief under the US/Switzerland tax treaty.