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Federal Court of Appeal upholds Tax Court of Canada decisions in *Marzen*

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On January 29, 2016, Canada's Federal Court of Appeal (FCA) dismissed the appeal by Canadian taxpayer, Marzen Artistic Aluminum Ltd. (Marzen), of the Tax Court of Canada's (TCC) decision in *Marzen Artistic Aluminum Ltd. vs the Queen (Marzen)*. This case pertained to transfer pricing adjustments that reduced the marketing fees paid to Marzen's Barbados subsidiary in 2000 and 2001. The FCA found no errors to warrant the appellate court's intervention regarding the decisions made by Justice Sheridan in the TCC judgment released on June 10, 2014.

The FCA upheld the findings of the TCC with respect to the identification of the transfer pricing transaction under review, the interpretive usefulness of the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines¹ (OECD Guidelines) to determine an arm's length price, the preference for the comparable uncontrolled price (CUP) method to apply the arm's length principle, and the refusal to award costs to Marzen.

The TCC and FCA also rejected using an "amalgam" transfer pricing approach to amalgamate separate entities into a single transfer pricing analysis.

Lastly, while the FCA did not comment on Marzen's reasonable efforts to determine and use arm's length transfer prices for the purposes of the Canadian Income Tax Act (Act), it is significant to note that the TCC had found Marzen deficient in meeting the reasonable effort requirements. This is particularly important for Canadian taxpayers, since for the first time a Canadian court has commented on the importance of appropriately documenting reasonable efforts to obtain and use arm's length prices to mitigate transfer pricing penalty risks.

Background facts

During the years under consideration, Marzen was a Canadian corporation based in British Columbia that was engaged in the design, manufacture and sale of window products in British Columbia and the United States.

Starline Windows Inc. (SWI), a non-arm's length corporation in the Marzen group of companies was incorporated in the United States and SWI personnel solicited orders for Marzen's window products from U.S. customers. Starline International Inc. (SII), another non-arm's length corporation in the Marzen group of companies, was

¹ The 1995 version of the OECD Guidelines were relevant in this case, since the years in issue were 2000 and 2001.

incorporated in Barbados with Marzen as SII's only shareholder. SII's managing director was David Csumrik, who was not related to Marzen, but had provided marketing advice to Marzen's owners prior to SII's incorporation. SII was described as being in the business of marketing window products such as those manufactured by Marzen.

The transactions under review by the TCC pertained to marketing fees paid by Marzen to SII during 2000 and 2001 under the Marketing and Sales Services Agreement. Marzen paid SII a monthly marketing fees based on a percentage of gross sales of window products initiated by SII, plus a one time performance bonus. Marzen paid SII marketing fees of CAD\$4,168,551 in 2000 and CAD\$7,837,082 in 2001.

SII retained and engaged personnel of SWI to perform the day-to-day sales and marketing functions under a Personnel Secondment Agreement, for which SII paid SWI costs of employment of the seconded personnel plus a service fee mark-up of 10 percent over SWI's actual costs. SWI also provided certain administrative support services to SII. For the secondment of personnel and administrative support services, SII paid SWI CAD\$2,058,049 and CAD\$2,811,892 in 2000 and 2001, respectively.

During 2000 and 2001, SWI purchased window products from Marzen at a price equal to the sale price to customers, such that SWI recognized no profit on sales, and earned only a cost-based service fee from SII as discussed above.

Mr. Csumrik was also the principal of a Barbados corporation, Longview Associated Limited (Longview), which was engaged in establishing international business corporations in Barbados and providing management and administrative support services to arm's length corporate clients for an annual fee of US\$30,000. Additionally, for an annual rate of US\$2,500, Longview would provide Mr. Csumrik's personal services as a managing director to Longview's corporate clients. Longview was not part of the Marzen-related group of companies.

With respect to the local business requirements in Barbados, SII engaged Longview to provide local management and administrative services for US\$30,000 annually and Mr. Csumrik's services, in his capacity as managing director of SII, for US\$2,500 annually.

Reassessment

The Minister reassessed Marzen's 2000 and 2001 taxation years, disallowing the deduction of any amounts in excess of the fees paid by SII to SWI. Quantitatively, the adjustment made by the Minister was CAD\$2,110,502 for 2000 and CAD\$5,025,190 for 2001.² The 2001 reassessment is particularly significant, as it exceeded the penalty threshold and the Minister determined that contemporaneous documentation, as required by subsection 247(4) of the Act, was not in place to mitigate or avoid the assessment of penalties under subsection 247(3).

TCC decision

In the TCC judgment, Justice Sheridan ruled that the arm's length amount that would have been paid by Marzen to SII would be equal to SWI's costs paid by SII plus Longview's costs for Barbados management and administrative services and managing director services, rather than the marketing fees and one-time bonus

² Amounts calculated as follows: In 2000 - Marzen payment to SII (\$4,168,551) less SII payment to SWI (\$2,058,049) is \$2,110,502. In 2001 - Marzen payment to SII (\$7,837,082) less SII payment to SWI (\$2,811,892) is \$5,025,190.

marketing payment as claimed by Marzen or SWI's costs alone as per the Minister's reassessment. While the inclusion of US\$32,500 for payments to Longview was a relatively small concession, it was an important one as it caused the 2001 transfer pricing adjustment of CAD\$5,025,190 as proposed by the Minister, to fall below the CAD\$5 million threshold relevant for transfer pricing penalty considerations.

In reaching her decision, Justice Sheridan relied on the OECD Guidelines, accepted the CUP method analysis as presented by the Crown, placed emphasis on the importance of services (functions) in determining that SII was an empty shell, did not rely on the conclusion from Marzen's expert witness report that the transactional net margin method (TNMM) would generate the most reliable result using an "amalgam" approach, and determined that Marzen did not make reasonable efforts to determine and use arm's length prices.

FCA decision

Marzen appealed the TCC decision to the FCA on the basis that the trial judge erred in her findings in respect of what an arm's length party would have paid SII. The FCA did not find any errors in the TCC judgement that would require the FCA to intervene in respect of TCC's decisions, thus reaffirming the TCC judgment.

Important takeaways

The *Marzen* case affirms certain tenets established by Canadian courts including the reliance on the OECD Guidelines, the importance of appropriate consideration for the CUP method, the position that the functional roles should accord with the transfer prices used and the importance of adhering to administrative requirements. *Marzen* also highlights the importance of careful consideration when amalgamating transactions and entities.

It is also significant that the FCA reiterated reliance on the then-current OECD Guidelines as an interpretive tool. Taxpayers should consider the heightened focus on functions performed by the respective related parties, particularly given the interrelated nature of functions, assets and risks. Given the recent changes to the OECD Guidelines as part of the OECD's base erosion and profit shifting initiative and other decisions in recent Canadian court cases, this is an important reaffirmation that having sufficient substance in an entity is an underlying tenet to justify an arm's length price and must be highly correlated with value creation.

Lastly, as iterated earlier, *Marzen* is one of the first Canadian court cases to examine the reasonable efforts threshold and is an important reminder for taxpayers to proactively get formal and robust transfer pricing documentation in place.

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