Docket: 2008-586(IT)G

BETWEEN:

WESCAST INDUSTRIES INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeal heard on October 5, 6, 7 and 8, 2009, at Toronto, Ontario
By: The Honourable Justice E.A. Bowie

Appearances:

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| Counsel for the Appellant: | David C. Nathanson, Q.C. and Adrienne K. Woodyard |
| Counsel for the Respondent: | Naomi Goldstein and Ky Hong (Eric) Luu |

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## JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2002 taxation year is allowed, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the appellant is entitled to a manufacturing and processing profits deduction in the amount of $65,228.98 payable under Part I of the *Act*.

The respondent is entitled to costs.

Signed at Ottawa, Canada, this 21st day of October, 2010.

"E.A. Bowie"

Bowie J.

Citation: 2010 TCC 538
Date: 20101021
Docket: 2008-586(IT)G

BETWEEN:

WESCAST INDUSTRIES INC.,

Appellant,

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## REASONS FOR JUDGMENT

**Bowie J.**

[1] The Appellant was reassessed under the *Income Tax Act*[1] for the 2002 taxation year. By that reassessment the Minister of National Revenue disallowed the appellant's claim to deduct the aggregate amount of $13,179,982 ($13M) paid by it to Weslin Autoipari RT (Weslin Hungary) pursuant to certain agreements among the appellant, Linamar Corporation (Linamar) and Weslin Hungary. The appellant and Linamar each owned a 50% interest in Weslin Hungary through a holding company. The issue in the appeal is whether, in computing the appellant's income for the year 2002, these payments should be treated as being on current or on capital account.

[2] The Minister also disallowed a manufacturing and processing profits deduction claimed by the appellant under section 125.1 of the *Act*. This deduction is no longer disputed by the respondent.

[3] At the opening of the trial the parties filed a very comprehensive statement of facts agreed upon for the purposes of this appeal, which reads as follows.

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1 R.S. 1985 c.1 (5th supp.), as amended.

PARTIAL AGREED STATEMENT OF FACTS

For the purposes of this appeal, the parties by their respective solicitors, hereby agree on the following facts. The parties may adduce additional evidence which is not inconsistent with the facts agreed upon below:

1. The Appellant, Wescast Industries Inc. ("Wescast"), is a corporation incorporated under the laws of the Province of Ontario. It carries on the business of manufacturing and supplying cast iron exhaust manifolds, turbine housings, integrated turbo-manifolds and catalytic converter containers for passenger cars and light trucks.

2. In 1999, Wescast operated a factory in Brantford, one in Strathroy, and two in Wingham, and was beginning construction of a third facility in Wingham.

3. In 1999 Wescast also had a 49% interest in United Machine Inc., which owned a factory in Michigan that manufactured exhaust manifolds.

4. The Brantford factory "casted" (constructed) exhaust manifolds, which were then "machined" (the edges of the manifolds were smoothed, and holes were drilled) by the Strathroy factory. Of the two factories that existed in Wingham in 1999, one was a casting facility and the other did machining work. The new factory at Wingham is also a casting facility.

5. Linamar Corporation ("Linamar") was incorporated in the Province of Ontario and was engaged in the business of machining and supplying automotive components. It is not related to Wescast.

**<u>Establishment of Weslin Hungary</u>**

6. Wescast, as part of its globalization and diversification strategy, decided to establish a casting factory in Europe and settled on Hungary as the best location.

7. Hungary held a number of attractions, including low costs and high quality labour. In addition, the Hungarian government offered a 10 year tax free holiday which was a major incentive in constructing the facility in Hungary.

8. During the summer of 1999, Wescast and Linamar began discussing the possibility of establishing a joint venture in Hungary. Wescast considered Linamar to be a good fit because of Linamar's technical capability, its need for a casting supplier and the diversification opportunities for Wescast.

9. On August 13, 1999, Wescast and Linamar executed a document titled "Expression of Interest" referencing the possibility of forming a joint venture.

10. On September 7, 1999, Wescast and Linamar incorporated Weslin Industries Inc. ("Weslin Ontario") under the laws of the Province of Ontario, for the purpose of owning all the issued and outstanding shares of Weslin Autoipari RT ("Weslin Hungary"), a corporation incorporated under the laws of the Republic of Hungary. Wescast, Linamar and Weslin Ontario entered into a Shareholders' Agreement dated September 20, 1999 (the "Shareholders' Agreement"). Wescast and Linamar agreed that they would each own 50% of the shares of Weslin Ontario and participate equally in all additional financing of Weslin Hungary.

11. Wescast and Linamar entered into a Strategic Alliance Agreement dated September 20, 1999.

12. Wescast and Linamar capitalized Weslin Ontario with $105 million. Weslin Ontario, in turn, capitalized Weslin Hungary with $105 million. This $105 million was initially intended to fund capital.

The business activities of Weslin Hungary were to consist of the manufacture and assembly of Products (as defined in paragraph 1.1(i) of the Shareholders' Agreement, namely, iron exhaust manifolds, turbo charger housings, differential cases and such further products which Weslin Hungary can demonstrate it can commercially exploit and which the parties to the Shareholders' Agreement may mutually agree upon in writing) (the "Products") in the Republic of Hungary and the sale of the Products to countries in Europe and such other countries as Wescast, Linamar and Weslin Hungary might mutually agree upon in the future.

13. The Weslin Hungary facility was to be modeled after the new Wingham facility being built by Wescast as described in paragraphs 2 and 4 hereof. The equipment and plant layout of Weslin Hungary was to be similar to the new Wingham facility, and was to include a HWS tight flask moulding line, auto pour and a range of dial and CNC type machining, depending on the programs.

14. Construction began on the Weslin Hungary facility in 2000. It was commissioned between the end of 2001 and early 2002. Machining production started in 2001 and casting production in 2002. Weslin Hungary first began to manufacture integrated turbo manifolds in 2003.

15. At the time of entering into the joint venture agreement, Wescast anticipated that any funding to be provided to Weslin Hungary to pay for start-up costs would be done by way of share capital.

16. Wescast and Linamar agreed to contribute operating resources to Weslin Hungary. The Shareholders' Agreement also provided that Wescast and Linamar would provide to Weslin Hungary "such assistance, technical, processing and marketing information, management, personnel administration, technology and know-how that each possesses relevant to the development, manufacture, distribution and sale of the Products." Specifically, Linamar was to bring its marketing and machining expertise to the joint venture.

17. The Shareholders' Agreement provided that "Wescast shall cause all production volume of Products being produced for the European market to be transferred to [Weslin Hungary] on a gradual basis as soon as is practical and the manufacturing capacity of [Weslin Hungary] is capable of accepting orders."

**<u>Sales and Marketing Agreement between Weslin Hungary, Linamar and Wescast Industries GmbH</u>**

18. Wescast Industries GmbH ("Wescast GmbH") is a wholly-owned subsidiary of Wescast, incorporated in Germany in or about 1999. It provided sales and marketing support for Weslin Hungary in Europe.

19. On September 20, 1999, Wescast GmbH, Weslin Hungary and Linamar entered into a Sales and Marketing Agreement whereby Wescast GmbH and Linamar agreed to provide technological and other advice to assist Weslin Hungary in the design, casting, machining of exhaust manifolds, turbo charger housings and differential cases, and the marketing and distribution thereof throughout Europe. Wescast GmbH charged Weslin Hungary on the basis of the cost of the services to Wescast GmbH plus 5%.

20. Wescast GmbH performed the services under the Sales and Marketing Agreement and charged Weslin Hungary a management fee of $1,954,214 in 2001 and $3,666,180 in 2002. Neither Wescast nor Linamar provided any services to Wescast GmbH.

**<u>Tax Advice Obtained by Wescast</u>**

21. In a memo dated October 2, 2000, Jim Slattery (former Chief Financial Officer of Wescast) noted that Wescast did not currently have a pro-active tax planning process or strategy and that it needed a comprehensive corporate

tax strategy to guide its growth and diversification in the simplest and most tax efficient manner. As a result, Mr. Slattery met with representatives from three accounting firms to consider how to execute the appellant's proposed tax strategy. Proposals were received from two: Grant Thornton and Deloitte & Touche ("Deloitte").

22. By letter dated January 5, 2001, John Bowey, a tax partner at Deloitte, provided to Wescast a proposal on the possibilities for restructuring Weslin Hungary.

23. By letter dated March 2, 2001, Deloitte submitted a proposed Work Plan to Wescast.

24. On March 20, 2001, there was a meeting to review the structure of Weslin. The contents of that meeting were summarized in a series of PowerPoint slides.

25. By letter dated March 26, 2001, Deloitte set out the terms of its engagement to assist Wescast and Linamar to restructure Weslin Hungary by devising a strategy and structure for Weslin Hungary.

26. By letters dated June 12, 2001 and July 30, 2001, John Bowey (Deloitte) provided to Jim Slattery an analysis of a possible restructuring of Weslin Hungary. By e-mail (with attachments) to Jim Slattery dated July 30, 2001, John Bowey further analyzed the matter.

27. By letter dated August 30, 2001, Jim Slattery signified his agreement to the terms of Wescast's engagement of Deloitte by signing a copy of a letter from Deloitte of that same date.

28. By memo to file noted "Preliminary Draft for Discussion Purposes Only", dated October 23, 2001, Charles Evans (Deloitte) summarized Deloitte's research related to the deductibility of certain payments to be made to Weslin Hungary.

29. In an e-mail dated December 11, 2001 to John Bowey, Jim Slattery and Keith Wettlaufer (Linamar), Judith Harris, counsel at Osler, Hoskin & Harcourt LLP ("Osler"), indicated that she would shortly be providing draft Cost Contribution Agreements and a draft Technology License that would reflect discussions at a recent meeting.

30. In a letter dated January 31, 2002, John Bowey (Deloitte) provided background information and comments to Judith Harris (Osler) regarding the Cost Contribution Agreements.

31. By memorandum dated January 31, 2002, Judith Harris and John Bowey provided a summary of the status of their discussions of tax matters relating to Weslin Hungary to, among others, Jim Slattery.

32. Under cover of e-mail dated March 1, 2002, Judith Harris provided draft Cost Contribution Agreements and comments to, among others Jim Slattery, Tom Shea (Wescast) and John Bowey.

33. In a memo to file dated March 11, 2002, Charles Evans documented his research relating to the accounting and tax reporting required with respect to the payments provided for in the Cost Contribution Agreement.

34. In a memo to file dated March 11, 2002, Steve Lawrenson (Deloitte) documented his research relating to the accounting reporting required with respect to the payments provided for in the Cost Contribution Agreements.

35. By memoranda dated April 18, 2002 Dave Dean (Wescast) forwarded to Jim Slattery unsigned copies of a Technology Development Contribution Agreement, a Promotion and Advertising Contribution Agreement, and a Human Resources Development Contribution Agreement, each of which was between and among Wescast, Linamar and Weslin Hungary.

36. By memo dated April 22, 2002, Tom Shea (Wescast) provided information to Jim Slattery and Dave Dean regarding the Cost Contribution Agreements.

37. Wescast and Linamar entered into Cost Contribution Agreements with Weslin Hungary, each made as of January 1, 2002, consisting of:

- a Master Contribution Agreement;
- an Agreement for Contributions to the Development of Human Resources;
- an Agreement for Contributions to Promotion and Advertising; and
- an Agreement for Contributions to the Development of Technology.

38. Under each of the Cost Contribution Agreements, Wescast and Linamar each agreed to pay Weslin Hungary an amount equal to 37.5 percent of the "Costs," as therein defined, incurred by Weslin Hungary for the 2000, 2001 and 2002 calendar years.

39. Weslin Hungary did not have any obligation to reimburse, pay or repay Wescast or Linamar, or to provide any services to either of them, in relation to any payments made under the Cost Contribution Agreements, except in the case of an overpayment.

40. The Cost Contribution Agreements were structured as "non-refundable subsidies" in order to avoid the payments being included in Weslin Hungary's income, which would avoid reducing Weslin Hungary's losses for Hungarian tax purposes. Losses realized by Weslin Hungary during the tax holiday period could be carried forward and deducted against taxable income in the post-tax holiday period. In order for the "subsidies" to be non-taxable in Hungary, there could be no requirement to repay them, and there could not be any link between the subsidy and any future profits repatriated, or royalty payments made by Weslin Hungary, to Wescast and Linamar.

41. In 2000, Weslin Hungary incurred the following expenses, which it characterized as follows:

- $1,978,903 for human resources development;
- $1,406,386 for promotion and advertising; and
- $1,570,580 for technology development.

42. In 2001, Weslin Hungary incurred the following expenses, which it characterized as follows:

- $3,327,037 for human resources development;
- $1,954,200 for promotion and advertising; and
- $6,677,521 for technology development.

43. In 2002, Weslin Hungary incurred the following expenses, which it characterized as follows:

- $2,501,333 for human resources development;
- $3,666,667 for promotion and advertising; and
- $12,061,333 for technology development.

44. Weslin Hungary deducted such amounts from its income for Hungarian tax purposes.

45. Prior to Wescast and Linamar making the payments under the Cost Contribution Agreements, the funds used to pay for the amounts described in paragraphs 42, 43 and 44 hereof came from the initial $105 million capital injection.

46. Wescast's share of the costs incurred by Weslin Hungary, as per the Cost Contribution Agreements (37.5 percent), was as follows:

| | Human Resources Development Costs | Promotion and Advertising Costs | Technology Development Costs | Total |
|---|---|---|---|---|
| 2000 | $742,000 | $527,000 | $589,000 | $1,858,000 |
| 2001 | $1,248,000 | $733,000 | $2,504,000 | $4,485,000 |
| 2002 | $938,000 | $1,375,000 | $4,523,000 | $6,836,000 |
| Total | $2,928,000 | $2,635,000 | $7,616,000 | $13,179,000 |

47. Wescast, Linamar and Weslin Hungary also signed a Technology License made as of January 1, 2002. The Technology License granted Weslin Hungary a personal license to use the "Licensed Technology" solely for:

a) the design, casting and machining of "Targeted Components" (as defined in paragraph 2.1(w) of the Technology License, which included iron components, namely, exhaust manifolds and turbo charger housings); and

b) the distribution, sale and servicing by Weslin Hungary of such manufactured Targeted Components, solely within the Territory (as defined in paragraph 2.1(aa) of the Technology License).

48. Wescast and Linamar granted the license to Weslin Hungary in order to assist Weslin Hungary in the sale, design, casting and machining of Weslin Hungary's products.

49. Under the Technology License, Wescast and Linamar retained full ownership over the Licensed Technology and improvements thereon.

50. Under the Technology License, Weslin Hungary was required to pay Wescast and Linamar a royalty within 25 days of the end of each month based on a percentage of the "Net Revenue," as defined in paragraph 2.1(p) of the Technology License.

51. Wescast received royalty income from Weslin Hungary in the following amounts for the years 2002 to 2007:

i. $ 42,027.50

ii. $ 123,532.00
iii. $ 336,616.50
iv. $ 559,811.00
v. $1,374,362.59
vi. $1,296,428.23 (as at August 2007)

52. In its returns of income filed for its 2000 and 2001 taxation years, Wescast did not deduct any amounts in respect of payments made under the Cost Contribution Agreements to Weslin Hungary.

53. In computing income from its business for the taxation year ended December 29, 2002, Wescast deducted the amount of $13,179,982, representing the total amounts paid in that year to Weslin Hungary under the Cost Contribution Agreements.

54. The Minister of National Revenue (the "Minister") did not accept the deduction in computing Wescast's income for the taxation year ended December 29, 2002 of the aforementioned amount of $13,179,982 by a reassessment made by notice of reassessment dated July 6, 2007 (the "Reassessment").

55. By the Reassessment the Minister also failed to accept Wescast's entitlement to a manufacturing and processing ("M&P") profits deduction in computing its tax otherwise payable under Part I of the *Income Tax Act* in the amount of $65,228.98.

56. Wescast objected to the Reassessment by notice of objection dated September 28, 2007. The Minister confirmed the Reassessment.

57. The Minister does not dispute Wescast's entitlement to the M&P profits deduction described in paragraph 56 hereof.

(Footnotes omitted)

[4] By the late 1990s the appellant was the foremost supplier of cast iron exhaust manifolds to the automotive industry in North America. It was a tier one supplier, which meant that it dealt directly with the manufacturers of vehicles, participating in the design phase as well as manufacturing. It was of paramount importance to it to maintain its status as a tier one supplier, not only to preserve its market share, but also to maintain its level of profitability.

[5] The appellant led considerable evidence to establish not only that it held this tier one status, and the importance of maintaining it, but also that conditions in the industry at the end of the twentieth century were such that it was essential that the appellant establish a manufacturing capacity in Europe. The consolidation taking place in the automobile industry, and the trend towards building various models and brands of vehicles on a common platform and with common engine components for different markets, meant that the appellant and other tier one parts suppliers had to be able to deliver product at a competitive price in both North America and Europe.

[6] A global manufacturing capacity was essential not only to enable the appellant to expand its sales into the foreign markets, but also to maintain its tier one status and to protect its position in the North American market. The three major North American manufacturers, who purchased most of the appellant's output, were increasingly using the same designs globally, and they were also increasingly seeking to cut costs, which meant paying less to component suppliers. They also were suffering a decline in their share of the North American automobile market, which of course meant a declining demand by them for components.

[7] The evidence establishes beyond any doubt that expansion, in the form of acquiring or creating a European manufacturing capacity, was not simply desirable, but a requisite for the long term survival of the company. As Mr. Finnie, who was CEO of the appellant at that time, put it, the message that they were getting universally from their customers was "you either have to go big or go home." This evidence was echoed by Mr. Frackowiak, who is the present chairman and CEO of the appellant and has been a member of the board of directors since 1992, and by Mr. Slattery, who was the vice-president in charge of corporate development from 1997 to 2000 and chief financial officer from 2000 to 2002. Their evidence was corroborated by that of William Golden, a long-time employee of General Motors who was a member of the team responsible for purchasing decisions in relation to exhaust manifolds on a world-wide basis from the early 1990s until he retired in 2004.

[8] Counsel for the appellant argues that the amounts that it paid to Weslin Hungary may be treated as being on current account, and therefore deductible in computing income for the 2002 taxation year, because they were payments that gave rise to substantial benefits to the appellant in its Canadian operations. Specifically, the appellant gained technical knowledge and know-how, both in machining and in the casting of iron manifolds, from working with Linamar's technicians in the start-up of Weslin Hungary. In particular, the appellant gained expertise in the formulation of alloys that can withstand the high temperatures of turbocharged engines, and in

computer numeric controlled machining processes, through its association with Linamar in Hungary. It also realized benefits in terms of its ability to attract more highly skilled employees and thereby improve the quality of its workforce in Canada. As Mr. Frackowiak put it in his evidence, the appellant needed to attract more sophisticated people to its workforce, and having a global operation was helpful in this.

[9] The appellant's business in Canada also was benefited by increased sales that it attributes to the existence of the Hungarian operation. Mark Swedan has been Manager of Corporate Development, Director of Hot End Systems, and most recently Director of North American Sales for Wescast. He testified that Wescast developed the ability to produce turbine housings in its Canadian operations as a direct result of the joint venture with Linamar in Hungary. Specifically, it was the expertise gained in machining those components, and the relationships developed in Europe with turbo charger manufacturers such as Honeywell and Borg Warner that enabled the appellant to attract the orders and supply these products in North America. He said that at the time of the trial the revenues, actual and projected, that the appellant attributed to business generated as a result of the establishment of the Hungarian plant amounted to about $150 million.

[10] As paragraphs 21 to 40 of the agreed facts make clear, Wescast and Linamar entered into the Contribution Agreements under which the disputed payments were made as the result of tax advice given by accountants and lawyers over a period of some 16 months. Mr. Slattery, who was the CFO of the appellant at that time, and John Bowey, a tax partner at the accounting firm Deloitte & Touche, gave evidence as to the deliberations that led to the formulation of these agreements. Mr. Slattery initiated discussions with Mr. Bowey, and with another accounting firm, with a view to obtaining tax advice in relation to the appellant's business, not only in connection with the joint venture, but on a comprehensive basis. It was Mr. Bowey, apparently, who proposed the Cost Contribution Agreements, on the theory that the funds being put into the startup of the Hungarian operation would have some direct benefits for the appellant's manufacturing operations in Canada, and so should be structured in a tax effective way. In a rambling discourse Mr. Slattery gave his explanation of the way in which they, along with Judith Harris, the lawyer who drafted the documents, arrived at their decision as to the structure of the Cost Contribution Agreements. He explained the attribution of the costs on the basis of 37.5% to each of the appellant and Linamar and 25% to Weslin this way:

Q. A certain percentage of each category of costs was determined as being the amount that Wescast and Linamar would pay to Weslin by way of cost contributions. How was that arrived at?

A. First of all, the nature of the amounts, we needed to pass a couple of tests. One was the nature of the expense needed to make sense. It had to be something that was sensible and that theoretically you would expend anyway because it would be, in and of itself, expenditure in search of a benefit and the two made sense in both nature and quantum.

Certainly with respect to the marketing, that was relatively simple because there was a cost pool in Germany that required subsidization in the early years of Weslin's existence. That pool of costs was already - - we already saw that it was going to be of significant benefit to Wescast in a very near term based on the program discussions that we were having with customers and potential customers that we probably would not be having had we not made the commitment to Europe. The whole sales, marketing and engineering office was a first step of a multistep strategy which ultimately – all of it, it was part of a comprehensive strategy that included building a facility in Europe. You couldn't really differentiate the two. What we wanted to do was get the sales and marketing in place before – again, that's what happened in North America. Then those relationships were being developed and we saw very quickly we were going to be able to fill a foundry in Hungary and then also contribute to the business volume that we wanted in North America.

We looked at the cost pool in Europe and we split it three ways. It was very judgmental and it was not an exact science, but from our perspective, it seemed to be a reasonable allocation based on the time and attention and effort that was being spent from our people in Germany on the sales and marketing effort and then also the benefit that the parties would hope to recoup. So that was on the sales and the marketing.

The next area, another area of benefit was on the people side and that was perhaps the simplest of the three. There was a pool of costs associated with our expatriates and they were all coming back to North America and who would all be benefiting from the experience they would be having in Europe which would make them better leaders, stronger leaders, better technically and in fact improve the technical capabilities and leadership capabilities of our entire operation in Canada. Also, in some cases, because of the relation that they had with Linamar, the intention at that time was that they would also be – our vision included potentially commonly-owned foundry machining facility for turbo chargers in North America owned through this strategic alliance. That was also seen as being a possibility, but certainly the relationships that some of these people had we anticipated would be a big benefit coming back to North America.

That was one part, but the other part as I outlined earlier was our organization became much stronger as an organization by having to help develop the people who ultimately ran the operation in Europe. We developed manuals and training programs and provided people – the best way to learn something is to actually have to teach it and that was a position that we put many of our people at all levels, from people who were pouring iron to those who were breaking castings and those who were machining. We developed procedures and did training and became very much a more international company as a result of that. That one is another one where it is relatively easy to identify the pool of costs. It's a question of judgment as to how you allocate it. We certainly knew that half of it would be – there would be a part which would certainly be residual to Weslin, but certainly a portion of it that would make sense that Wecast and Linamar should pay. We arrived on the percentages that we did. It was largely judgmental, but we felt in retrospect quite reasonable given the overall organizational benefits that we had anticipated and in fact that we saw.

Q. Weslin had been capitalized at approximately $105 million?

A. That's correct.

Q. To the extent that Weslin needed funds over and above that sum it was receiving them through these cost contribution payments?

A. That is correct. We capitalized through hard capital and capital injection through Weslin in Canada the construction of the facility. A lot of the start-up losses were subsidized by Canada through these cost sharing or Cost Contribution Agreements. In part, the rationale was that we knew that we were going to get a benefit from having this European operation, and that benefit was going to be significant to our Canadian operation. However, to actually achieve that benefit, we had to get there which means in part we had to have the people, we had to have the thing running. We needed to make those subsidies in order to achieve the benefits that we expected to get in Canada by having this arrangement.

Q. Would you have entered into this Hungarian joint venture in the absence of those benefits?

…

THE WITNESS: The answer [to] that I would say is that it is a hypothetical question, and I can't answer it that way. What I can say is that the cost and the risks and exposure and dedication to people resources associated with the European venture was not something that we felt at that time there was a compelling need to do. What made it compelling was the, “If we don’t do this, what will our North American business look like in ten years time? If we don’t do this, these are the factors that will affect our North American business”. The benefits that we expected to derive from it were probably what swayed the decision from investing in anything. It was the thing that ultimately made the decision; a “no brainer” as far as Wescast was concerned. That was where we agonized as to, “What will happen to our business? How important is this? We don’t want to invest in Europe simply for the sake of it. We have so much money that we can do a lot with anyway”, or so we felt, but once we examined that assumption, it became clear that we would be running a tremendous risk by not becoming a global supplier. That was very, very important as far as the decision making was concerned. That is well documented and that was absolutely the belief of the entire management team.[2]

[11] Mr. Bowey also addressed the decision making process in his evidence:

A. I think the thing that strikes me most about my engagement in these discussions when it became apparent that they were looking to benefit far beyond profits in Hungary from producing the car parts that they were going to produce in Hungary and, as I said, as their thinking evolved on why this could be deductible in Canada if, either as a loss subsidization payment or, as it ended up, as part of a Cost Contribution Agreement. I said to him in a meeting we had, “Jim, I need to understand. Would you have made this investment in Hungary with Linamar that you did were it not for these other factors that you’re describing to me that will be hard to quantify but yet are critically important to Wescast?” He looked me in the eye and said, “I can tell you we would not have done it at this price.” And that’s what really, I think, after all of our work, got us to the point of saying – he is saying that if these other factors, these benefits, that would accrue directly from Wescast were important enough to him to say that without them we would not have made this investment as a true investment at this price, it made us even more confident that they were entitled to tax relief in Canada. Now, that didn’t tell us, “Okay, well, how much would you have paid?” But from that discussion, I did go back to him and say, “Well, Jim, so the logical next question would be, if you were evaluating this as a pure investment play, what would you have done?” Again and this is well into 2001, it’s long after they’ve made the financial commitment and their investment, but I was saying to him that if it was just investing in an organization that would eventually produce dividends for your organization from profits it would generate in Hungary, he said, "I can’t tell you that,” but said, “I can tell you that our minimum benchmark rate of return is 20 percent,” and he said that’s on the low end.

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[2] Transcript, p. 178, l. 4 to p. 184, l. 3.

I just remember, at the time, I think he and I sat there with some forecasts. He sent me some forecasts after one of the meetings he and I had on what they were predicting the profitability to be, and we had done some sort of back of a cigarette pack calculations of, if you were to capitalize the forecasting income stream and determine how much capital would you put into the venture to obtain that income stream, the number that came up was something in the range of $50 to $55 million, when their aggregate commitment was $75 million if you included the projected start up losses. Again, that's when I began to think, "If that's what you're telling us your thought process was, even though, you didn't articulate it at that time, that's really important because then they'll say that some amount of your aggregate commitment, even though, in the early days, it appeared that, that aggregate commitment they intended all of it to go in as share capital or loans or advances, that at least part of what they were committing to do was not justified by the rate of return that they were anticipating receiving from generating profits in Hungary." It was motivated by a collection, a basket of other things that he told us was a prime driver in them making the decision to go ahead at that price.

I think it was from that point forward we realized that all our efforts to think about – could we restructure, could we identify the stream of payments from Hungary to Wescast in Canada, that if they did want to take a position to deduct their share of the start up losses, would be the income necessary to support it be realized? We're now not so sure we need to be thinking that way because justification existed in your original motivation. Again, we couldn't quantify it, nor could he. But he gave us examples of potential business that they might lien from a new opportunity, or savings they may realize in some other existing plans in Canada, or knowledge they would gain or, on the other side, the risk they were mitigating of loss of business. Without putting numbers, he said the potential of all of these possibilities is much higher than the losses we're envisioning supporting as part of our commitment.

Q. You came up with what notion?

A. We, Deloitte, initially were of the view that simply reimbursing each of the parties for their proportion of the losses as they had originally intended to do would be justified based on this. But Judith Harris from Oslers was involved with us, and she and they were of the view that aligning the contributions the gratuitous payments that Wescast and Linamar would make with the categories of cost that Slattery had referred to, and narrowed it down to sales and marketing costs because, certainly, that was one of the benefits that Wescast envisioned receiving. The human resource costs related to the expatriate connection and the technology cost related to the access that they had to technology. In their view it was a better way to go than simply subsidizing the start up losses. And we didn't disagree with that, we supported that position.

Q. How was the formula for determining the cost contributions ultimately arrived at?

A. I don't think it was particularly scientific. It was arrived at in consultation between Wescast and Linamar. I can tell you, in the design and in the original thinking behind it, it was to be an approximation for the commitment they had to share the funding of the start up losses to begin with, but it would only have been by coincidence that they ended up being something else. The principle was still the same, that they were justified in providing those gratuitous payments based on the benefits they anticipated receiving.[3]

[12] I have no doubt that there were some advantages gained by the appellant from the start-up of the Hungarian operation that redounded to its advantage in some degree in carrying on its business in Canada. I also have no doubt that the evidence of the appellant's witnesses, most particularly that of Mr. Slattery, Mr. Bowey and Mr. Swedan, was intended to portray those advantages in a much more favourable light than the facts actually warrant. It is significant that while considerable correspondence, both electronic and paper, was circulating among the appellant, its accountants and its lawyers, with a view to specifying and quantifying the benefits to the Canadian operations of the appellant, no one apparently attempted any financial analysis, on paper or otherwise, that could be produced. Mr. Bowey spoke of "some sort of back of a cigarette pack calculations", but they were not available at the trial, nor did any of the appellant's witnesses make any attempt to reproduce them. The evidence of benefits flowing to Wescast in Canada was not at all specific — it consisted simply of the kind of vague assertions that are reproduced above.

[13] It is also significant that little was said of these advantages of which Mr. Slattery and Mr. Bowey spoke in such glowing terms when the Senior Management Team of the appellant prepared a memorandum[4] for the Board of Directors on June 22, 1999 to recommend proceeding with the joint venture. In a six-page memorandum, two pages are devoted to "Rewards to Wescast." These detail the advantages that Wescast can expect to gain by having a manufacturing presence in

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[3] Transcript, p. 324, l.20 to p. 329, l. 21.

[4] Exhibit A-2, Tab 3.

Europe, and by collaborating rather than competing with Linamar in the European market and in the market for non-manifold products. All that is said in relation to the benefits now relied on to justify the deduction of some $13M for benefits flowing to the appellant's Canadian business is this:

> *Access to Machining Expertise*
>
> - Linamar has extensive expertise and experience in profitably machining a wide range of complex, high precision parts. We expect that we will gain access to this expertise, ensured through their association with the manifold operation, and that this will help us improve our cost competitiveness and capital utilization in Europe as well as in North America.[5]

Otherwise, the benefits to the appellant that are outlined in that memorandum are simply the advantages that will result from having a European manufacturing presence.

[14] Appendix 3 of the same memorandum outlines the financial projections for a stand alone manifold facility in Hungary. In two tables titled "Start up Cash Operating Losses 1999-2001" and "Total Start Up Costs 1999 – 2005" it estimates what are described as "Total soft, ramp up costs over 5 year period" to be $26.6 million, including $15.307 total cash operating losses for the three year period 1999 to 2001.

[15] Appendix 2 of that memorandum details some 25 positions in the Hungarian plant that would be filled by expatriate Canadians during the start-up period, and yet there is no suggestion in the memorandum that some intangible benefit might flow from this to the appellant's business in Canada.

[16] Clearly the appellant, as one would expect, foresaw and planned for these start-up soft costs needed to bring the $105 million Hungarian subsidiary into production. The 2002 Contribution Agreements are the product of the fertile minds of professional tax planners attempting to recharacterize 75% of the start-up costs as costs of carrying on the appellant's business and that of Linamar in Canada. Ms. Goldstein correctly described this in the course of her argument as retroactive tax planning.

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5 *Ibid*. p. 4.

[17] Cheryl Robinson, a chartered accountant, testified for the appellant on the subject of generally accepted accounting principles (GAAP). Ms. Robinson is a partner in the firm KPMG LLP and has more than 25 years experience in accounting and auditing. Her responsibilities in the firm include quality control and consultation on difficult accounting matters, as well as developing training courses on GAAP. I admitted her evidence, over the objection of counsel for the respondent, as I considered that her opinion might be useful in determining the question before me.

[18] Ms. Robinson was retained to express an opinion as to whether it was acceptable under GAAP for Wescast to expense the cost contribution payments made under the Cost Contribution Agreements in its non-consolidated accounts. She gave the opinion that "… it is reasonable to conclude that it is acceptable under GAAR to record the cost contribution as an expense in the non-consolidated accounts of Wescast." In her written statement of her evidence she expressed the factual underpinning of her opinion this way:

> We have been advised that there were a variety of reasons for Wescast to enter into the joint venture including reasons relating to Wescast's "ordinary revenue generating or service delivery activities". These include:
>
> - Access to the customer list of Linamar, the joint venture partner;
> - Elimination of prospective North American competition;
> - A more global presence to enhance its relationship with its major customers and to gain access to other foreign-based customers, thereby increasing Wescast's sales in North America;
> - Skills enhancement for expatriate employees involved in the start-up of Weslin; and
> - Technical know-how available to Wescast from the design platform and innovative production techniques being proposed for the new plant of Weslin.
>
> We have also been advised that it was anticipated that many of these benefits would ultimately enhance Wescast's North American profitability in a significant way. Finally, we have been advised that the costs for which Wescast made the Cost Contribution were incurred by Weslin in the normal course of Weslin's operations.

[19] This suggests to me that Ms. Robinson was considering the purpose of the joint venture agreement to be the immediate purpose for which the appellant made

the cost contribution payments, and so effectively considering those payments in isolation from the $105 million investment in the Weslin Hungary plant, and the fact that the payments were required to provide start-up working capital for it. When asked on cross-examination whether the cost contributions could have been recorded as an asset under GAAR Ms. Robinson declined to express an opinion, saying instead that her retainer was only to consider whether it was acceptable to treat them as an expense, and that she would not opine on the alternatives "without conducting further analysis and research". Considering that her evidence was based on the appellant's view that the substantial purpose of the payments was to benefit the appellant in its Canadian business, rather than to provide the needed startup capital to the Hungarian operation, and considering too her reluctance on cross-examination to express an opinion beyond the very narrow parameters of her retainer, I have considerable doubt about her objectivity, and I give little weight to her evidence.

[20] Mr. Nathanson supports his argument with reference to 33 cases, running the century-long gamut from *Vallambrosa Rubber*[6] to *Valiant Cleaning*.[7] These were countered by 17 cases cited by Ms. Goldstein, with remarkably little overlap. It is the principle applied by Campbell J. in *Valiant Cleaning* that the appellant invokes, which is that advances of working capital made to a subsidiary, if they are made for the dominant purpose of safeguarding the parent's business from financial damage that it would otherwise suffer as a result of the subsidiary failing to meet its commitments, may properly be treated by the parent as expenditures on current account. That it is a purpose test is clear. Dixon J. put it this way in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation*:[8]

> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is intended to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.

[21] Weslin Hungary expended the $13M with which this case is concerned between 2000 and 2002, using funds that it received from its two parents in the initial $105M capitalization, and it quite properly charged those expenditures on current

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6 *Vallambrosa Rubber Co. Ltd. v. Farmer*, (1910) 5 TC 529.

7 *Valiant Cleaning Technology Inc. The Queen*, 2008 TCC 637.

8 (1946) 72 CLR 634 (HCA) @ p. 648.

account in those three years. They were start-up costs. The equivalent payments made to it by Weslin under the Contribution Agreements were simply Wescast's share of the working capital that everyone knew from the beginning would have to be provided by the parents to Weslin Hungary in order to bring its plant into production. There may have been some incidental benefits to Wescast from the start-up, as distinct from the benefits that flowed from the establishment of a manufacturing presence in Europe in the form of the Weslin Hungary plant, but the evidenced does not identify them with any precision. Nor does it quantify them or distinguish them from the latter.

[22] Nor were they the purpose for which Weslin made the payments. The payments were made by the two parent companies because providing Weslin Hungary with the necessary working capital to survive the start-up period was part and parcel of the decision to create it and to build the factory in Hungary. There is no question that that decision, from the appellant's side, was driven by the trend to globalization in the automotive industry, and the long-term need of the appellant to "go global" for its future survival, but that, of course, could not justify treating the capitalization of Weslin Hungary as a current expense of its parent companies. The fixed capital expenditure of $105M and the working capital expenditure of $26M, of which $13M was the appellant's share, were made for exactly the same purpose, which was to create an operating factory in Europe as part of a long-term global strategy. The appellant's tax advisors, and its witnesses at trial, attempted to establish a different purpose for the cost contribution payments, namely, providing benefits, independent of the factory itself, to the appellant and Linamar. There was no such purpose driving these payments; they were quite simply the provision of startup working capital to Weslin Hungary.

[23] There is no bright line test to distinguish capital from revenue outlays. Certain principles do emerge from the authorities, however. Professor Krishna summarizes them this way:

> 1. The character of the advantage or the duration of the benefit (the more enduring the benefit the more likely that the expenditure is on account of capital);
>
> 2. Recurrence and frequency of the expenditure (the more frequent the expenditure the less enduring the benefit);

3. Identification of the payment as a *surrogatum* for expenditures that would be on account of capital or revenue (a substitute for a capital expenditure is more likely a capital expenditure).[9]

In this case the payments are an integral part of the establishment of the Hungarian facility, and so enduring in their nature. The duration of the Agreements is stated to be the life of the joint venture, but it is subject to earlier termination by any party on 30 days' notice. Clearly the intent was that the payments would not continue beyond the point at which Weslin Hungary became profitable as a stand alone entity. The payments are a *surrogatum* for the share capitalization that was originally intended to be the method of financing the startup costs of the Hungary plant. These factors all point in the direction of capital outlay rather than revenue.

[24] In argument, Mr. Nathanson referred me to the following passage from the judgment of Lord Denning MR in *Heather (Inspector of Taxes) v. P-E Consulting Group Ltd*.:[10]

> The question – revenue expenditure or capital expenditure – is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy: but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditures can be put correctly into one category or the other; but this is simply not possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in the marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners – be they accountants or lawyers – must of necessity put them into one category or the other; and then, by custom or by law, by practice or by precept, the border is staked out with more certainty. In this area, at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find.

In his submission the nearest case to be found is the decision of Campbell J. in *Valiant Cleaning v. The Queen*.[11] This may be why Mr. Slattery had read that case in the course of preparing to give his evidence.

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9 Krishna, Vern. *The Fundamentals of Canadian Income Tax* (9th ed. 2006) at p. 334.

10 [1973] 1 All E. R. 8 @ 12.

[25] I do not agree that *Valiant Cleaning* is similar to the case before me. In that case the taxpayer, a tier 1 supplier to the automotive industry in North America, acquired a subsidiary, Elan, that operated in the U.K., for the purpose of extending its presence into the U.K. as part of a strategy of globalization of its business. The cost of acquisition of the shares of Elan and two subsequent cash advances made to it were treated by the taxpayer as capital outlays. Elan continued to have serious financial difficulties thereafter, and found itself in the position of having contractual obligations to its customers that it was unable to meet. Without further cash advances it would have had to abandon those contracts. The results of that would have included irremediable damage to the reputation of the parent company, loss of its status in the industry as a tier 1 supplier, and ultimately failure of its own business in Canada. The present case is not concerned with a subsidiary in exigent circumstances, on the brink of default in its contractual obligations. The payments here were not made to save the parent company from potential extinction resulting from loss of its reputation as a supplier as a result of imminent default by its subsidiary. It is concerned only with the provision of startup capital to a newly formed subsidiary. The capital investment was made as part of a necessary long-term strategy of globalization, and the provision of working capital was part of that capital investment. The proper analogy is not to the advances that were in issue in *Valiant Cleaning*, but to those first two advances of working capital that it treated, rightly as Campbell J found,[12] as capital expenditures.

[26] Of the many cases to which I was referred by counsel the one nearest to this one is *Stewart & Morrison Ltd. v. M.N.R.*[13] The taxpayer incorporated a U.S. subsidiary to carry on business in the U.S. with the intention that it would be managed by the taxpayer and be a future source of income for it. The subsidiary required working capital, and the parent company arranged a bank loan which it guaranteed, and also made cash advances to it. When the business failed the taxpayer sought to deduct the amount of the loans from income. Judson J, for the Court, held that the loans, being working capital provided by the taxpayer to its subsidiary, were capital in nature, and that the deduction of them was therefore prohibited by paragraph 12(1)(*b*) of the Act, the predecessor of the present paragraph 18(1)(*b*).

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11 *Supra*.

12 *Ibid*. @ para. 20.

13 [1974] S.C.R. 477.

[27] In *M.N.R. v. Steer*[14] an investor in an oil drilling concern guaranteed a bank loan to provide working capital for the drilling operations. When the business failed and the company defaulted on the loan, the investor was required to honour the guarantee. Judson J., writing for a unanimous Court, described the transaction as a deferred loan to the company, and held that the loss was a capital loss, the deduction of which was prohibited by paragraph 12(1)(*b*).

[28] Other examples of the same principle are to be found in the Federal Court – Trial Division judgments of Dubé J. in *The Queen v. H. Griffiths Co. Ltd.*[15] and of Strayer J. in *Morflot Freightliners Ltd. v. The Queen*.[16]

[29] Once it is found that the payments made through the mechanism of the Cost Contribution Agreements were in fact the appellant's contribution to the startup working capital of Weslin Hungary then I am bound to conclude that the appellant is precluded by paragraph 18(1)(*b*) of the *Act* from deducting them from income.

[30] Counsel for the appellant argued that if these payments are considered to be on capital account then the Minister will treat them as capital "nothings", to the taxpayer's great detriment. The law, he argued, rightly abhors a "nothing", and that result should be avoided. Without presuming to decide that the payments are "nothings", I simply observe that if that is the case then it is the result of the appellant's carefully considered decision to adopt a tax strategy that was carefully conceived by its advisors for the specific purpose of minimizing its liability for tax in Canada without jeopardizing the right of the Hungarian subsidiary to carry forward the full extent of its startup losses. The risk was surely known to the appellant and its advisors. Indeed, a major element of the decision as to the percentage of the losses that would be brought back to the Canadian parent companies was their estimate of the point at which the Minister would be likely to reassess to disallow the deduction.

[31] The appeal will be allowed, but only to the extent necessary to give effect to the respondent's concession made in paragraph 57 of the Agreed Facts as to the manufacturing and processing profits deduction. The reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the appellant is entitled to a manufacturing and processing profits deduction in

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14 66 DTC 5481 (SCC).

15 76 DTC 6261.

16 89 DTC 5182.

computing its tax otherwise payable under Part I of the *Act* for the 2002 taxation year. The respondent is entitled to costs.

Signed at Ottawa, Canada, this 21st day of October, 2010.

"E.A. Bowie"

Bowie J.

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