Docket: 2010-860(IT)G

BETWEEN:

MARZEN ARTISTIC ALUMINUM LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 25, 26, and 27, 2013 and September 3, 4, 5 and 6, 2013 at Vancouver, British Columbia.

Before: The Honourable Justice G. A. Sheridan

Appearances:

Counsel for the Appellant:	Steven M. Cook Natasha Reid Erin L. Frew
Counsel for the Respondent:	Michael Taylor Selena Sit

JUDGMENT

In accordance with the attached Reasons for Judgment, the appeals of the 2000 and 2001 taxation years are allowed, in part, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that an arm's length's party would have paid an amount to Starline International Inc. that exceeded the fees paid by Starline International Inc. to Starline Windows Inc., but only in the amount of US$32,500 in each of 2000 and 2001.

In view of the Appellant's limited success in these appeals, costs are awarded to the Respondent.

Signed at Ottawa, Canada, this 10th day of June 2014.

"G. A. Sheridan"

Sheridan J.

Citation: 2014 TCC 194
Date: 20140610
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BETWEEN:

MARZEN ARTISTIC ALUMINUM LTD.,

Appellant,

and

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Respondent.

REASONS FOR JUDGMENT

Sheridan J.

I. Introduction

[1] These appeals arise out of a transfer pricing adjustment made by the Minister of National Revenue (the "Minister") under paragraphs 247(2)(*a*) and (*c*) of the *Income Tax Act* (the "*Act*") in respect of fees paid by the Appellant to Starline International Inc. ("SII"), a Barbados-based corporation wholly owned by the Appellant. In computing its income for 2000 and 2001, the Appellant deducted the fees paid to SII of CAD$4,168,551 and CAD$7,837,082, respectively.

[2] In 2000 and 2001, SII paid to Starline Windows Inc. ("SWI"), another corporation in the Appellant's group of companies, a total of US$1,383,723 and US$1,811,992, respectively, for the secondment of its employees to perform certain services for SII.

[3] In 2000 and 2001, SII declared dividends of CAD$2,011,500 and CAD$5,299,620, respectively. The Appellant included these amounts in its income for Canadian tax purposes in the 2000, 2001 and 2002 taxation years. The dividends were then deducted from the Appellant's taxable income pursuant to section 113 of the *Act* on the basis that they had been paid out of SII's exempt surplus.

[4] In reassessing the Appellant's 2000 and 2001 taxation years, the Minister disallowed the deduction of any amounts in excess of the fees SII paid to SWI[1]:

	2000	2001
Paid by the Appellant to SII	$4,168,551	$7,837,082
Paid by SII to SWI	($2,058,049)	($2,811,892)
Difference	$2,110,502	$5,025,190

[5] A transfer pricing penalty of CAD$502,519 was levied under subsection 247(3) of the *Act* for the 2001 taxation year only.

II. Witnesses

A. Appellant's Lay Witnesses

(1) Mr. Ron Martini

[6] During the years in question, Mr. Martini, was the president and sole director of the Appellant. With only a grade 7 education, Mr. Martini immigrated to Canada at the age of 18. After working for two years as a welder, he and three partners incorporated the Appellant in 1970. Approximately 20 years later, Mr. Martini and his wife had become the sole owners of the company and by 1995, the Appellant was the largest window manufacturer in British Columbia.

[7] Mr. Martini struck me as a man whose many years of experience in the industry had made him a knowledgeable and astute businessman.

(2) Mr. Art Fabian

[8] Like Mr. Martini, Mr. Fabian also immigrated to Canada and established himself in a successful business career. He earned a Bachelor of Science in Education in the Philippines where, after graduating, he taught high school physics. He then became a medical sales representative for GlaxoSmithKline in Manila, receiving regular promotions until 1989 when he and his family

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[1] Reply to the Notice of Appeal, paragraphs 8 and 9(yy).

immigrated to Canada. He immediately began work as a shoe salesman in Vancouver and by late 1990, had become the company's area supervisor. He left that employment to sell windows for a business which soon after, was purchased by the Appellant. In 1991, Mr. Martini placed Mr. Fabian in charge of overseeing the company during the transition period. With his background in science, sales and management, Mr. Fabian soon worked his way up to becoming what Mr. Martini described at trial as his "right-hand man" in the Appellant's business operations.

[9] Mr. Fabian was the first witness to be called and spent all of one day and most of the next morning on the stand. He was very thorough in his explanation of, among other things, the business of selling windows, the different requirements of the single home residential market and the high-rise condominium market and especially, the nature of the Appellant's various operations. However, he was less forthcoming when it came to explaining the role played by Mr. Csumrik in respect of the functions of SII and SWI.

(3) Mr. David Csumrik

[10] Mr. Csumrik is a lawyer with a background in accounting and an impressive history in various business dealings in Canada and the US. As of the time of trial, Mr. Csumrik was the principal of Longview Associated Limited ("Longview"), a company engaged in establishing international business corporations in Barbados and providing management and administrative support services to them.

[11] Mr. Csumrik's testimony often left me with the impression that there was more to the story than the Court was hearing. His overall credibility was further weakened by discrepancies between his sworn evidence at trial and certain written representations he provided during the audit in respect of the role he played in the functions of SII and SWI. More will be said about this later.

B. The Respondent's Lay Witness

(1) Mr. Thomas Stasiewski

[12] The Respondent called Mr. Thomas Stasiewski, a former employee of the Canada Revenue Agency ("CRA") who performed all but the preliminary steps of the audit of the Appellant's 2000 and 2001 taxation years. Mr. Stasiewski has a Certified General Accountant designation and began work with the CRA in 1975. He held various positions in the auditing field throughout his career; by the time

the Appellant's audit began in 2003, Mr. Stasiewski was in a section of the International Audit Department that dealt with transfer pricing issues. I found Mr. Stasiewski to be a credible witness.

[13] Although initially intended to be the Respondent's nominee on examination for discovery, Mr. Stasiewski retired prior to the conduct of discoveries. He declined to attend on the Respondent's behalf because of Treasury Board policies restricting the amount of his remuneration. As a result, Ms. Tanya Fleck, another CRA auditor became the Respondent's nominee on discovery.

[14] At trial, the Appellant moved to have Mr. Stasiewski excluded as the Crown's witness. That motion was dismissed for the reasons given at pages 793 to 798 of the Transcript.

[15] For ease of reference, Mr. Stasiewski is referred to herein as the "Primary Auditor" and Ms. Fleck, as the "Nominee Auditor".

C. Expert Witnesses

(1) Appellant's Expert: Mr. Barry MacDonald

[16] The Appellant called as its expert witness Mr. Barry MacDonald, a partner at PricewaterhouseCoopers LLP with some 30 years experience in transfer pricing and international tax planning. Mr. MacDonald was duly qualified as an expert witness for the Appellant and his expert report entered in evidence as Exhibit A-2 ("Appellant's Expert Report").

(2) Respondent's Expert Witness: Mr. Oliver Rogerson

[17] The Respondent's expert witness was Mr. Oliver Rogerson, the Chief Economist for the CRA based in Ottawa. Mr. Rogerson began his career with the CRA in 1999 and specializes in transfer pricing analysis.

[18] After Mr. Rogerson was duly qualified as the Respondent's expert witness in the field of economic analysis of transfer pricing, the Appellant objected to the admissibility of the report he had prepared. After hearing the submissions of counsel, the report was excluded for the reasons given at pages 798 to 807 of the Transcript. There was no objection to Mr. Rogerson's Rebuttal Expert Report and it was duly admitted in evidence as Exhibit R-1 ("Respondent's Rebuttal Expert Report").

III. Evidence

A. Background

[19] The parties filed a Statement of Agreed Facts and a Joint Book of Documents[2]. Portions of the examinations for discovery were read in at the hearing.

[20] At all relevant times, the Appellant was engaged in the design, manufacture and sales of aluminium and vinyl window products ("Window Products") in Langley, British Columbia. The Appellant's sole director was Mr. Ron Martini. Mr. Martini and his family controlled directly or indirectly the Appellant, SII and SWI. Thus, the Appellant, SII and SWI are deemed under the *Act* not to deal at arm's length.

[21] SWI was located in Washington State. SWI was a tax resident of the United States ("US") where it filed tax returns for the taxation years 1998 to 2001. Mr. Rick Stark became the general manager of SWI in April 1998.

[22] SII, a tax resident of Barbados, was incorporated in Barbados by Mr. David Csumrik, also a resident of Barbados, on September 29, 1998. Mr. Csumrik acted as the company's initial director and on February 11, 1999 became its managing director. Two other directors were also appointed at that time, Mr. Stark and Mr. Terry Vipond, Mr. Martini's son-in-law.

[23] Mr. Csumrik was also the principal of Longview. Neither Mr. Csumrik nor Longview was related to the Appellant, SII or SWI for the purposes of the *Act*.

B. Activities Prior to July 1, 1999

(1) Appellant's Direct Sales to US – 1993 to early 1998

[24] By 1995, the Appellant was the largest window manufacturer in British Columbia with the majority of its customers in the Lower Mainland and branches in Kamloops, Kelowna and on Vancouver Island. Ninety per cent of its sales revenue was attributable to the single-family residential market, the remaining ten per cent to high-rise buildings.

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[2] Exhibit A-1.

[25] While most of its sales were in Canada, from 1993 to early 1998, the Appellant also attempted, with limited success, to sell Window Products directly from its location in British Columbia to customers in the US residential market.

(2) SWI's Sales Activities in US – April 1998 to June 1999

[26] In 1998, Mr. Martini decided to shift this role to SWI. SWI had been incorporated in Washington State sometime prior to 1993 and was reinstated as a Washington State corporation on September 21, 1993 where it remained inactive until 1998.

[27] In April 1998, SWI opened a sales office and storage facility near Seattle, Washington. Mr. Stark, an experienced general manager in the Appellant's Victoria sales office, was transferred to the SWI office to act as its general manager. Mr. Stark hired and trained a staff of approximately 20 employees to provide sales, administrative, accounting, storage and delivery services for SWI. SWI carried its own property and liability insurance.

[28] Like the Appellant in Canada, SWI's focus in Washington State was the residential market. SWI purchased Window Products from the Appellant at a price which would provide a margin of 15-18%. SWI had access to the Appellant's computer system, including its price list. SWI personnel solicited orders for Window Products from US customers and entered those orders directly into the Appellant's system for manufacture at the British Columbia plant.

[29] During the 1998 fiscal period, SWI realized sales revenue of US$551,320 and incurred a loss of US$487,309. Mr. Martini asked Mr. Fabian to look into the company's failure to penetrate the Washington State residential market. After discussions with Mr. Stark, Mr. Fabian determined that SWI was being outflanked by its larger and better-established US competitors.

[30] Around this time, Mr. Martini and Mr. Fabian also met with counsel for the Appellant at Thorsteinssons LLP in Vancouver to discuss the utilization of SWI's losses. During his examination-in-chief Mr. Martini explained that counsel "…suggested that if I needed a marketing person he knew of one that could have probably, possibly help us".[3] That person was Mr. David Csumrik.

(3) Mr. Csumrik and Longview

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[3] Transcript, page 376, lines 17-18.

[31] At the time of counsel's discussions with Mr. Martini and Mr. Fabian, Mr. Csumrik was living in Barbados. In the 15 years prior to his relocation there in 1997, Mr. Csumrik had been involved in various businesses in Canada and the US. He invested in and acted as the CEO of a Vancouver company selling specialized lighting systems to theatres in the US. Next, he and a partner established a computer software development and licensing company. His partner provided the technical know-how and Mr. Csumrik, the business expertise. That venture ultimately led to the sale of one of the company's products to Microsoft Windows for an undisclosed amount, reportedly a $20-million-dollar transaction[4].

[32] After the sale, Mr. Csumrik carried on as a consultant in Vancouver obtaining software licensing agreements and raising investment capital for other companies. Looking to invest some of the profits from the Microsoft deal, Mr. Csumrik then teamed up with two Toronto-based real estate developers. That endeavour was ultimately unsuccessful and Mr. Csumrik returned to Vancouver.

[33] In 1996, he collaborated with his former high-tech partner to launch a plant biotechnology company. To undertake this project, certain exploitation rights had to be acquired from the Carnegie Institution of Washington ("Carnegie"). According to Mr. Csumrik, his partner "… was instrumental in convincing them that we would use more efforts to exploit the technology than would Monsanto"[5]; Mr. Csumrik's role was to conduct negotiations to secure the licensing agreement with Carnegie's chief financial person.

[34] Mr. Csumrik sought advice from Thorsteinssons LLP as to how to structure the new endeavour in a "tax efficient manner"[6]. He and his partner ultimately decided to establish the company in Barbados and in 1997, Mr. Csumrik moved to Barbados where they:

> … formed a company called Linnaeus Inc. in Barbados, licenced it as an international business company in Barbados, set up the attendant bank accounts, the requisite licensing agreements with Carnegie, and … did business as Linnaeus and still do business as Linnaeus Inc. from Barbados.[7]

[35] In the spring of 1998 Mr. Csumrik established Longview, a company which he described as providing "one-stop accounting, corporate administration,

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4 Transcript, page 265, lines 22-27.
5 Transcript, page 272, lines 13-15.
6 Transcript, page 273, line 2.
7 Transcript, page 274, lines 5-10.

corporate secretarial, office facility; like a packaged office with, as I say, accounting, clerical, administrative and corporate secretarial"[8] for companies incorporated in Barbados. He set up Longview after being approached by a client referred to him by Thorsteinssons LLP looking to incorporate in Barbados. This was followed by two other Thorsteinssons LLP referrals and subsequently, other clients who had heard of Longview by word of mouth.

[36] On cross-examination, Mr. Csumrik provided further details of Longview's services: it provided staff to maintain the books of account and prepared financial statements of the international business corporation, kept business registrations current with the Barbados authorities, prepared Barbados tax returns, provided someone to answer the phone and handle correspondence, maintained the corporate records required to operate the company, provided legal referrals in Barbados to set up additional corporations or trusts, opened bank accounts in Barbados or elsewhere in the world, as required.[9] The usual fee for such services was US$30,000 annually.

[37] For an annual fee of US$2,500[10], Mr. Csumrik (through Longview) would also provide his personal services as managing director to Longview's corporate clients. As such, he would perform the following tasks:

> A As the manager I would direct the staff to fulfill all the requirements of -- the daily requirements of the business, be it taking orders, processing orders, paying bills, dealing with customer queries. I would then oversee the corporate -- I would be the general manager of the business as it operated in Barbados, or from Barbados.[11]
>
> Q Now, the staff, for example, or the business activities of the company, would that be something [the client would] supply to you? Would [the client] provide the staff and you manage them? Or would Longview provide … the staff as well?
>
> A It would be by circumstance. In certain instances we would -- Longview would supply the accounting, staff the clerical. In some cases we have supplied customer support whereby we have -- customers would phone in to get support and they would phone a

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8 Transcript, page 326, lines 4-8.

9 Transcript, page 328, line 8 to page 330, line 19.

10 In certain cases a higher fee would apply but $2,500 was the regular rate. See transcript, page 335, lines 22-25.

11 Transcript, page 327, lines 9-15.

> person in Barbados. We would supply that. In other instances we would manage the sales people or the technical support people throughout the world. We would manage them from Barbados. They would report to us although they would get paid either as independent contractors and/or if they were in the U.S. they would get paid by a facilitating company that would be a non-arm's-length company to the group, not --
>
> Q Something like SWI was.
>
> A Yes, exactly, yes. [12]

(4) Discussions between the Appellant and Mr. Csumrik; the Incorporation of SII

[38] In late summer 1998, Mr. Martini and Mr. Fabian met with Mr. Csumrik in Vancouver. Mr. Csumrik recounted his successful business record and experience in management and negotiation in Canada and the US. For their part, Mr. Martini and Mr. Fabian explained the nature of the Appellant's business and failure to penetrate the Washington State residential window market. Over the next few weeks, they gave Mr. Csumrik what he described as a "very condensed course"[13] on the making of windows, including a visit to the Appellant's manufacturing plant. Mr. Csumrik also met with Mr. Stark to learn about SWI's activities in Washington State.

[39] Shortly after meeting Mr. Martini and Mr. Fabian, Mr. Csumrik incorporated SII in Barbados on September 29, 1998 with Mr. Csumrik acting as its first director. Neither he nor Mr. Martini was concerned about the possible loss of the approximately $2,000 in incorporation costs should their discussions not bear fruit. Mr. Csumrik said the company could always be used for some other client looking to incorporate in Barbados.

[40] Discussions continued between Mr. Martini and Mr. Csumrik and it was understood that Mr. Csumrik expected to be compensated for whatever assistance he might ultimately provide. By the end of 1998, Mr. Csumrik had concluded that the Appellant was focussed on the wrong market. He advised Mr. Martini and Mr. Fabian to shift the Appellant's efforts from Washington State's residential market

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12 Transcript, page 327, line 16 to page 328, line 7.

13 Transcript, page 279, lines 5-6.

to the burgeoning high-rise market in southern California, with a view to targeting western Canadian developers in the area. Mr. Csumrik admitted that he himself had no contacts with such developers and could not recall how he had come to know about their projects in southern California:

> Q So when you met with Mr. Fabian and Mr. Martini and then you agreed to assist them and you undertook the structure, you suggested to them that they should focus on the high-rise market instead of the residential market. That's one of the things you suggested as a marketing strategy, is that correct?
>
> A Yes.
>
> Q And you suggested to them that some Canadian developers would be looking to build in the United States and that might give Marzen an in to the U.S. market. Is that also fair?
>
> A If I said "in" I didn't -- I thought it might help them with a – level the playing field vis-à-vis competition, yes.
>
> Q And you mentioned specifically to them Bosa and Pinnacle as two developers from Canada that you believed would be taking on projects in the United States.
>
> A Yes.
>
> Q What was the source of your belief that Bosa and Pinnacle would be expanding into the U.S.?
>
> A I don't know if I read it in newspapers, read it in the trade magazines. I don't even know where I would have garnered that from, but I somehow came to possess that knowledge.
>
> Q But you weren't in contact with people at Bosa or Pinnacle from your days in real estate development?
>
> A No. [14]

[41] As noted at paragraph 11 of these Reasons, this testimony is at odds with certain written representations made by the Appellant at the audit stage. These

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[14] Transcript, page 340, line 5 to page 341, line 5.

documents were put to the Primary Auditor by counsel for the Appellant in furtherance of the Appellant's position that the Primary Auditor had wrongly rejected the Appellant's claims regarding the extent of Mr. Csumrik's involvement with SII and SWI. In these documents, Mr. Csumrik was described as having useful contacts with Canadian developers with projects in the US. The first document was authored by Mr. Csumrik:

> Two such developers are the Pinnacle Group and Bosa Ventures, both of whom were well known to me through my previous working life as a lawyer/businessman in the Vancouver area.[15] [Emphasis added.]

[42] The following description appears in a letter from counsel for the Appellant to the Primary Auditor:

> Mr. Csumrik has extensive experience in managing sales forces in the US for other products. He has key contacts and personal connections with significant Canadian builders who were entering the southern California real estate market. It is through Mr. Csumrik's contacts that the Company was able to penetrate the California market.[16] [Emphasis added.]

[43] Like Mr. Csumrik, the Appellant had had no prior dealings with such companies but Mr. Csumrik believed the Appellant's successful history in the British Columbia residential window business could be leveraged to its advantage. Mr. Csumrik also testified that he advised Mr. Martini and Mr. Fabian that because the high-rise market in southern California was fundamentally different from the residential market in Washington State, SWI's sales personnel would have to embrace new skills and marketing techniques. Mr. Csumrik's evidence was that he had learned the importance of this tactic when dealing with US customers in his theatre lighting business.

[44] On February 11, 1999, SII's organizational resolutions were passed with the Appellant as SII's sole shareholder. Mr. Stark and Mr. Vipond joined Mr. Csumrik as directors of the company. Mr. Martini was aware of Mr. Csumrik's intention to remain in Barbados and that he expected to be compensated for his marketing advice. Both parties were interested in reaching an agreement and discussions continued on how that could be accomplished.

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15 Exhibit A-1, Tab 59.

16 Exhibit A-1, Tab 54.

[45] Mr. Martini asked Mr. Fabian to summarize what had emerged from their discussions with Mr. Csumrik over the past few months and in particular, to identify the possible options. In his Case Study to Mr. Martini dated April 5, 1999[17], Mr. Fabian "highly recommended" the third option, that the Appellant "acquire the services of a fully established sales and marketing firm" to market Window Products in the US. Mr. Fabian prepared a second document dated April 26, 1999 and entitled "A Study of the Three Major Industry Segment that Will Directly Affect Our Successful Business Launching and Bolster Market Share in the United States of America".

[46] By the early spring 1999, Mr. Martini and Mr. Csumrik had reached an agreement regarding his compensation. According to their testimony, they had a "hand-shake" agreement that if his advice proved successful, Mr. Csumrik, in his personal capacity, would be remunerated by Mr. Martini and/or the Appellant in some fashion at an undetermined time in the future. Mr. Csumrik's evidence was that he was comfortable with this loose arrangement first, because both he and Mr. Martini were "old style" businessmen who trusted each other. He added that this had always been his preferred manner of doing business.

[47] In support of his claim of a separate remuneration arrangement with Mr. Martini and/or the Appellant, Mr. Csumrik referred to letters dated January 5, 2004[18] and June 2, 2008[19], respectively, in which Mr. Martini had invited him to pursue business opportunities involving the sale of certain products manufactured by the Appellant and/or companies under Mr. Martini's control. I note that their oral agreement was not reduced to writing until after the audit began on April 16, 2003. Mr. Csumrik admitted that, as of the time of trial, he had not exploited either of these opportunities, explaining that in 2004, he was too busy with his own businesses to take on an additional project and was also embroiled in a matrimonial dispute. As for the 2008 proposal, Mr. Csumrik said that while he initially found it attractive, the onset of the US financial crisis later in that year ultimately made it less so. But both he and Mr. Martini testified that it was still open to Mr. Csumrik to avail himself of these opportunities should he choose to do so.

[48] At the same time Mr. Martini and Mr. Csumrik were discussing how he would be compensated, Mr. Martini was receiving legal and accounting advice from Thorsteinssons LLP and other professional advisors on how best to structure

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17 Joint Book of Documents, Tab 83.

18 Exhibit A-1, Tab 49.

19 Exhibit A-1, Tab 51.

the new marketing approach. Mr. Martini was asked on cross-examination about his understanding of the reasons for establishing SII in Barbados:

Q And you believe that that was necessary because Mr. Csumrik was living in Barbados?

A No, that was a structure that the lawyers and accountant came up.

Q What did you understand about the reasons for adopting that structure?

A The reason was that Barbados had a lower tax rate than the Canadian tax rate.

Q All right, so income that was earned in Barbados would be taxed at a lower rate.

A That's correct.

Q And also I suppose you must have been aware that income earned in Canada that -- income taxed in Canada to Marzen would be reduced by marketing fees that Marzen paid to a marketing company. That would be deductible.

A Yes.

Q And you also understood that to the extent that business income was earned in Barbados by Starline International and tax was paid in Barbados, that under the Canadian tax regime that money could be paid as a -- that after-tax money could be paid as a dividend to Marzen as the Canadian parent.

A That's correct, yeah.

Q And Marzen would not be taxable on those dividends received in Canada.

A Yes.

Q I imagine this made the structure very appealing to you.

A The structure was appealing, but unless we sold something, the structure would be worth nothing.[20]

[49] Mr. Csumrik was also asked on examination-in-chief about the decision to locate SII in Barbados; at no point during that exchange did he confirm that his residency in Barbados had anything to do with Mr. Martini's decision to incorporate SII in Barbados[21]. When Mr. Martini was given the opportunity to provide further details about this decision on cross-examination, he candidly acknowledged that Mr. Csumrik's desire to remain in Barbados had not been a factor:

Q Did you believe that it was necessary to have a company in Barbados in order for Mr. Csumrik to provide his assistance to your marketing efforts?

A It didn't have to be in Barbados, no, but he was in Barbados.

Q Right. All right. Did you believe it was necessary to have a marketing company for Mr. Csumrik to provide his services to your company?

A I didn't believe it was necessary for them, no.

Q But you went along with the structure that was proposed to you

A That's correct. [22]

[50] Counsel for the Respondent also asked Mr. Martini about his expectations regarding the dividends that the structure could generate if the marketing strategy was successful:

Q At the time the structure was entered, was it your expectation that dividends would be declared to the extent that cash was available?

A My expectation were there, yes. If I can add to that, the kind of volume that we were achieving, we had to restructure Canada, we had to spend millions of dollars in equipment and buildings and the money

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20 Transcript, page 410, line 25 to page 412, line 6.
21 Transcript, page 284, line 27 to page 285, line 20.
22 Transcript, page 409, lines 7-22.

was needed in this country.

Q I'm not disputing that you had a use for the money. I'm just asking you about your expectation.

A Okay. [23]

C. Activities after July 1, 1999

(1) Agreements and Arrangements under the Barbados Structure as of July 1, 1999

(a) Arrangement between Appellant and SWI

[51] On July 1, 1999 the Appellant continued to supply Window Products to SWI for resale but with a change in their cost to SWI. Under the Barbados Structure, the Appellant supplied Window Products at a cost equal to SWI's sale price to US customers thus resulting in no profit being recognized by SWI. The Appellant measured its Window Products sales in the US market by reference to its sales to SWI.

(b) The Four Agreements under the Barbados Structure

[52] On July 1, 1999, four agreements were executed putting in place the new structure for marketing the Appellant's Window Products in the US ("Barbados Structure").

(i) Marketing and Sales Services Agreement – Appellant/SII ("MSSA")[24]

[53] The MSSA is the transaction under review. In the preamble, SII is described as being "in the business of marketing products such as" the Appellant's Window Products.

[54] Under Clause 1.1 of the MSSA, SII agreed to provide, *inter alia*, the following services to the Appellant in jurisdictions other than Canada or the Caribbean, most particularly in the US:

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[23] Transcript, page 430, line 19 to page 431, line 5.

[24] Exhibit A-1, Tab 1.

(a) to use its best efforts to improve the Appellant's business by marketing Window Products in the US;

(b) to receive offers to purchase Marzen products from potential purchasers and forward them to the Appellant;

(c) to prepare and maintain offer or order schedules and daily sales report summaries;

(d) to send out in accordance with the Appellant's directions, notices to potential purchasers who have placed orders to confirm approval, rejection or variance of the order and then send out additional information as directed;

(e) to provide follow-up correspondence to purchasers in respect of specific queries that may be raised related to a particular sale of Marzen products;

(f) to undertake evaluations and analysis of Marzen sales through SII as directed by Marzen.[25]

[55] Under Clause 3.2, the Appellant also agreed to advance to SII "such reasonable amounts as may be requested by SII from time to time" to assist SII with the costs of providing its services to the Appellant. Mr. Csumrik explained the effect of this clause as follows:

> … the marketing sales agreement provided that if we needed working capital, they [the Appellant] must provide it. So we didn't have any working capital requirements other than very nominal amounts.[26]

[56] Under Clause 3.1, the Appellant agreed to pay to SII a monthly fee equal to the greater of US$100,000 or 25% of gross sales initiated by SII of Window Products.

[57] On cross-examination, Mr. Martini testified that he was responsible for determining the fees the Appellant would pay under the MSSA and explained how he had come up with the 25% formula:

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[25] See Exhibit A-1, Tab 1, Clause 1.1.

[26] Transcript, page 359, lines 14-17.

Q And I think you referred to comparing your Canadian markup and your Starline Windows 1998 markup as factors in deciding that 25 percent was reasonable.

A That's correct.

Q Could you take me through that decision-making process again, please?

A The cost of sales in Canada for Marzen was 14 percent, 14 to 15 percent. Our cost here in Canada. So we are selling in a market where everybody knows we don't have to go and look for new customers, repeated customer. I felt that if we go in the new country and if I have to market to people that don't know us, 25 percent was reasonable.

Q And where did the 18 percent markup that you were applying within SWI in 1998 enter into that decision?

A The 18 percent, the 18 percent that we ended up as a markup in 1998 was not done beforehand. That's the result of us selling to the marketplace, we ended up with an 18 percent markup. So with an 18 percent markup we still lost 430,000 that year.

Q I just want to take a step back to make sure I understand correctly. The 18 percent markup you're referring to in SWI in 1998, how was that determined?

A We would sell a window to SWI. They would buy it from us, our cost plus some overhead, and then they would go out on the market and sell them to whatever money they could get. So the market decides what the price is. We don't decide what the customer pays for it. And they were actually able to achieve at the end of the day, 18 percent market.

Q So there wasn't a formula in place to determine what price Marzen would charge to SWI for the product?

A There was a formula, was cost plus -- I forget, plus some overhead. I forgot what it was but almost at cost.

Q So what you're saying is under that structure, SWI could realize an 18 percent markup.

A That's correct.

Q And that wasn't enough to cover its costs.

A It wasn't, no. [27]

[58] Although Mr. Martini acknowledged the 25% marketing fee was greater than SWI's costs under the pre-July 1999 regime, his evidence was that he believed the Appellant could still make a profit because of the increased volume of sales. He said he did not use any comparable businesses in determining the fee formula because he could not identify any but also admitted he had not sought professional assistance to assist him to that end. He had not reduced to writing the basis for his decision.

[59] Mr. Martini was asked on cross-examination whether SII's status as a non-arm's length party had influenced the amount of the fees under the MSSA:

Q In determining that you were prepared to pay 25 percent as a marketing fee, did the fact that the company you were paying to was controlled by Marzen influence your decision?

A I thought it was a common sense decision. Does that answer the question?

Q I'm not entirely confident it does. What I'm asking you is, did you, in deciding that 25 percent was a reasonable amount you were prepared to pay, did you take into account the fact that the company you were paying to was controlled by Marzen, was your subsidiary and not an unrelated company?

A I would probably have done that with an unrelated company if that was what they presented to me.

Q Now, if you had paid marketing fees to an unrelated company, you would not have secured the same beneficial tax results whereby Marzen could deduct the fees, the company could pay tax in another jurisdiction, and then pay a dividend back to Marzen.

A No, we would not.

Q But you would have done it anyway.

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[27] Transcript, page 417, line 17 to page 419, line 10.

A I would have done it because in times like now, they would be losing money, so it's beneficial both ways. [28]

(ii) MSSA Bonus Payment Agreement

[60] Pursuant to an exchange of letters between Mr. Martini and Mr. Csumrik[29] in August 2000, the MSSA was amended to provide that the Appellant would pay SII a one-time bonus of 10% on all confirmed contracts in the California market on condition that SII achieve at least US$10 million in net sales between August 1, 2000 and December 31, 2001 ("MSSA Bonus Payment"; references herein to the MSSA after the amendment include the MSSA Bonus Payment).

[61] Mr. Martini testified that he authorized Mr. Csumrik's request for the Appellant to pay SII the MSSA Bonus Payment but did not know how Mr. Csumrik had arrived at the 10% formula. When Mr. Csumrik was questioned about this during his examination-in-chief, he provided the following explanation:

Q And when you set up the 10 percent bonus amount, what was the rationale for asking for 10 percent? Was there any analysis that you'd undertaken?

A No. No. I knew we were going to have some increased costs. I wanted Starline International Inc. to increase its level of profitability because I knew I would look better if that was to happen, and because Marzen owned SII and I wasn't getting any of this money anyways, he should have been indifferent.

Q Did you ultimately direct Starline Windows to increase its presence in the California market after this agreement was acknowledged?

A I believe we opened up a sales office. I can't remember if it was a result of this or if this was a result of opening up a sales office in California.

Q You're satisfied there's some link though.

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[28] Transcript, page 424, line 13 to page 425, line 12.

[29] Exhibit A-1, Tabs 34 and 35.

A I'm satisfied that that would have been -- there's some connection between the two.[30][Emphasis added.]

[62] Mr. Martini testified that he had no reason to think the 10% amount was unreasonable, especially since he countered Mr. Csumrik's request with the condition that a minimum of US$10 million in sales would be achieved during the period. As it turned out, the total sales greatly exceeded the required minimum resulting in an MSSA Bonus Payment of US$2,090,422.

[63] On cross-examination, Mr. Martini was asked what the amounts under the MSSA and the 10% MSSA Bonus had been paid for:

Q Now, you would agree with me that to the extent that bonus [the 10% MSSA Bonus Payment] reflected expenses that SII incurred to pay SWI for extra workers or extra marketing efforts in California, that that bonus went to fund the marketing. You agree with that.

A Yes.

Q And if -- you would also agree, I think, that if SII spent less than the $2 million that you paid as a bonus on the cost of SWI, that that amount was received by SII as income.

A Yes.

Q And you would also agree that no part of that $2 million went to benefit Mr. Csumrik.

A I agree.

Q And in fact wouldn't you agree that of all of the fees that Marzen paid to SII in 2000 and 2001, which I think totals close to $12 million Canadian, only the $32,500 per year went to benefit Mr. Csumrik or Longview?

A That's correct.

Q And only the amounts that SWI invoiced SII for to recover the costs of the sales staff went to benefit the sales people who were making the

[30] Transcript, page 317, lines 8-28.

sales.

A That's correct.

Q So whatever their compensation was, could be salary, could be bonus, that's paid for through the cost recovery from SWI to SII.

A That's correct.

Q And then additionally SII has to pay SWI some fees for administrative services, access to display models.

A Yes.

Q Those features. But all the rest of the money, whatever's left over in the marketing fee paid to SII, that's income of SII.

A Yes.

Q And it doesn't provide any benefit to the people that did the marketing sales work, Mr. Csumrik or the sales people.

A No.[31] [Emphasis added.]

(iii) Personnel Secondment Agreement – SII/SWI ("PSA")[32]

[64] In the preamble to the PSA, SII is described as being "in the business of marketing windows and doors designed and manufactured by [the Appellant] in the United States and elsewhere". SWI is described as having "qualified personnel employed in the sales and marketing of windows and doors to be marketed by SII".

[65] Under Clause 1.1 of the PSA, SWI agreed to "provide the services of personnel on an exclusive basis ('the Seconded Personnel') to be retained and engaged by SII in the marketing of [the Appellant's] products in the US and elsewhere ('the Services')". Under Clause 3.1, SII agreed to pay SWI a monthly fee to cover SWI's aggregate costs of the employment of the Seconded Personnel plus a service fee of 10%.

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31 Transcript, page 415, line 22 to page 417, line 12.

32 Exhibit A-1, Tab 2.

[66] Under Clause 1.2, SWI agreed to "ensure that the Seconded Personnel seconded to SII to provide the Services are competent and duly qualified"; under Clause 2.1, SII was "solely responsible for the direction, administration and management of the Seconded Personnel".

[67] On cross-examination, Mr. Fabian was asked whether, under the PSA, SWI was in the business of providing personnel and how it was determined that SWI be paid an additional 10% over its actual costs:

> Q … I said SWI is now carrying on a little business of providing employees to somebody else for profit.
>
> A Well, again, at the end of the day, sir, I would say, I'm looking at more when you said "business", like personal [*sic*, "personnel"], temporary business. You know, where you have a temp guy, you need somebody at temp. That's the business that I'm more looking at when you told me that. But, this one is just incidental, that these people were hired and being used by SII and therefore SWI should get some profit out of it. Simple, simple, a simple business thing I believe.
>
> Q Are you saying that there was some sort of negotiation where SWI demanded to be compensated for this and SII agreed?
>
> A There was no, nothing like that. Again, it's not really their business to provide, like, you know, a temporary company, a temp company who provides secretarial or accounting. It's not really like that. They have an existing client, so again, you know, probably just to be profitable they have ten percent. [33]

(iv) Administrative and Support Services Agreement – SII/SWI ("ASSA")[34]

[68] Under the ASSA, SWI agreed to provide certain secretarial and other administrative support services to SII. SII agreed to pay to SWI monthly fees, as amended from time to time, of US$23,000 (July 1999 – June 2000); US$30,000 (July 200-June 2001); and US$35,000 (July 2001- December 2001).

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33 Transcript, page 182, line 25 to page 183, line 18.

34 Exhibit A-1, Tab 3.

[69] In the preamble to the ASSA, SWI is described as being "in the business of providing services related to the marketing and distribution of products designed and manufactured by [the Appellant]".

[70] Under Clause 1.6, SWI was "solely responsible for the administration and management of its employees including pay, supervision, discipline and all other matters arising out of the relationship between SWI and its employees".

(v) Delivery/Depot/Repair & Maintenance Services Agreement – Appellant/SWI ("DDRMA")[35]

[71] Under the DDRMA, SWI is described as related to the Appellant and carrying on "the business of storage, delivery, repair and maintenance, and collection services in relation to the [Appellant's] products".

[72] Under the DDRMA, SWI agreed to provide certain services in relation to the delivery, depot, repair and maintenance of Window Products as well as certain bill collection and enforcement duties. The Appellant agreed to pay the amounts set out in the Statement of Agreed Facts at paragraph 22(d). The effect of this agreement was that the Appellant covered all of SWI's costs related to these services.

(c) Arrangements between SII and Mr. Csumrik/Longview

[73] Under a separate arrangement, Longview provided SII with Mr. Csumrik's personal services as managing director of SII for US$2,500 annually. Longview provided its local management and administrative services for US$30,000 annually. These amounts were in accordance with Longview's usual rates for such services.

(2) Services Performed by SII, SWI and Mr. Csumrik/Longview under the Barbados Structure

[74] During his examination-in-chief, Mr. Martini summarized the operation of the new marketing structure as follows:

> A The new marketing structure was Mr. Csumrik, the architect of the marketing system, seconded the people that work at [SWI]. [SWI] would sell the product in the U.S. and they would buy from [the Appellant], and when [SWI] received the money from the customer,

[35] Exhibit A-1, Tab 4.

> the same amount would go right through [the Appellant], and then [the Appellant] would pay a 25 percent fee to [SII] for the sales costs.[36]

[75] Although having described Mr. Csumrik as the "architect" of the new structure, Mr. Martini later admitted that he had no personal knowledge of what Mr. Csumrik actually did; he relied on reports from Mr. Fabian and Mr. Stark[37]. Mr. Stark, SWI's general manager, was not called as a witness at the hearing.

[76] Mr. Csumrik that he was in regular contact with Mr. Fabian:

> Q What was the purpose of those conversations?
>
> A The purpose of those conversations – it should be appreciated that there's a learning curve that happens when you get involved in a new business. I wasn't -- I didn't understand the business. Mr. Fabian did understand the business. So we would talk about, okay, an order goes in, when is it going to ship? You know, what are the problems? How come those are -- how come something got returned? How are we going to ship, you know, this big order if $3 million worth of windows comes in? This wasn't a carry-on of previous business down there. This was -- you know, this was expanding their capabilities and it was all new business so it was a learning process. So we probably spoke weekly if not more.[38] [Emphasis added.]

[77] Mr. Fabian testified that he was closely involved with the Appellant's day-to-day operations. Mr. Fabian provided a detailed explanation of the complicated process of bidding on, ordering and invoicing and scheduling the supply of windows to high-rise developers in southern California. What came out of this was that Mr. Fabian was worthy of Mr. Martini's description of him as his "right-hand man". As shown in the testimony below, he was the overseer of all aspects of the Appellant's sales and marketing in the US, including the activities of Mr. Stark in the US and Mr. Csumrik in Barbados. He testified that he normally called Mr. Csumrik once a week:

> Q And what would you discuss in your weekly call?

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36 Transcript, page 386, lines 12-19.
37 Transcript, page 406, line 25 to page 408, line 3.
38 Transcript, page 310, line 25 to page 311, line 12.

> A We were discussing about the new project that they have, also discussing about the updates of how Mr. Csumrik and his team are doing in terms of implementing the concept and strategy that we have put in place with this new marketing agreement. And also there are times that we have discrepancy with the books where, for example, the sales has to be reconciled with what we have and what they have and what Starline Windows Inc. has. So we have to practically reconcile and making sure we are not missing anything or we're not over charged by Starline Windows Inc. or Starline International Inc.[39]

[78] However, Mr. Fabian also kept in close contact with SWI's general manager, Mr. Stark:

> Q And how much interaction did you have with Mr. Stark?
>
> A I have so much interaction with Mr. Stark too, mainly because Mr. Stark is a non-technical guy, he is actually a salesman, a good salesman so he would ask me questions about technical issues about the windows. And I would also ask him how they are progressing with their target in the high-rise market in the areas that Mr. Csumrik would have asked them to target, just to get an update. And also to update me on current coming sales or whatever it is that is on the plan so that we would know or I would know and I can relay that information to Mr. Martini at the end of the day.[40]

[79] Mr. Fabian also kept Mr. Martini informed of the progress being made in southern California. Although described as a "hands-off" employer, Mr. Martini was still keeping an eye on sales under the Barbados Structure, just as he had done prior to July 1, 1999. Of particular interest to him were the sales results as documented in the company's "Red Book":

> Q So is that -- when you mention the red book, is that the summary that you received?
>
> A I received a monthly summary but it's -- of course is an addition of all the days, yeah, yeah.
>
> Q So you didn't get the weekly report, you got a report that took the

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39 Transcript, page 107, line 20 to page 108, line 5.

40 Transcript, page 108, lines 6-19.

> weekly results and accumulated them and it was for each month.
>
> A Yes, yeah.
>
> Q And what was the value of that red book to you and the information that was contained on it?
>
> A Information was -- that's how I could tell the performance for the sales team. We always had it from day one actually. And also it allow us to schedule the work that was coming up, went to manufacture and what -- and if we had actually enough room in those days.[41] [Emphasis added.]

[80] It is clear from the above testimony that Mr. Fabian was the hub of the Appellant's wheel of operations both before and after July 1, 1999. As such, he was very familiar with the activities of SWI personnel during both periods and was asked on cross-examination to compare their duties, having reference to SII's sales and marketing obligations to the Appellant under Clause 1.1 of the MSSA (see paragraph 55, above). After reviewing each of these items on cross-examination, Mr. Fabian conceded that, with the exception of sub-clause 1.1(a), prior to July 1, 1999, SWI had performed essentially the same tasks now ascribed to SII under the MSSA:

> Q Now, we've just looked at a list of six things that SII is responsible to do for [the Appellant] under the marketing and sales services agreement. It seems like all of that stuff was previously done be SWI employees, is that correct?
>
> A What do you mean?
>
> Q Well marketing products, receiving orders, transmitting them, preparing schedules, summarizing sales, corresponding with purchasers, all that stuff was done by SWI employees before you set this structure in motion.
>
> A By SII?
>
> Q Before SII came on board all of these things were done by SWI.

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41 Transcript, page 396, line 19 to page 397, line 8.

A Yes, they did actually but our result is minus $487,000. Yes, they did, but they were not effective in doing the --

Q Yes. But let's leave the marketing aside. The receiving orders, the reconciling sales reports, the corresponding with purchasers, all of that was done by SWI.

A That's right. …[42]

[81] However, Mr. Fabian went on to say that sub-clause 1.1(a) was by far the most important of SII's obligations under the MSSA. Like Mr. Martini, Mr. Fabian credited Mr. Csumrik, on SII's behalf, with having designed and implemented the marketing services:

> … [because of the $487,000 loss] we need somebody to train Mr. Rick Stark to focus on the things that he has to do, and during the time that this was not in place … Mr. Rick Stark is not achieving anything. Probably they know that this is part of their job, but nobody's coaching them on what to do. Nobody is training them, nobody is leading them, nobody is directing them; nobody is quarterbacking those people. That's why Mr. Csumrik came to me and start quarterbacking, leading these people, directing them, telling them, you need to hire people who are technically inclined, that knows exactly or that they can sit down with the developer and discuss projects without being like, "What are you talking about?" They also need to make sure that there is customer service, customer service, follow-up. All these things have to be done.
>
> So in SWI, prior to 1999, they know that this is part of -- it's a marketing concept that has to be followed by any marketing company. However, … Mr. Rick Stark and his group are not doing it the right way. That's why we need somebody like marketing director like Mr. Csumrik who can lead this thing so that we can move forward and start earning -- start profiting in SWI.[43]

[82] Although counsel for the Respondent invited both Mr. Fabian to elaborate on what Mr. Csumrik did as "coach" or "quarterback", he was unable to do so. Such vagueness was completely at odds with Mr. Fabian's other detailed testimony and his natural willingness to provide full answers whenever he could.

[83] Similarly, Mr. Csumrik, who had given candid and detailed descriptions of his prior personal business successes, had little say about the practicalities of his coaching duties on behalf of SII. Like Mr. Fabian, he also resorted to generalities

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42 Transcript, page 170, lines 20 to page 171, line 13.

43 Transcript, page 171, lines 13 to page 172, line 9.

in describing his role – indeed, his evidence only became detailed when explaining what he did *not* do:

> … I wasn't -- I didn't make sales. I'm not a salesman. I didn't intend to learn all the ins and outs of the windows themselves. I didn't intend to -- I wasn't earning a finder's fee. That's not what I was doing. I was just trying to tell [Mr. Stark] how to do business down there and who I thought he should do business with, and you know, why I thought that. So I guess I was like a mentor, a coach, a director.[44]

[84] However, Mr. Csumrik did provide some specific examples of his activities. Mr. Csumrik said he was concerned that Mr. Stark would be unable to make the transition from the residential sales strategy based on "relationships" to the technical sales requirements of the high-rise market. For that reason, he said, he stayed in regular contact with Mr. Stark to keep him focused on these objectives. Mr. Csumrik cited one example of correspondence[45] where Mr. Stark appeared to be "reverting to his legacy"[46]; that is to say, focussing on the Washington State residential market. Mr. Csumrik's reaction was effectively to ignore such behavior because he "… wasn't very interested in the residential sales. I was interested in the high-rises that were projects that had been recently sold, and asked [Mr. Stark] for a list so I could review it."[47]

[85] Mr. Csumrik also described his role in reviewing the "Red Book" and gave examples of occasions where he had identified reporting errors of a clerical nature affecting SII's financial obligations to SWI. He said he reviewed bids and if ever there were problems, discussed them with Mr. Stark. A weakness of his evidence was there was little documentary evidence to support claims of close involvement in SWI's operations. Mr. Csumrik explained that was because he was more comfortable using the phone or email[48]. On the rare occasions he reduced such communications to writing, he explained, the purpose was "… frankly, because I wanted to build a file for reasons of taxation for the most part. … this was sort of just to show that there was some business being conducted in Barbados for the most part."[49]

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44 Transcript, page 301, line 24 to page 302, line 4.
45 Exhibit A-1, Tab 46.
46 Transcript, page 309, line 7.
47 Transcript, page 309, lines 11-14.
48 Transcript, page 310.
49 Transcript, page 310, lines 6-11.

[86] As noted above, Mr. Csumrik had no contacts among the Canadian developers with projects in southern California which limited his capacity to steer SWI employees to an particular potential client:

> Q What was your involvement in the process of the sales staff going to Bosa and making that sale, getting that contract?
>
> A I didn't have any direct involvement in that process.
>
> Q Did you tell Mr. Stark or his project coordinator or sales people or whoever it was what to do or what to say to Bosa or who to go to?
>
> A No.
>
> Q And you didn't talk to anyone at Bosa and say, you know, "Remember me? I think you should give these guys a look. They've got a good product." Nothing like that?
>
> A No
>
> Q So after recommending that they should target particular developers and particular projects, you left it to the sales team to go out there and do the legwork and make it happen.
>
> A Yeah, left it to the sales team to do their jobs, yes.[50]

[87] Mr. Csumrik went on to explain the level of his involvement in pursuing new projects once the initial sale had been made, including how he came to know about them:

> Q Then after the Horizon project there were more sales, more sales to Bosa and more sales to other developers. What was your involvement in securing those contracts?
>
> A I wasn't a salesman. I had no involvement in securing any contracts.
>
> Q Did you direct the sales team back to more projects?
>
> A Yes.

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[50] Transcript, page 342, line 17 to page 343, line 8.

Q And how were you aware of those projects?

A Again, if you read the industry papers and the -- over the internet, which is how I would do it because I was in Barbados, people talk about it, pending projects, da da da, Bosa doing a big expansion into San Diego and on and on. So you hear it from the architects. I didn't hear it from the architects in San Diego but it comes back. So you just -- you know. I mean you would know if you were in the business.

Q Was there no one at Starline Windows Inc. or Marzen who could also follow those developments and that information?

A Well, Mr. Stark wasn't. I wasn't familiar with anybody else whose position it was to make it their business to do that, but Mr. Stark, that was not his level or his comfort zone.

Q Now, after that first contract was secured, the Horizon one, what do you know about how the bid to Bosa for the next project was received? Do you know anything about that, other than that a contract was secured?

A I'm sorry, the question?

Q All right. Well, it just seems to me that after -- maybe after Starline has done the Horizons project, Bosa now sort of knows them. When Bosa is going to do the next project, maybe they're more receptive to Starline. Would you agree with that?

A You would hope they would be.

Q And that's the whole point of the marketing strategy, isn't it?

A Again, you would hope that you did a good job on the first contract and they would be comfortable with the pricing and the service and the value they derived from the first contract. You would hope that that would help you get the second contract, yes.

D. The Audit; Examination for Discovery "Admissions"; Cross-examination of the Primary Auditor; and the Primary Auditor's Penalty Recommendations

(1) <u>The Audit</u>

[88] Because the Appellant raised certain issues regarding the Primary Auditor's conclusions upon which the reassessments were based and the approach taken to the imposition of penalties under subsection 247(3), it is useful to set out a brief summary of the relevant aspects of the audit process.

[89] The audit began as a domestic audit but was later assigned to the International Audit Department because of the international nature of the Appellant's operations. Notice of the audit was first sent to the Appellant by Primary Auditor's predecessor on April 16, 2003[51]. A little over a year later, the file was reassigned to the Primary Auditor. Although there had been at least one meeting and some correspondence[52] between the former auditor and the Appellant, the Primary Auditor said that when he took over the file, he "started from scratch".

[90] In a letter to the Appellant dated June 2, 2004, the Primary Auditor requested certain documentation from the Appellant[53]. In response to that request, counsel for the Appellant wrote to the Primary Auditor describing, among other things, the corporate entities involved and their roles together with that of Mr. Csumrik and Longview[54]. The Appellant ultimately delivered several boxes of documentation to the Primary Auditor which he testified he reviewed before reaching the conclusions reached in his Functional Analysis[55], Audit Report[56] and Proposal Letter[57].

(2) Examination for Discovery of the Nominee Auditor: "Admissions"

[91] As noted above, although the Primary Auditor performed the lion's share of the audit, he was not the Respondent's nominee in examination for discovery; that role fell to the Nominee Auditor. In his opening remarks, counsel for the Appellant indicated to the Court his intention to show that certain answers given by the Nominee Auditor on discovery amounted to admissions that some crucial findings made at the audit stage by the Primary Auditor - particularly those relating to the functions performed by SII, SWI and/or Mr. Csumrik – were incorrect. In support of these contentions, counsel for the Appellant read in certain portions of the

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51 Exhibit A-1, Tab 52.
52 Exhibit A-1, Tabs 52, 53 and 54.
53 Exhibit A-1, Tab 55.
54 Exhibit A-1, Tabs 57, 58 and 59.
55 Exhibit A-1, Tab 65.
56 Exhibit A-1, Tab 68.
57 Exhibit A-1, Tab 64.

examination of the Nominee Auditor which he submitted contradicted the Primary Auditor's conclusions that:

1. there was "no evidence" of meaningful services by SII [which corresponds to Assumption 9(kk)];

2. marketing of the Appellant's Starline Window Products in the US was undertaken "exclusively" by employees of SWI [which corresponds to Assumption 9(ii)];

3. SII provided "no meaningful value-added services"; and

4. the value of Mr. Csumrik's services was "zero".

(3) Cross-Examination of the Primary Auditor

[92] The Primary Auditor accepted the Nominee Auditor's answers as given and admitted they qualified to some extent his findings as set out above. However, he maintained that the Appellant had still failed to provide sufficient proof of its claims regarding the role played by Mr. Csumrik, on behalf of SII, as the designer and director of the marketing operations implemented by SWI.

[93] Counsel for the Appellant then took the Primary Auditor through some of the written representations to determine why the Primary Auditor insisted on "doggedly maintaining that the Appellant's documents were not evidence of anything". Counsel for the Appellant put to the Primary Auditor certain of the Appellant's documents provided during the audit describing Mr. Csumrik's role: two documents prepared by counsel for the Appellant[58] (referred to herein as "Tab 54" and "Tab 57", respectively) and one by Mr. Csumrik[59] (referred to herein as "Tab 59") at the audit stage.

[94] Turning first to counsel's description of Mr. Csumrik's role in Tab 54, that document is a letter from counsel for the Appellant dated July 9, 2003 in response Primary Auditor's request for information when he took over the Appellant's file in June 2003:

[58] Exhibit A-1, Tab 54 and Tab 57.
[59] Exhibit A-1, Tab 59.

Q And the second last paragraph it says:

> "During the course of our recent meeting you had the opportunity to meet and interview David Csumrik, who is the managing director of SII. Mr. Csumrik has extensive experience in managing sales force in the United States for other products. He has key contacts and personal connections with significant Canadian builders who are entering the southern California real estate market. It was through Mr. Csumrik's contacts that the companies were able to penetrate the California market." [Emphasis added.]

So you reviewed that and rejected it.

A There was no evidence to support it.

Q You gave it zero weight.

A I considered it, but in short of having something to support it, what was I going to do?[60] [Emphasis added.]

[95] Counsel for the Appellant also took the Primary Auditor through each page of Tab 59, the job description drafted by Mr. Csumrik personally and enclosed in counsel's letter to the Primary Auditor dated June 16, 2005. Beginning at the bottom of page 1, in pages 2 and 4 of the document Mr. Csumrik described his duties as managing director of SII.

[96] On page 3 of Tab 59 Mr. Csumrik set out what "generally could be referred to as coordination of the sales and marketing activities and indirect supervision of the seconded [SWI employees]". Mr. Csumrik then continued to describe his services as follows:

> … Again, as you are aware these services mimic the services that SII by agreement is obligated to provide to … [the Appellant]. The sales and marketing functions are provided by the sales and marketing personnel seconded by SII from [SWI].
>
> The supervision of these personnel is undertaken in a couple of ways, firstly by being in constant contact with the General Manager of SWI and secondly by receiving and reviewing the "Red Book Sales" on a weekly basis. Red Book Sales

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60 Transcript, page 871, line 13 to page 872, line 4.

> provides me on a weekly basis with each person's orders for that particular month broken down by territory and providing the amount of the discount from list price. Rick and I would then discuss and correspond on the specific location and timing of various projects.

[97] After reviewing this description with the Primary Auditor, counsel for the Appellant put the following questions to him:

> Question: So [Mr. Csumrik's] given a general description of what he does in the second and third paragraph with respect to coordinating the sales staff. Do you agree that that's what he's doing?
>
> A: That's what he says he's doing.
>
> Question: And you don't accept that that's what was done?
>
> A: That's the whole point, I think. We don't accept that. There's no evidence to support it. [61] [Emphasis added.]

[98] Returning, now, to Tab 59 for the conclusion of Mr. Csumrik's explanation of his role, he wrote:

> From time to time I will direct the sales/marketing team to projects that I have knowledge are in the works. You may be aware that a significant amount of our expansion in the US market has come from the California market, initially the San Diego/Carlsbad area and more recently the San Francisco area. What you may not be aware of is the fact that Vancouver based developers led the way in both of these markets. Two such developers are the Pinnacle Group and Bosa Ventures, both of whom were well known to me through my previous working life as a lawyer/businessman in the Vancouver area. Certainly my previous experience as a lawyer and business person has been invaluable in my role with the company. My previous real estate development activities certainly provided me with the experience and expertise to allow me [*sic*] understand the business and to assist it in providing leadership from here in Barbados. [Emphasis added.]

[99] A similar statement appears in paragraph 2 of page 3 of Tab 57, counsel's description of Mr. Csumrik's role:

> … In addition to Mr. Csumrik's exploiting his *direct relationship* with certain Canadian real estate developers undertaking significant projects in California, Mr.

[61] Transcript, page 895, line 21 to page 896, line 2.

> Csumrik was also responsible for coordinating the selling efforts of the seconded employees of SII in the United States. … [Emphasis added.]

[100] After having reviewed these various documents and upon being asked for his reaction to them, Primary Auditor had this to say:

> Q And just again, looking at the description on page 3 of the letter of what Mr. Csumrik does, second paragraph down, you gave that no weight?
>
> A There is no evidence. I had no evidence to support any of this. This is just a statement.[62] [Emphasis added.]

(4) Primary Auditor's Penalty Recommendations

[101] Another issue canvassed by counsel for the Appellant during his cross-examination of the Primary Auditor was his recommendation to the CRA's Transfer Pricing Review Committee regarding the basis for the imposition of a penalty under paragraph 247(4)(*a*) of the *Act*:

> Q And I think the last thing I want to explore is you said in your testimony that if you had received a response to your proposal letter you might have adjusted it.
>
> A Well I would have -- definitely if you had concerns with the functional analysis we would have entertained your thoughts on it.
>
> Q Now would you agree with me that the assessing proposal that you set out put the appellant in the worst possible position? So you've simply allowed or you've allowed nothing in relation to the services that are provided to the appellant save and except for the costs that are incurred by SWI?
>
> A Right.
>
> Q You've given no value at all for anything else?
>
> A Right.

[62] Transcript, page 889, lines 10-15.

Q And you've also been able to impose -- would you agree that the limitation for imposing a penalty is you have to be in excess of $5 million in adjustments?

A Yes, I believe that's correct.

Q And then for the 2001 year they are just over that threshold, aren't they?

A I believe they were if I look at this, wherever it is. Yes, they were.

Q So if we had -- if there had been any credit given in relation to the services provided by SII, they would have been under the $5 million threshold?

A If anything had changed in the audit, they very well could have been.[63] [Emphasis added.]

[102] And again, at the end of the cross-examination of Primary Auditor, counsel verified the Primary Auditor's conclusions regarding what value ought to be ascribed to the services the Appellant received under the MSSA:

Q Mr. Stasiewski having regard to the documents that we've gone through today and the submissions, I suggest to you that in the course of your audit you had ample clear evidence of the functions performed by the parties including the involvement of Mr. Csumrik, the nature of their relationships, the amounts paid by Marzen to SII, the huge increase in the U.S. sales following the adoption of the new marketing strategy, and the value that was received by Marzen as a result of the strategy being implemented. Would you agree with that?

A I had a pretty good idea of what was going on.

Q And having regard to all that you concluded that the value that SII brought, together with the seconded employees who were performing services on behalf of it, was no greater than the amounts that were being paid by SII to SWI?

A That's correct.[64] [Emphasis added.]

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63 Transcript, page 909, line 16 to page 910, line 19.

64 Transcript, page 914, line 23 to page 915, line 13.

E. Financial Results under the Barbados Structure

[103] It is an agreed fact that Window Products sales increased from US$551,320 in 1998 to US$4,952,859 in 1999 to US$11,983,554 in 2000 and US$13,230,737 in 2001. Almost all the sales achieved in 2000 and 2001 were made to two Canadian developers in southern California, Bosa Brothers and Pinnacle.

[104] In 1999, 2000 and 2001, the Appellant paid SII fees under the MSSA of US$755,700, US$2,803,326 and US$3,051,668, respectively. In 2001, the Appellant also paid SII a one-time bonus amount of US$2,090,422 under the MSSA Bonus Payment. The Canadian dollar amounts for the total fees paid in 2000 and 2001 are CAD$4,168,551 and CAD$7,837,082, respectively.

[105] In 1999, 2000 and 2001, SII paid SWI fees under the PSA and the ASSA totalling US$606,732, US$1,369,721 and US$1,811,922. The Candian dollar amounts for the total fees paid in 2000 and 2001 are CAD$2,058,049 and CAD$2,811,892, respectively.

[106] In addition to its sales revenue, SWI included in its income the fees received from SII under the secondment and administrative services agreements (including the employee cost recovery amounts, not just the 10% markup), and from the Appellant under the delivery/depot agreement.[65]

[107] In its financial statements, SWI deducted the expenditures that were cost-recovered from SII pursuant to the secondment agreement, and from the Appellant pursuant to the delivery/depot agreement.[66]

[108] In 1999, 2000 and 2001 SWI's net profits were US$274,032 in 1999, US$241,499 in 2000 and US$733,432 in 2001.

[109] In computing income from operations in the 1999 to 2001 taxation years, the Appellant deducted the marketing fees paid to SII as an expense. In its income statement, the Appellant included dividends received from SII as "other income" and added to it income from operations in determining income before taxes. The Appellant's financial results included the following, shown in Canadian dollars:

1999 Year

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65 Exhibit A-1, Tabs 70B, 70C and 70D.

66 Exhibit A-1, Tabs 70B, 70C and 70D.

Revenues	$38,876,749
Gross margin	$9,396,094
Income from operations	$43,377
Other income (no dividend from SII)	$24,108
Income before taxes	$67,485

2000 Year	
Revenues	$44,650,187
Gross margin	$13,557,642
Income from operations	$450,290
Other income (no dividend from SII)	$1,988,037
Income before taxes	$2,438,237

2001 Year	
Revenues	$54,440,728
Gross margin	$17,431,267
Income from operations	($748,018)
Other income (no dividend from SII)	$5,560,931
Income before taxes	$4,812,913

[110] In both the 2000 and 2001 taxation years, the marketing fees paid to SII were the largest expense on the Appellant's income statements.[67]

[111] Paragraphs 54-56 of the Statement of Agreed Facts show that SII's financial results in 1999, 2000, and 2001 included the following (US$):

1999 Year			
Revenue			
	Marketing fees		$755,701
Expenses			($674,986)
		Net Income	$80,715

2000 Year			
Revenue			
	Marketing fees		$2,850,174
	Interest		$5,072
Expenses			($1,453,341)
		Net Income	$1,401,905

[67] Exhibit A-1, Tabs 69B and 69C.

2001 Year		
Revenue		
	Marketing fees	$5,236,186
	Interest	$5,309
Expenses		($1,847,106)
	Net Income	$3,394,119

[112] SII's pre-tax profits from 1999 to 2001 totalled US$4,876,739 (approximately CAD$7.3 million).[68]

[113] According to its 1999 through 2001 Barbados corporate tax returns, SII paid total income taxes in Barbados of US$121,985, as follows[69]:

1999	$2,086
2000	$35,047
2001	$84,952
TOTAL	$121,985

[114] It is an agreed fact that commencing in April 2000, SII began declaring and paying quarterly dividends to the Appellant as follows, shown in US dollars:

2000 Year			
April 24		$75,000	
August 15		$675,000	
December 15		$600,000	
	Total	$1,350,000	(Cdn $2,011,50)
2001 Year			
May 31		$360,000	
July 26		$375,000	
October 22		$175,000	
December 31		$2,525,956	
	Total	$3,435,956	(Cdn $5,299,620)

[115] Mr. Csumrik explained how these amounts were determined and paid:

> Q Were you given any instructions with respect to when to declare a dividend, or how much the dividend should be?

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68 Exhibit A-1, Tabs 71A, 71B, and 71C.

69 Exhibit A-1, Tabs 79A, 79B, and 79C.

A I would advise -- at the end of each quarter, I would advise the shareholder as to how much cash and retained earnings were available should they want the directors to declare a dividend. So --

Q So would it be then the shareholders' decision to have a dividend declared?

A Well, in law the directors do it. But I believe we consulted with the shareholder.

Q Now, if we just go back to the April 2000 dividend, after that is declared, the retained earnings remaining in the company are about $3,000. By August 15th, 2000, you don't know what the financial results for 2000 will be, do you?

A No.

Q And you don't know what retained earnings there will be at the end of 2000.

A No.

Q But you were able to pay a dividend of $675,000.

A Well, yes, we paid it, yes.

Q And what was that determination based on?

A That was based on the results for the first quarter ended March 31. Sorry, it is probably for the first two quarters ended June 30th. We would have had enough cash in the bank, together with enough retained earnings for current fiscal period, six-month period earnings to pay 675.

Q So if you didn't know the retained earnings for that year and there was no retained earnings from 1999, this would be based on how much cash was on hand and your estimate of what was actually needed as working capital?

A No. It would be based on the actual earnings for the six-month period ended June 30th, 2000. It was -- we didn't have any working capital requirements, in essence, because the agreement provided if we had any, we'd get the money from Marzen. I forget which paragraph that was in both the administrative -- sorry, I think it was the secondment agreement. No, sorry, the marketing sales agreement provided that if

> we needed working capital, they must provide it. So we didn't have any working capital requirements other than very nominal amounts.[70]

IV. Legislation

[116] The relevant portions of subsection 247(2) of the *Act* read as follows:

> 247(2). Where a taxpayer … and a non-resident person with whom the taxpayer does not deal at arm's length … are participants in a transaction or series of transactions and
>
> > (a) the terms and conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length…
>
> any amounts that but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer … for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if,
>
> > (c)… the terms and conditions made or imposed, in respect of the transaction or series had been those that would have been made between persons dealing at arm's length…

V. Issues

[117] It is agreed that the Appellant and SII were not dealing with each other at arm's length under the MSSA. The issues in these appeals are as follows:

1. whether the terms and conditions imposed in respect of the MSSA between the Appellant and SII differ from what would have been agreed to by persons dealing at arm's length;

2. if yes, what adjustments should be made to the quantum of the fees that the Appellant paid to SII under the MSSA so that it is equivalent to the price that would have been paid had the Appellant and SII been dealing at arm's length; in other words, whether the Appellant would have paid SII any fees under the

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[70] Transcript, page 357, line 27 to page 359, line 17.

MSSA in excess of the amounts allowed by the Minister had they been dealing at arm's length; and

3. whether the Appellant is liable to a penalty under subsection 247(3) of the *Income Tax Act* in respect of the transfer pricing adjustment made for its 2001 taxation year.

[118] Each of these issues will be dealt with separately under the headings below.

A. Issue 1: Whether the price paid by the Appellant to SII under the MSSA differs from what would have been paid had they been dealing at arm's length.

(1) Appellant's Position

[119] The Appellant's position is that having regard to the marketing structure put in place by the Appellant and SII, the terms and conditions adopted by the parties regarding the services provided directly and indirectly by SII do not differ from those that would have been agreed upon between arm's length parties. The Appellant contends that the Court must take into account both the direct services provided by SII and also the indirect services rendered by SWI employees under the secondment agreements between SWI and SII. Indeed, the Appellant argues that SWI and SII must be treated as one entity referred to as an "amalgam" whose functions included Mr. Csumrik's involvement. As will be discussed below, this factual assumption formed the basis of the Appellant's Expert Report and informed its approach to the transfer pricing analysis.

[120] According to the Appellant, upon the establishment of the Barbados Structure on July 1, 1999, SII - under the direction of Mr. Csumrik and in collaboration with SWI - undertook the marketing of the Appellant's Window Products in the US. Mr. Csumrik, on behalf of SII, developed the marketing strategy used under the Barbados Structure and provided on-going supervision and advice to SWI in furtherance thereof. Because of these relationships, the Appellant submits that SII and SWI must be viewed as acting as one entity under Mr. Csumrik's direction in the performance of SII's obligations to the Appellant under the MSSA.

[121] The Appellant further contends that the "proof is in the pudding", noting that under the Barbados Structure, the Appellant achieved an impressive increase in sales, proof in itself that the payment of the fees under the MSSA was justified.

[122] The Appellant also argued that the admissions of the Nominee Auditor on discovery and the Primary Auditor's testimony at trial dealt a grievous blow to the assumptions underpinning the Minister's reassessments. According to counsel, the combined effect of the Nominee Auditor's answers on discovery and the Primary Auditor's cross-examination showed him to be "incapable of articulating any basis for rejecting"[71] the Appellant's position during the audit that:

> 1. the Appellant received service of substantial value under the MSSA;
>
> 2. Mr. Csumrik provided on-going direction to the SWI sales team; and
>
> 3. without the direction and participation of Mr. Csumrik, the Appellant would not have successfully penetrated the US high-rise market.[72]

[123] In these circumstances, it is the Appellant's position that a reasonable business person standing in the shoes of the Appellant and dealing at arm's length from SII would have paid the fees under the MSSA.

(2) Respondent's Position

[124] The Respondent's position is that there is no evidence to show that SII provided any meaningful services, or that such services would have justified, to an arm's length person, the payment of the majority of the fees under the MSSA.

[125] The Respondent rejects out of hand the Appellant's treatment of SII and SWI as a single entity under the Barbados Structure, arguing that the arm's length principle requires an entity-by-entity approach to a transfer pricing analysis.

[126] The Respondent also contends that the Appellant has not met its onus of proving incorrect the assumptions underpinning the reassessments. In reassessing the Appellant's 2000 and 2001 taxation years under subsection 247(2) of the *Act*, the Minister made the following general assumptions as set out in paragraph 9 of the Reply to the Notice of Appeal:

> 9(uu) the terms and conditions made or imposed between the Appellant, SWI and SII with respect to the Barbados Marketing Structure

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[71] Appellant's Written Argument at paragraph 91.

> differed from the terms and conditions that would have been made or imposed had those parties been dealing at arm's length;
>
> 9(vv) an arm's length's party would not have paid SII the marketing fees that the Appellant did in the 2000 and the 2001 taxation years for the services that SII provided;

[127] In making an adjustment to the price under the MSSA, the Minister concluded that only the amount SII paid to SWI under the PSA and the ASSA was an arm's length amount and made the following further assumptions:

> 9(ii) marketing of the Appellant's products in the United States was undertaken exclusively by the employees of SWI;
>
> 9(kk) SII performed no meaningful value-added services in Barbados to support the Appellant or SWI;
>
> 9(pp) The profits allocated to Barbados (marketing fees paid by the Appellant less fees paid to SWI) were not paid out by SII to cover costs or expenses incurred by SII or to compensate its managing director David Csumrik;
>
> 9(ww) in the 2000 and 2001 taxation years, an arm's length's party would not have paid marketing fees to SII that exceeded the fees paid by SII to SWI; and

[128] However, in response to the Appellant's argument at trial regarding the effect of the Nominee Auditor's "admissions" on discovery, the Respondent acknowledged that it was Mr. Csumrik who came up with the "game-changing idea"[73] and that he provided some useful suggestions and strategic advice and reconciled sales reports on a weekly basis. But counsel for the Respondent submitted that notwithstanding these small concessions, the evidence did not support the conclusion that Mr. Csumrik provided much, if anything, by way of meaningful value-added services to marketing products or generating sales.

[129] Counsel for the Respondent noted that, as of the hearing, Mr. Csumrik had received no compensation for his efforts beyond the fees SII paid Longview for his management and director services. He had no employment or contractual relationship with SII or shares or any other interest in the company through which

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[73] Transcript, page 1081, lines 1-9.

he could benefit. The Respondent's position is that it defies common sense that an experienced businessman and lawyer like Mr. Csumrik would provide his services on behalf of SII for so little compensation.

[130] The Appellant's answer to this was that Mr. Csumrik was to be compensated for his efforts under a separate arrangement between Mr. Csumrik and the Appellant and/or Mr. Martini.

[131] According to the Respondent's analysis, that response results in a double paradox: the more the Appellant emphasizes the unique value of Mr. Csumrik's contribution to SII's performance of its marketing obligations in justification of the fees paid to SII, the more unreasonable it seems that Mr. Csumrik would have provided such services for only minimal compensation. If, as the Appellant alleges, Mr. Csumrik's real incentive for creating such value for SII was a separate compensation agreement with the Appellant and/or Mr. Martini, that only begs the question of what the Appellant paid SII the fees for.

[132] Counsel for the Respondent submitted that virtually all profits realized by the controlled group of the Appellant, SWI and SII in the 1999-2001 years were realized by SII as a result of the marketing fees. Counsel noted that in the 1999, 2000 and 2001 taxation years, the Appellant had minimal operating profits followed by losses and SWI had flat operating profits; meanwhile, SII had exponentially growing operating profits.

[133] In 2000 and 2001, the Appellant paid SII approximately CAD$13 million out of which SII paid to SWI CAD$4.9 million fees for the secondment of its sales and administrative staff. The remaining balance of just over CAD$7 million was paid to SII for the marketing services under the MSSA; all of these fees were deducted from the Appellant's Canadian income with all but a portion being paid back to the Appellant as exempt surplus dividends.

[134] Counsel for the Respondent acknowledged the objection of counsel for the Appellant that, because the Appellant could not segment its Canadian and US sales, it was not possible to analyze the Appellant's performance but maintained that common sense permitted the inference that the MSSA fees were paid simply to benefit the Appellant itself.

(3) Analysis

(a) Introduction

[135] The first task is to determine what services SII provided to the Appellant under the MSSA. For the reasons given below, many of the factual assumptions in the Appellant's Expert Report regarding the nature of Mr. Csumrik's involvement in SII's and SWI's activities[74] are unfounded. As will be further discussed under Issue 2, this was one of the reasons I chose not to rely upon the Appellant's Expert Report.

[136] There is no question that SII on its own could do nothing. I agree with counsel for the Respondent's argument that it was an empty shell with no personnel, no assets and no intangibles or intellectual property. That SWI provided sales and marketing staff to SII at an arm's length price under the PSA and ASSA is not in issue. Thus, the key to determining the services provided by SII is identifying the role played by Mr. Csumrik; specifically, in what capacity Mr. Csumrik provided what services to whom and to what extent his efforts can be attributed to the services SII was obliged to provide to the Appellant under the MSSA.

(b) Mr. Csumrik's "Game-changing Idea"

[137] Both Mr. Martini and Mr. Fabian credited Mr. Csumrik with the idea of shifting the Appellant's focus from the Washington residential market to southern California high-rise market; counsel for the Respondent conceded it was Mr. Csumrik who came up with that "game-changing idea". Even if this is true, however, the evidence does not support a finding that Mr. Csumrik provided that service on behalf of SII.

[138] In my view, Mr. Csumrik developed and provided that advice in his personal capacity directly to Mr. Martini/the Appellant. First, there is the question of timing: the testimony of the Appellant's witnesses showed that by the fall of 1998 Mr. Csumrik had advised Mr. Martini and Mr. Fabian that the Appellant should change its market focus and apply different marketing techniques. While counsel for the Appellant argued that Mr. Csumrik incorporated SII in expectation of using it to direct the Appellant's marketing efforts, the evidence shows that when Mr. Csumrik came up with the new marketing strategy, SII was languishing on a shelf in Barbados, waiting for someone – according to Mr. Csumrik's evidence, possibly the Appellant or perhaps one of Mr. Csumrik's Longview clients - to make use of it.

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74 Exhibit A-2, page 2, paragraphs 1.1(f)(i)(4-15).

[139] By the time SII became part of the new marketing structure on July 1, 1999, it was because the Appellant had already accepted the marketing advice Mr. Csumrik had provided directly to Mr. Martini and had decided to target the southern California high-rise market. There is no evidence that Mr. Csumrik transferred any proprietary interest he may have had in that idea to SII. On this latter point, this is one of the flaws in the Appellant's Expert Report which will be discussed under Issue 2: the Appellant's Expert Report assumed that the marketing strategy was SII's "valuable intangible" asset[75] but reached no conclusions as to whether it had belonged to Mr. Csumrik initially and was transferred to SII or had been created by Mr. Csumrik on behalf of SII after July 1, 1999.

[140] Finally, there is the matter of Mr. Csumrik's compensation. It was the Appellant, not SII, who found Mr. Csumrik and availed itself directly of his marketing advice. Mr. Martini's evidence was unequivocal that no part of the MSSA fees the Appellant paid to SII was intended for or paid to Mr. Csumrik. It was Mr. Martini, not SII, who agreed to compensate Mr. Csumrik personally for that advice. In my view, the evidence supports the conclusion that, assuming Mr. Csumrik was the source of the game-changing idea, he provided it to the Appellant in his personal capacity and not on behalf of SII. Thus, there was no need for the Appellant to pay fees to SII in respect of that advice.

(c) Mr. Csumrik as the Developer of SII's Marketing Strategy and Director of SWI's Marketing Operations

[141] The next strand of the Appellant's amalgam argument is that Mr. Csumrik, on behalf of SII, continued to develop the marketing advice he provided to the Appellant in collaboration with Mr. Stark and provided on-going supervision of SWI employees to ensure compliance with the new strategy. In my view, this very much overstates the role Mr. Csumrik actually played.

[142] First, there is little evidence to show, what additional development would have been required or actually occurred once Mr. Csumrik had identified for the Appellant the new market focus and sales approach. While statements in Tabs 54, 57 and 59 of Exhibit A-1 made Mr. Csumrik out to have had personal connections with the Canadian developers who had projects in the southern California high-rise market, at trial, he said he only knew 'of' them, apparently from as tenuous a connection as having lived in False Creek during a time when they may have had projects there. More importantly, he contradicted his earlier statements, flatly

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75 Transcript, page 568.

admitting that he had no contacts among the various developers and thus, could not direct SWI to any particular individuals in the high-rise market. He also agreed on cross-examination that if the marketing strategy was effective, there should not be any need to resell the client on SWI's capacity to deliver the goods after the first sale had been successfully completed.

[143] As for Mr. Csumrik's involvement in the practicalities of designing new sales techniques for the high-rise market, he explained that he had learned the importance of meeting the technical specifications and building code requirements when dealing with US customers in his theatre lighting business. However, it was not readily apparent how such knowledge would be transferable to the window business.

[144] In argument, counsel for the Appellant cited Mr. Fabian's detailed testimony describing what was required to complete a technical sale to underscore the difference in sales techniques in the residential and high-rise markets. Mr. Fabian spent a good deal of time explaining this function; he did so in a thorough and convincing manner. What I learned from his evidence was that only someone with considerable expertise and experience in the window business could devise and manage what counsel himself described as "a complicated process"[76]. I did not understand Mr. Csumrik to say that he possessed such attributes; nor did he explain what he could have contributed to its development beyond his initial suggestion that SWI adjust its skills to meet the needs of its clients in the new market.

[145] Regarding Mr. Csumrik's supervision of the SWI employees, while all described him as the "coach", none provided a satisfactory explanation of what that actually entailed. Mr. Csumrik was candid that what he knew about the window business he had learned from the "condensed course" provided by Messrs. Martini, Fabian and Stark. He frankly admitted he was not a salesman and had no interest in becoming one.

[146] By contrast, Mr. Martini and Mr. Fabian had worked their way up in the window business. Mr. Martini described Mr. Fabian as his right-hand man; Mr. Fabian described Mr. Stark as a good salesman with many years in the business. Although Mr. Stark did not testify, the evidence shows that Mr. Martini had enough confidence in him to move Mr. Stark from his position of General Manager on Vancouver Island to head up SWI's first Washington-based initiative in April

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[76] Transcript, page 1038, line 16.

1998; even after that endeavour produced disappointing results, he kept Mr. Stark in the position upon the implementation of the Barbados Structure and at all times during the taxation years under review.

[147] Given such evidence, it is doubtful that once advised of the new market focus and the need for a different sales approach, Mr. Stark and the experienced SWI employees would have to be repeatedly told by Mr. Csumrik – an admitted neophyte to the business - to pursue Canadian developers and to make sure they met their product specifications. It is more likely that under Mr. Stark's direction, they adapted their residential sales skills and experience to meet the needs of those with projects in the southern California high-rise market.

[148] Subject to the concessions of the Respondent as discussed further under the heading below, I do not accept the Appellant's contention that Mr. Csumrik played a significant role on behalf of SII in the development of a marketing strategy or the on-going supervision of SWI's activities.

(d) Mr. Csumrik as Manager of SII's Marketing Activities

[149] The Appellant further contended that Mr. Csumrik was actively engaged on behalf of SII in the daily activities of its marketing obligations under the MSSA.

[150] What evidence is there of Mr. Csumrik's day-to-day involvement? For his part, Mr. Martini frankly admitted he had no personal knowledge of Mr. Csumrik's regular duties in Barbados, relying on Mr. Fabian for such information. Mr. Fabian testified he was in regular contact with Mr. Csumrik after July 1, 1999 and that SWI's "Red Book" sales reports were duly dispatched to Barbados for Mr. Csumrik's review before being sent on to the Appellant. His testimony was confirmed by Mr. Csumrik.

[151] I am not at all convinced that Mr. Csumrik did much more than give such records cursory review. But even if I were to accept the fact of such actions having been taken, there is no evidence of their business utility. Mr. Martini's testimony was that the Appellant had "always" used the "Red Book" system to monitor sales and schedule the manufacturing such orders entailed. After July 1, 1999, Mr. Fabian continued to review the Red Book, so did Mr. Stark – even Mr. Martini kept an eye on it. The only difference after the establishment of the Barbados Structure was that Mr. Csumrik had to go through the same information before sending it on to the Appellant. Overall, I am persuaded by the argument of counsel for the Respondent that the purpose in redirecting the flow of information through

Barbados was to make it appear that SII was providing a valuable service to the Appellant under the MSSA. Indeed, as will be seen from Mr. Csumrik's testimony below, maintaining appearances seemed to have been one of his main concerns.

[152] Some of the activities that the Appellant attributed to Mr. Csumrik's performance of SII's obligations under the MSSA overlapped with the various management services he was providing to SII through Longview. For example, Mr. Csumrik noted that he had occasionally came across incongruities in the sales figures and clerical errors that would have wrongly increased the amount of fees SII paid to SWI under the PSA and/or the ASSA. This sort of oversight is not inconsistent with his description of the services Longview typically provided to its off-shore clients. Similarly, Mr. Csumrik said Longview could manage its clients' sales people all over the world from Barbados: "They would report to us although … if they were in the U.S. they would get paid by a facilitating company that would be a non-arm's-length company to the group…"[77] and acknowledged that was "like" what was done for SWI.

[153] Mr. Csumrik also commented that his main interest in maintaining records of his communications with Mr. Stark was "to build a file for reasons of taxation". He elaborated on that somewhat ambiguous statement by saying it was also "just to show there was some business being conducted in Barbados". Taken at its most anodyne, this description of his activities could reasonably be considered part of the corporate management services Longview was able to provide.

[154] Mr. Martini first became aware of the possibility of enlisting Mr. Csumrik's assistance in the context of having sought legal advice in respect of SWI's losses in 1998. In his Case Study, which was prepared around the same time, Mr. Fabian recommended that the Appellant engage "an established sales and marketing firm". The evidence shows that Mr. Csumrik did not meet that criterion but Mr. Martini volunteered that he was willing to put his trust in Mr. Csumrik on the strength of Thorsteinssons' recommendation. For his part, Mr. Csumrik had a history with counsel for the Appellant and obtained advice from Thorsteinssons in establishing Longview; its first client was a referral from that law firm. Mr. Csumrik had expertise and experience with international business corporations in Barbados and was able to provide through Longview "one-stop-shopping" services to its clients.

[155] While Mr. Csumrik was thus well placed to facilitate the establishment of an international business corporation in Barbados, his unwillingness to relocate to

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[77] Transcript, page 328, lines 1-7.

Canada or the US did not necessitate SII's establishment in that country. At no point in Mr. Csumrik's testimony did he say that was why SII had been established in Barbados; on cross-examination, Mr. Martini expressly rejected that contention. Nor was there any obvious need for Mr. Csumrik to provide his services through a corporation located in Barbados; Mr. Martini agreed Mr. Csumrik could have provided them directly to the Appellant or SWI. There is no evidence to support the Appellant's contention that the Barbados Structure "… was predicated on gaining Mr. Csumrik's participation"[78].

[156] In reaching the above conclusions, I recognize that the Appellant is entitled to organize its commercial operations in a tax effective manner. I am not suggesting that Mr. Csumrik was engaged in providing tax advice to the Appellant.

[157] All in all, I am not persuaded by the Appellant's argument regarding the extent to Mr. Csumrik's involvement in the performance of functions on behalf of SII. The most that can be said, given the Respondent's concessions in respect of the admissions on discovery, is that in fulfilling his duties as managing director under the arrangement between SII and Longview, Mr. Csumrik also reviewed some sales records and provided some strategic advice and suggestions to SWI on behalf of SII.

(e) "The Proof is in the Pudding"

[158] Finally, the Appellant contended that proof of Mr. Csumrik's meaningful involvement in the operations of SII and SWI and by consequence, of the justification of the MSSA fees, was shown by the increased sales ultimately achieved in the southern California high-rise market. This was another key factual assumption underpinning the approach taken by Mr. MacDonald in the Appellant's Expert Report, referred to by both Mr. MacDonald and counsel for the Appellant as "the proof is in the pudding".

[159] Surely, counsel argued, the enormous increase in US sales achieved between July 1, 1999 and December 31, 2001 – in excess of 2,000% - ought to be proof enough that the Appellant received value for money under the MSSA through the combined efforts of Mr. Csumrik, SWI and SII. This same proposition was put to the Primary Auditor on cross-examination:

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78 Transcript, page 1035, lines 9-10.

> Q And so we have a new marketing plan and we've gone from [US$]500,000 or [US$]570,000 to [US$11.2 million] and [US$12.2 million] in 2000 and 2001. Is that evidence of something?
>
> A That just means they got into the market at the right time and they -- and they actually got in right when the market was starting to boom in the United States.
>
> Q So it was serendipitous? It was just timing?
>
> A I'm just saying there was a number of explanations that are possible.[79]

[160] Notwithstanding counsel for the Appellant's incredulous reaction to the Primary Auditor's testimony, Mr. Csumrik had already made much the same point in response to counsel's questions during his examination-in-chief. When Mr. Csumrik was asked about the sales ultimately achieved by the Appellant in the southern California market, he described the results as "outstanding" but volunteered the following reason for that success:

> Q And just to close off, Mr. Csumrik, can you describe the overall results that were achieved under the new marketing structure that was implemented?
>
> A I'd say over a relatively short term being 2000 to 2005 or '7 or whatever it was, that they were outstanding results. You know, then the real estate market as -- I would suggest to you that the real estate market was growing, reminded me of -- somewhat of the software market when I was in that. You didn't have to be good, you just had to be there. I mean there were -- things were going. So we gained market share. I don't know if we gained it at the expense of others or if we just gained it because the market was growing in San Diego, Southern California generally in those days, and it was good. It was a fun ride.[80][Emphasis added.]

[161] Thus, it is clear from the Appellant's own evidence that the increase in sales might have been just good timing. While I agree with counsel for the Appellant that the financial results achieved under the Barbados Structure are relevant to the

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79 Transcript, page 890, line 28 to page 891, line 10.

80 Transcript, page 323, lines 3-17.

arm's length transfer pricing analysis, they do not, in themselves, justify the fees paid under the MSSA and the MSSA Bonus Payment Agreement. Another weakness of the "proof is in the pudding" argument is that it overlooks other aspects of the financial flow in 2000 and 2001; for example, that under the Barbados Structure the fees paid to SII accounted for the Appellant's largest expense, by far; meanwhile, at the same time the Appellant was reporting losses from its operations, SII's profits were generating healthy dividends for the Appellant.

[162] Describing this as a "fantastic state of affairs"[81], counsel for the Respondent also noted Mr. Csumrik's evidence that because Clause 3.2 of the MSSA required the Appellant to provide, upon request, additional funds to SII for carrying out its services and because SII had no need for working capital, he was satisfied that any surplus cash could be paid out as dividends quarterly. Thus, SII was risk free; just as before the Barbados Structure, the risk remained in Canada with the Appellant.

[163] Counsel for the Appellant rebutted the Respondent's contention by arguing that the Appellant was able to pay the dividends because of Clause 3.2. Counsel for the Appellant also pointed to Mr. Martini's evidence that the dividends were used to expand the Appellant's Canadian business operations to meet the demands of increased sales in southern California high-rise market[82].

[164] These arguments do little to advance the Appellant's case. That the Appellant put the dividends to good use hardly justifies its payment of fees to SII under the MSSA. As for the Appellant's obligation to provide funding under Clause 3.2 - on demand and in excess of the fees already imposed under the MSSA – the Appellant's argument does not address how that would be palatable to an arm's length party who lacked the Appellant's capacity to recoup such funds through dividend payments.

[165] The Appellant's argument in support of the 10% MSSA Bonus Payment is equally unconvincing. Counsel for the Appellant sought to justify the formula first by arguing that Mr. Csumrik had played an active role in its negotiation. In support of this contention, counsel referred the Court to an exchange of correspondence between Mr. Csumrik and Mr. Martini[83]. For his part, Mr. Martini did not know

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81 Transcript, page 1074, line 20.
82 Transcript, page 1123, lines 7-21.
83 Exhibit A-1, Tabs 34 and 35.

how Mr. Csumrik had come up with the 10% amount; when Mr. Csumrik was asked about it, he candidly stated:

> I wanted [SII] to increase its level of profitability because I knew it would look better if that was to happen, and because [the Appellant] owned SII and I wasn't getting any of this money anyways, he should have been indifferent.[84] [Emphasis added.]

[166] Counsel for the Respondent referred to this statement as a "damning" [85] admission that the quantum of fees the Appellant was paying to SII under the MSSA bore no relation to the value of services it was receiving. The fees were not paid for anyone's benefit; they were just going into SII and back out to the Appellant.

[167] Counsel for the Appellant rebutted the Respondent's interpretation of Mr. Csumrik's statement by arguing that the logical inference to be drawn from it was that Mr. Csumrik wanted SII to look good because if "… SII looks good, it's a result of Mr. Csumrik's direction and operation and it enhances his position with respect to future opportunities"[86].

[168] First of all, in response to the Appellant's argument regarding the 10% MSSA Bonus Payment, taken in light of all the other evidence, there is little in the correspondence[87] cited above to indicate any serious negotiation of a price for services. Mr. Csumrik could not exactly recall the need for such additional funding and admitted there was no particular rationale underpinning the 10% amount[88]. But more importantly, counsel's characterization of Mr. Csumrik's statement does not advance the Appellant's overall position: taken to its logical conclusion, it reinforces the fact that Mr. Csumrik was to be personally compensated for his services. I agree with the contention of counsel for the Respondent that his efforts had nothing to do with the performance of SII's obligations that would justify the payment of fees under the MSSA.

[169] All of which leads back to the double paradox identified by counsel for the Respondent. Mr. Csumrik had no relationship with SII, contractual or otherwise, that would have entitled him to any portion of the MSSA fees or the MSSA Bonus

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84 Transcript, page 317, lines 12-17.
85 Transcript, page 1098, line 22 to page 1099, line 6.
86 Transcript, page 1126, lines 4-7.
87 Exhibit A-1, Tabs 34 and 35.
88 Transcript, page 317, lines 8-10.

Payment. These fees were not paid with the intention of benefiting Mr. Csumrik personally; hence, the need for the separate compensation arrangement with Mr. Martini.

[170] The arm's length principle assumes that independent enterprises "… will compare the transaction to other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive".

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

[172] I am persuaded by the argument of counsel for the Respondent that the only inference to be drawn is that the Appellant paid the fees to SII to secure a tax benefit. The only reasonable explanation for the Appellant to have agreed to pay SII under the MSSA was so the fees could be reported as profits and then returned to the Appellant as exempt surplus dividends. Meanwhile, the marketing fees could be deducted from income for Canadian tax purposes. None of these attractive advantages would have been available to an arm's length party.

[173] In all the circumstances, the Appellant has failed to demolish the Minister's assumptions that:

> 9(uu) the terms and conditions made or imposed between the Appellant, SWI and SII with respect to the Barbados Marketing Structure differed from the terms and conditions that would have been made or imposed had those parties been dealing at arm's length;
>
> 9(vv) an arm's length's party would not have paid SII the marketing fees that the Appellant did in the 2000 and the 2001 taxation years for the services that SII provided;

[174] Accordingly, I find that the terms and conditions of the MSSA differed from what would have been agreed upon had the Appellant and SII been dealing at arm's length and that an arm's length would not have paid the marketing fees that the Appellant did in the 2000 and the 2001 taxation years for the services that SII provided.

B. Issue 2: Whether the Appellant would have paid SII any fees under the MSSA in excess of the amounts allowed by the Minister had they been dealing at arm's length

(1) Introduction

[175] Having answered Issue 1 in the affirmative, it remains to determine what adjustments should be made to the quantum of the fees that the Appellant paid to SII under the MSSA so that it is equivalent to the price that would have been paid had the Appellant and SII been dealing at arm's length.

[176] Both parties relied on the principles established in *Canada v. GlaxoSmithKline*, 2012 SCC 52 (S.C.C.); *The Queen v. General Electric Capital of Canada*, 2010 FCA 344 (FCA); and *Alberta Printed Circuits Ltd. v. The Queen*, 2011 TCC 232 (T.C.C.) and directed the Court's attention to the *OECD Guidelines 1995* and the Canada Revenue Agency's IC 87-2R.

[177] Because the *Act* is silent as to how to carry out the analysis contemplated by subsection 247(2), Canadian courts have endorsed the use of the *OECD Guidelines*. The *OECD Guidelines* do not have the force of law but rather, are intended as tools to assist in determining what a reasonable business person would have paid if the parties to a transaction had been dealing with each other at arm's length[89].

[178] In *GlaxoSmithKline*, the Supreme Court of Canada confirmed that the transfer pricing analysis is strongly fact driven; when assessing the evidence, the trial judge must keep in mind "the respective roles and functions [of the parties to the transfer pricing transaction]"[90]. Further guidance may be found in *General Electric* (F.C.A.) wherein Noel, J.A. sets out the proper approach to the application of paragraphs 247(2)(*a*) and (*c*):

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89 *Canada v. GlaxoSmithKline* at paragraphs 20-21.

90 At paragraph 62.

> [54] The concept underlying subsection 69(2) and paragraphs 247(2)(*a*) and (*c*) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.
>
> [55] This interpretation flows from the normal use of the words as well as the statutory objective which is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non arm's length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. … all the factors which an arm's length person in the same circumstances as the respondent would consider relevant should be taken into account.

(2) Expert Reports

[179] The critical first step in a transfer pricing analysis is to identify the transaction under review. Because of the significant divergence in the approach taken by the parties' expert witnesses in addressing this issue, it is useful to consider their reports before going further with the analysis of the evidence.

[180] The Appellant's Expert Report was based on the assumption that SWI and SII operated as an "amalgam" under Mr. Csumrik's direction. This approach was, no doubt, influenced by the manner in which the letter of instruction framed the questions for his response:

> A. In your opinion, what are the appropriate data and economic factors to be considered when determining what an arm's length person, standing in the shoes of [the Appellant], would have agreed to pay for the services described below [in the Factual Assumptions provided to Mr. MacDonald, provided to [the Appellant] by [SWI] and [SII]? and
>
> B. Having regard to the data identified under A, what is your opinion as to a reasonable range of prices that an arm's length person, standing in the shoes of [the Appellant], would have agreed to pay for the services, as such are described below [in the Factual Assumptions provided to Mr. MacDonald], provided to [the Appellant] by [SWI] and [SII]? [91] [Emphasis added.]

[181] Mr. MacDonald said he had treated SII and SWI as one entity, referred to at times as an amalgam, with Mr. Csumrik being somehow rolled up in its functions,

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91 Exhibit A-2, page 1, paragraphs 1.1, items A and B.

based on the assumptions underpinning the Appellant's Expert Report[92] and his interviews of Mr. Csumrik, Mr. Martini and Mr. Fabian. On cross-examination Mr. MacDonald summarized his approach to the functions of each participant under the Barbados Structure as follows:

> Q For purposes of your opinion, though, I'm going to suggest to you that it doesn't really matter who, among those players that I mentioned, Mr. Csumrik, Mr. Stark, the sales employees and so on, which of those parties performed the tasks that generated sales. Would you agree with that?
>
> A I think I agree with that. I was looking at the overall marketing structure of the amalgam, and that was looked at also with the financial results of the amalgam in 2000 and 2001.
>
> Q Right. So when you are looking at the two entities, SII and SWI as an amalgam, you're basically looking at them as one service provider to Marzen, to the appellant. Do you agree with that?
>
> A Correct.
>
> Q So it doesn't matter which of those two entities or who of their employees are working the phones or presenting to developers or reading the trade journals or looking at building permits, or any of the things that they might have done?
>
> A Correct.[93]

[182] Mr. MacDonald acknowledged on cross-examination that the amalgam approach was contrary to the arm's length principle of treating the members of an MNE as separate entities. He further acknowledged that the Appellant, SWI and SII *were* separate legal entities; that there were contracts in place between the Appellant and SII, SWI and SII; and the Appellant and SWI; and that those contracts assigned different functions to the parties[94]. However, he concluded it was appropriate to bundle SII and SWI together under the MSSA:

> A Because stepping in the shoes of whet [*sic*] an arm's length parties would do in a situation between Marzen and SII and the amalgam, I believe that it is

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92 Exhibit A-2, page 2, paragraphs 1.1(f)(i)(4-15).

93 Transcript, page 534, line 24 to page 535, line 16.

94 Transcript, page 580, line 24 to page 581, line 26.

> important to look at the amalgam based on the marketing intangibles it has, based on the secondment agreement and based on the fact that SWI does not earn a gross margin on the re-sale of its inventory. It earns no profit on that. So this led me to believe that the two are acting in concert as a marketing service provider and should be remunerated on its overhead distribution functions -- sales functions I should say. So those facts led me to my conclusion.[95]

[183] The Respondent's expert witness, Mr. Rogerson, did not accept the amalgam approach taken in the Appellant's Expert Report. Although the report Mr. Rogerson prepared was excluded from evidence[96], the Respondent's Rebuttal Report[97] was admitted and Mr. Rogerson provided the Court with a careful and through analysis of the weaknesses he had identified in Appellant's Expert Report.

[184] Overall, I am persuaded by Mr. Rogerson's testimony that the Appellant's Expert Report was fundamentally flawed in that it wrongly identified the transaction under review as being between the Appellant and the SWI/SII amalgam; to treat SWI and SII as one entity was contrary to paragraph of 1.16 the *OECD Guidelines 1995* which states that "…the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business".

[185] The amalgam approach is also inconsistent with the evidence of the Appellant's own witnesses which shows that they themselves recognized and understood the individual status and functions of the entities established under or involved in the Barbados Structure. Turning first to Mr. Martini, when he was asked on cross-examination who benefited from the fees paid under the MSSA and the MSSA Bonus Payment, he made a frank distinction between Mr. Csumrik, SWI and SII in asserting that only SII was the intended beneficiary of such fees. Similarly, when Mr. Fabian was cross-examined about the terms of the relationship clauses in the Four Agreements, he exhibited a clear understanding of the parties' respective powers:

> Q I mean, the reality is, all these companies [the Appellant, SWI and SII] are controlled by Mr. Martini and his family, right/
>
> A Well, no, it's --

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95 Transcript, page 581, line 28 to page 582, line 12.

96 For the reasons given in Transcript, pages 798 to 807.

97 Exhibit R-1.

Q It's on the schematic. [Schedule A to the Statement of Agreed Facts]. They can make these -- they can make SWI and SII agree to whatever they want them to.

A No, actually, sir, you know, SWI is a separate corporate entity that has its own identity, so [Mr. Stark] can declare and do what he can. So if he change the price of his window and say, "Mr. Rick Stark said I want to sell my window at 10 percent less", he has -- he can do that. He's on -- he is his own business. Although it's owned by the Martini family, it's still a business on its own that can make decision for its own.

Q Okay. I'm just going to ask you about paragraph 4.1 of the personnel secondment agreement. So I'll give you a minute to read it.

A Okay.

…

A So Mr. Fabian, this paragraph says:

"Nothing in this agreement is to be construed as creating a partnership or joint venture relationship, either generally or for any specific purpose, between SWI and SII or a former employee or master/servant relationship between SII and the employees of SWI."

So the paragraph says no partnership or joint venture between SII and SWI, and no employment relationship between the SWI workers and SII. Are you with me on that?

A Yes, sir.

Q Why was it necessary to include that disclaimer in this agreement, do you know?

A Because they're not partners to one another. Starline Windows Inc. is a separate company on its own. SII is a company on its own. There's no partnership. Starline Windows Inc. is not part owner to SII, nor SII is part owner or part shareholder of SWI. So that's what it is.[98]

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98 Transcript, page 183, line 19 to page 185, line 14.

[186] On cross-examination, Mr. MacDonald was asked about paragraph 1.36 of the *OECD Guidelines 1995* which deals with the need to respect legal relationships put in place by the taxpayer:

> Q I'm just going to ask you to go back to those guidelines from the OECD and to turn ahead to paragraph 1.36… [which] … says in part:
>
> > "A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters 1, 2 and 3. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them."
>
> Now, would you agree that that guideline says to a tax administration, you need to respect the legal relationships put in place by the taxpayer?
>
> A That's my reading, yes.
>
> Q And would you agree with the suggestion that a taxpayer pricing its own transfer prices should do the same thing? The flip side should apply.
>
> A 1.36 does refer to exceptional cases, so it's not a rule that applies in every situation, but I think -- again, going back to accepted transfer pricing practices, it -- we can look at a bundle of transactions and the economic rights and the functional circumstances around that and, you know, one party may be providing things on different terms. So we tend to look at the entirety of the arrangement when it makes sense, when there's a number of elements involved. This is not uncommon.
>
> Q So the statements in this guideline, they don't change your view about the correctness of viewing SII and SWI for purposes of your transfer pricing study as one?
>
> A Well, it could apply. I won't dismiss it. I would say that that would be one approach to look at the transactions under review. I took a different approach which I feel is also reasonable.[99]

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99 Transcript, page 585, line 14 to page 586, line 26.

[187] On redirect, counsel for the Appellant referred Mr. MacDonald to paragraphs 1.42 and 1.43 of the *OECD Guidelines 1995* and asked Mr. MacDonald to address questions put to him on cross-examination regarding the obligation to conduct an entity-by-entity analysis:

> Q And I think the tenor of the questions was to suggest to you that the OECD guidelines want you to treat entity by entity.
>
> A Yes.
>
> Q And you indicated in these circumstances you didn't believe that was appropriate. I wondered if you could turn to Section 1.42.
>
> And if you just want to take a look at 1.42, and perhaps 1.43.
>
> …
>
> A Yes, I used the term "bundling" in my reply and they used the term "packaged deal" in 1.43, so it's the same effect.
>
> Q So these guidelines, would you agree with me, expressly acknowledge that there are circumstances when you should combine entities and treat them as an amalgam?
>
> A I agree.[100]

[188] Counsel for the Appellant relied on this exchange in support of his argument that the *Guidelines* did not require an entity-by-entity approach in every case. However, a review of paragraphs 1.42 and 1.43, the passages referred to above, shows that they are not talking about entities. Rather, they deal with the circumstances under which it is appropriate to bundle transactions between associated enterprises, rather than using the transaction-by-transaction normally employed under the arm's length principle. Similarly, the "package deal" Mr. MacDonald referred to in paragraph 1.43 has to do combining transactions. There is nothing in paragraphs 1.42 or 1.43 to suggest it is appropriate to bundle entities under an arm's length analysis.

[189] In rebuttal argument, counsel for the Appellant also suggested that the reference in paragraph 1.16 to treating associated enterprises as separate entities

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[100] Transcript, page 585, line 14 to page 586, line 26.

must be read in light of the "Global Formulary Apportionment" approach set out under "Other Methods" in Chapter 3 of the *Guidelines*. The Global Formulary Apportionment approach is an alternative to the arm's length principle. Paragraph 3.61 of the *Guidelines* states that the advocates of the Global Formulary Apportionment approach prefer it because, *inter alia*,:

> … an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.

[190] According to counsel for the Appellant, paragraph 1.16 does not require that in performing a functional analysis SWI and SII be treated as separate entities. Rather, the use of the terms "enterprises" and "entities" throughout the *OECD Guidelines 1995* is intentional and reflects the economic perspective of associated enterprises whose economic functions are linked rather than the legal perspective urged by the Respondent. Thus, it was permissible for the Appellant's Expert Report to treat SWI and SII as an amalgam.

[191] I am not persuaded by this argument either. The chapter dealing with the Global Formulary Apportionment approach shows that OECD Member countries have rejected its use in transfer pricing[101], in part, because it abandons the separate entity approach[102]. While acknowledging that it is not always easy to separate the functions of each entity, the *Guidelines* nevertheless endorse its application[103].

[192] Mr. Rogerson identified another flaw in the Appellant's Expert Report: although premised on the amalgam model, the Appellant's Expert Report does not consistently adhere to it; from time to time, SWI and SII are also described as performing separate functions: *i.e.*, SII acting through Mr. Csumrik is portrayed as the "architect" of the marketing strategy and SWI, under his direction, as its "executor"[104].

[193] Finally, counsel for the Respondent submitted that many of the assumptions underpinning the conclusions in the Appellant's Expert Report – in particular, those

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101 *OECD Guidelines 1995*, paragraphs 3.63 and 3.74.
102 *OECD Guidelines 1995*, paragraph 3.71.
103 *OECD Guidelines 1995*, paragraphs 1.13 and 1.14.
104 Exhibit A-2, page 4, paragraph 11.

pertaining to Mr. Csumrik's role[105] - were factually incorrect. I agree with this contention; as noted in paragraph 135, above, some of the important discrepancies between Mr. MacDonald's factual assumptions and my findings were identified in the consideration of the evidence under Issue 1.

[194] To conclude, having heard the evidence of Mr. MacDonald and Mr. Rogerson and carefully reviewed the Appellant's Expert Report and the Respondent's Rebuttal Report in light thereof, I am of the view that the Appellant's Expert Report should not be relied upon because it is based on questions that do not properly identify the transaction under review, assumptions found not to be facts and an approach that is at odds with the arm's length principle as contemplated by the *OECD Guidelines 1995*.

(3) Analysis

[195] The critical first step in a transfer pricing analysis is to identify the transaction under review; in the present case, that is the MSSA (as amended to include the 10% MSSA Bonus Payment) between the Appellant and SII. The arm's length principle requires an entity-by-entity assessment of the roles and functions of those implicated in the Barbados Structure.

(a) The Minister's Assumptions

[196] It is useful to begin by restating the Minister's assumptions regarding the arm's length price:

> 9(ii) marketing of the Appellant's products in the United States was undertaken exclusively by the employees of SWI;
>
> 9(kk) SII performed no meaningful value-added services in Barbados to support the Appellant or SWI;
>
> 9(pp) the profits allocated to Barbados (marketing fees paid by the Appellant less fees paid to SWI) were not paid out by SII to cover costs or expenses incurred by SII or to compensate its managing director David Csumrik;
>
> 9(ww) in the 2000 and 2001 taxation years, an arm's length's party would not have paid marketing fees to SII that exceeded the fees paid by

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105 Exhibit A-2, page 2, paragraphs 1.1(f)(i)(4-15).

SII to SWI;

(referred to collectively as the "Minister's Price Assumptions")

[197] As noted above in Issue 1, the Appellant contended that the Primary Auditor wrongly rejected the Appellant's position that:

1. the Appellant received service of substantial value under the MSSA;

2. Mr. Csumrik provided on-going direction to the SWI sales team; and

3. without the direction and participation of Mr. Csumrik, the Appellant would not have successfully penetrated the US high-rise market.[106]

(referred to collectively as the "Appellant's Contentions")

[198] The Appellant has not fully proven the Appellant's Contentions. Starting with point (3) of the Appellant's Contentions, it may be that, absent Mr. Csumrik's idea to change its market focus, the Appellant would not have penetrated the US market – but the Appellant has not persuaded me that Mr. Csumrik's conceptualization and development of the marketing strategy can be attributed to SII. As for point (1), if by "substantial value" the Appellant means that the entire amount of the fees under the MSSA were justified, the evidence does not support such a claim.

[199] However, the Appellant has succeeded, to a limited extent, in rebutting, in part, the assumptions set out above. As there is a certain overlap between some aspects of the Appellant's Contentions and the Minister' Assumptions, they will be dealt with together. In respect of point (2) of the Appellant's Contentions, that Mr. Csumrik provided on-going direction to the SWI sales team, the Respondent conceded that, contrary to the assumption in paragraph 9(ii), Mr. Csumrik, on behalf of SII, provided *some* on-going direction to the SWI sales team by way of reviewing sales reports and providing *some* strategic advice and suggestions to SWI on behalf of SII. Thus, contrary to paragraph 9(kk), he performed, on behalf of SII, *some* value-added services in Barbados to support the Appellant or SWI.

[200] However, the performance of most of such services overlapped with the functions he performed in his capacity as managing director of SII through Longview. From this it follows that the Appellant has successfully rebutted paragraph 9(pp) - but only to the extent that the profits allocated to Barbados

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106 Appellant's Written Argument, paragraph 91.

(marketing fees paid by the Appellant less fees paid to SWI) were paid out by SII to compensate Mr. Csumrik in his role of managing director with administrative support from Longview.

[201] That leaves for consideration the assumption in paragraph 9(ww) that an arm's length's party would not have paid marketing fees to SII that exceeded the fees paid by SII to SWI. Given the above finding, that assumption has been rebutted but again, only to the extent that the fees paid by the Appellant to SII were used to pay for the services provided under SII's arrangement with Mr. Csumrik/Longview.

(b) Determination of the Arm's Length Price

[202] In reassessing the Appellant's 2000 and 2001 taxation years and adjusting the price under the MSSA, the Minister did not take into account the value of the services provided by SII to the Appellant under the arrangement with Mr. Csumrik through Longview.

[203] According to the Respondent's position at trial, counsel for the Respondent submitted that the transaction between the Appellant and SII ought to be viewed as follows:

- SII contracted to supply services to the Appellant [under the MSSA];
- SII then sourced those services from SWI and Mr. Csumrik/Longview under separate subcontracts (the secondment and administrative agreements with SWI, and retaining Longview);
- SII used the fees paid by the Appellant pay fees to SWI its secondment fees, and to pay Mr. Csumrik/Longview their fees; and
- the marketing fees [the Appellant] paid to SII had three components:

    1. a price relating to the re-supply of SWI's services;
    2. a price relating to the re-supply of Mr. Csumrik's services; and
    3. a mark-up to SII for co-ordinating such services [107].

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[107] Respondent's Written Argument, paragraph 139(d).

[204] Given that the Minister assumed the fees SII paid to SWI under the PSA and the ASSA represented arm's length amounts, the Respondent submitted that the issue boiled down to:

> … whether the component of the fees relating to the re-supply of services of Csumrik; and any amount that functions as a mark-up to which SII is entitled is an arm's length amount.[108]

[205] Having found that SII performed no functions on behalf of the Appellant under the MSSA other than those provided on its behalf by SWI and Mr. Csumrik/Longview, it follows there was no basis for the payment of the mark-up component to SII.

[206] The Respondent's analysis is based on the *OECD Guidelines 1995* which provide commentary and methodology for determining whether transfer prices are consistent with what parties dealing at arm's length would have paid. Paragraph 1.6 of the *Guidelines* summarizes the application of the arm's length principle as follows:

> By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (*i.e.*, comparable uncontrolled transactions), the arm's length principle follows the approach of treating the members of an MNE [Multinational Enterprise] as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focussed on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's length principle.

[207] In *GlaxoSmithKline Inc.*, the Supreme Court of Canada recognized that the exercise of determining an arm's length price is essentially a comparative one. The difficulty, of course, is to find a proxy that most nearly replicates the circumstances of the transaction under review.

[208] While the current version, *OECD Guidelines 2010*, does not impose hierarchy on the various transfer pricing methods, under the version applicable to

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[108] Respondent's Written Argument, paragraph 142.

the taxation years under appeal, the *OECD Guidelines 1995*, they were categorized in two groups and ranked in descending order of reliability as follows:

1. Traditional Transaction Methods:

    - Comparable Uncontrolled Price method ("CUP Method") Respondent [108] and [160] – value of Mr. Csumrik and Longview
    - Resale Price method
    - Cost Plus method

2. Transactional Profit Methods:

    - Profit Split method
    - Transactional Net Margin method ("TNMM")

[209] The parties' experts reached very different conclusions as to which of these methods was the most appropriate in determining an arm's length price under the MSSA. Having already declined to rely on the Appellant's Expert Report for the reasons set out above, it is not necessary to deal at length with the Appellant's argument regarding the appropriate methodology to apply in the present matter. However, I note for the record that the Appellant's expert witness concluded that the Transactional Net Margin Method ("TNMM") would generate the most reliable result. The TNMM assesses the arm's length character of transfer prices in a controlled transaction by testing the net profit results of one of the participants in the transaction against comparable third party enterprises.

[210] Based on the Respondent's Rebuttal Report prepared by Mr. Rogerson, counsel for the Respondent argued that the CUP Method ought to be applied in the present appeals. The CUP Method compares the price paid for a service in a non-arm's length transaction to the price of a comparable service in an arm's length transaction. Under the CUP Method, either an internal or external comparable may be used. An internal comparable compares the transaction under review to another transaction between one of the parties to the controlled transaction and a third party.

[211] Counsel for the Respondent contended that the arm's length transaction between SII and Mr. Csumrik/Longview is a comparable uncontrolled transaction which could reliably serve as an internal comparable under the CUP Method. Mr. Csumrik dealt with SII at arm's length; he expected to be compensated for his

work, negotiated a fee and provided his services accordingly. That fee, US$32,500 fee in each of 2000 and 2001, is a comparable uncontrolled price ("CUP") for the controlled transaction between the Appellant and SII.

[212] Although admitting on cross-examination that the CUP Method was the method of choice under the *OECD Guidelines 1995*, Mr. MacDonald rejected its use in the Appellant's Expert Report because he concluded no reliable comparable could be identified. He was also of the view that the arrangement between SII and Mr. Csumrik/Longview was not a reliable CUP Method because it did not take into account Mr. Csumrik's compensation under the separate arrangement with Mr. Martini/the Appellant which, according to Mr. MacDonald could not be valued[109].

[213] This is of little assistance to the Appellant. First of all, it must be noted that the only reason no value could be put on Mr. Csumrik's side deal with Mr. Martini/the Appellant was that after some 15 years, he had still not taken advantage of whatever opportunities that arrangement was supposed to produce. But in any case, the value of the separate compensation arrangement is not relevant to the application of the internal CUP as submitted by the Respondent because that was between Mr. Csumrik personally and Mr. Martini/the Appellant. It had nothing to do with the provision of Mr. Csumrik's managing director services to SII through Longview. Such confusion is the result of the blurring of roles flowing from the amalgam approach and non-factual assumptions underpinning the Appellant's Expert Report.

[214] By contrast, Mr. Rogerson's Respondent's Rebuttal Report, like his testimony, was thorough and clear in its analysis of the Appellant's Expert Report. In addition to the other weaknesses he identified in the Appellant's Expert Report, I also accept Mr. Rogerson's analysis of the errors and inconsistencies in the application of the TNMM in the Appellant's Expert Report and his opinion that they rendered it unreliable. As I have already decided not to rely on the Appellant's Expert Report, there is no need to set these out in detail but I hereby adopt the arguments in respect of the Appellant's Expert Report methodology in subparagraphs 157(dd) to (kk) of the Respondent's Written Argument.

[215] I am persuaded by the Respondent's argument that the arrangement between SII and Mr. Csumrik/Longview serves as a reliable internal CUP. It accords with *OECD Guidelines 1995* in that it treats SWI and SII as separate entities and respects the legal relationships created under the Barbados Structure. Further, it

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109 Appellant's Written Argument, page 45, paragraph (j).

recognizes SII for what it was, "a flow-through entity or facilitator that makes the services of others available to the Appellant"[110]. I am also satisfied that a reasonable business person would not have paid SII more than the price Mr. Csumrik attached to his own services through Longview. It is an agreed fact that the value of Mr. Csumrik/Longview services was US$32,500 in each of 2000 and 2001.

[216] Thus, the appeals of the 2000 and 2001 taxation years are allowed, in part, and the reassessments are referred back to the Minister for reconsideration and reassessment on the basis that an arm's length's party would have paid an amount to SII that exceeded the fees paid by SII to SWI, but only in the amount of US$32,500 in each of 2000 and 2001.

C. Issue 3 – Penalties

[217] The Minister imposed penalties under subsection 247(3) of the *Act* in respect of the 2001 taxation year only. The relevant portions of subsection 247(3) read as follows:

> 247(3) A taxpayer (other than a taxpayer all of whose taxable income for the year is exempt from tax under Part I) is liable to a penalty for a taxation year equal to 10% of the amount determined under paragraph (*a*) in respect of the taxpayer for the year, where
>
> (*a*) the amount, if any, by which
>
> (i) the total of
>
> (A) the taxpayer's transfer pricing capital adjustment for the year, and
>
> (B) the taxpayer's transfer pricing income adjustment for the year
>
> exceeds the total of
>
> (ii) the total of all amounts each of which is the portion of the taxpayer's transfer pricing capital adjustment or transfer pricing income adjustment for the year that can reasonably be considered to relate to a particular transaction, where

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110 Respondent's Written Argument, paragraph 140.

(A) the transaction is a qualifying cost contribution arrangement in which the taxpayer or a partnership of which the taxpayer is a member is a participant, or

(B) in any other case, the taxpayer or a partnership of which the taxpayer is a member made reasonable efforts to determine arm's length transfer prices or arm's length allocations in respect of the transaction, and to use those prices or allocations for the purposes of this Act, and

(iii) the total of all amounts, each of which is the portion of the taxpayer's transfer pricing capital setoff adjustment or transfer pricing income setoff adjustment for the year that can reasonably be considered to relate to a particular transaction, where

(A) the transaction is a qualifying cost contribution arrangement in which the taxpayer or a partnership of which the taxpayer is a member is a participant, or

(B) in any other case, the taxpayer or a partnership of which the taxpayer is a member made reasonable efforts to determine arm's length transfer prices or arm's length allocations in respect of the transaction, and to use those prices or allocations for the purposes of this Act,

is greater than

(*b*) the lesser of

(i) 10% of the amount that would be the taxpayer's gross revenue for the year if this Act were read without reference to subsection (2), subsections 69(1) and (1.2) and section 245, and

(ii) $5,000,000.

[218] Under subsection 247(3), the penalty is equal to 10% of the amount by which the transfer price adjustment exceeds the lesser of (a) the taxpayer's gross revenues for the year, and (b) $5 million. Thus, no penalty will apply unless this monetary threshold has been crossed.

[219] In the present matter, in imposing a penalty in the 2001 taxation year, the Minister relied on the following calculations:

Table 1	Amount subject to Penalty

Transfer price on marketing fees paid to non-arm's length non-residents	$5,025,190

Table 2	Subsection 247(2)		Subsection 247(3)			Total Sales	Adjustment as a percentage of sales
	Transfer Pricing Adjustment	Lesser of 10% of Revenue and $5,000,000	Excess	Penalty Consideration			
Taxation year end	A	B	C=A-B	D	D multiplied by 10%		
31/12/00	$2,110,502	$4,465,019	Nil	Nil	Nil	$44,650,187	4.7%
31/12/01	5,025,190	5,000,000	$25,190	$5,025,190	$502,519	$54,440,728	9.2%
				Total Penalty	$502,519		

[220] In the present matter, if after reconsideration and reassessment of the 2001 taxation year the transfer pricing adjustment does not exceed the required threshold, no penalty shall be imposed under subsection 247(3).

[221] In the event that that proves not to be the case, it is necessary to consider the second aspect of the penalty provision; under clause B of subparagraph 247(3)(*a*)(ii) and clause B of subparagraph 247(3)(*a*)(iii), no penalty will apply to a transfer pricing adjustment that relates to a transaction where the taxpayer has made "reasonable efforts" to determine and use arm's length transfer prices for the purposes of the *Act*.

[222] However, these provisions must be read in conjunction with the deeming provisions contained in subsection 247(4). Subsection 247(4) requires the taxpayer to make or obtain records or documents supporting the transfer price in issue by the date that the taxpayer's return for the year is due and permits the Minister to request such documentation from the taxpayer. If the taxpayer fails to provide such information within 90 days of the Minister's request, subsection 247(4) deems the taxpayer not to have made "reasonable efforts" to determine and use arm's length allocations in respect of a transaction.

[223] Paragraph 247(4)(*a*) further requires that the records or documentation provide "a description that is complete and accurate in all material respects" of the items set out in subparagraphs (i) to (vi); as the provision is written conjunctively, the taxpayer must fulfill all of these requirements to avoid the effect of the deeming provision:

> (i) the property or services to which the transaction relates,

(ii) the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction,

(iii) the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,

(iv) the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,

(v) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction, and

(vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction;

[224] There are two transfer price amounts under the MSSA that require consideration under these provisions: the fees under the 25% formula and the 10% MSSA Bonus Payment.

[225] The issue in the present matter is whether the records or documentation provided by the Appellant in accordance with the Minister's request under subsection 247(4)(*c*) meet the requirements of subparagraphs 247(4)(*a*)(v) and (vi), above. There is no dispute that the Minister sent a written request for contemporaneous documentation on April 16, 2003[111] and that the Appellant responded by letter dated July 9, 2003[112]("Appellant's July 9, 2003 Response", discussed earlier in these Reasons at paragraph 94). The Appellant did not take issue with the Respondent's summary[113] of the contents of the Appellant's July 9, 2003 Response:

a. a cover letter from counsel;

b. the four inter-company agreements creating the Barbados Structure (the MSSA, the PSA; the ASA and the DDRMA);

c. correspondence between SWI and SII regarding increasing SWI's fees under the ASA;

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111 Exhibit A-1, Tab 52.

112 Exhibit A-1, Tab 54.

113 Respondent's Written Argument, paragraph 169.

d. correspondence between SII and the Appellant regarding the one-time 10% MSSA Bonus Agreement; and

e. the business study prepared by Mr. Fabian.

[226] The Respondent's position is that none of the material in the Appellant's July 9, 2003 Response addresses the requirements of subparagraphs 247(4)(*a*)(v) and (vi):

(v) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction, and

(vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction;

[227] According to the Respondent's argument, the only document that even touches on these matters is the "Case Study" dated April 5, 1999[114] prepared at Mr. Martini's request by Mr. Fabian regarding how to improve SWI's sales in the US. Counsel for the Respondent submitted that while the Case Study takes a 25% marketing fee as a given in the proposed scenarios, it does not address how that figure was determined. Counsel noted further that the evidence of Mr. Martini and Mr. Fabian was that, at the time the Case Study was prepared, no decision had yet been made as to the amount of the marketing fee. Mr. Martini said he had come up with the 25% formula based on his own business experience and observations of SWI's performance in the US market prior to the implementation of the Barbados Structure. He candidly acknowledged that he had no documents to show how he had decided on the 25% marketing. He said he could not find any comparators but admitted that he had not sought professional advice to assist with that exercise.

[228] Counsel for the Respondent made a similar argument in respect of the determination of the 10% formula used in the MSSA Bonus Payment. While the exchange of correspondence between Mr. Csumrik and Mr. Martini[115] shows that amount was requested and that Mr. Martini agreed to it subject to certain sales levels being met, it does not explain how the 10% amount was determined. Mr. Csumrik's testimony was that there was no underlying rationale for that figure.

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114 Exhibit A-1, Tab 83.

115 Exhibit A-1, Tabs 34 and 35.

[229] In view of the above, the Respondent contends that the Appellant has failed to meet the requirements of subparagraphs 247(4)(*a*)(v) and (vi) is deemed not to have made reasonable efforts to determine and use arm's length transfer prices and accordingly, is liable to a penalty in respect of the 2001 taxation year under subsection 247(3).

[230] The Appellant addressed the issue of penalties only briefly in oral argument. The submission of counsel for the Appellant in response to the Respondent's position is reproduced in its entirety below:

> My friend has suggested that the appellant has not satisfied the requirements under subsection 247(3) with respect to contemporaneous documentation. And we totally disagree with that. The letter that we sent on July 9th, 2003, which I believe -- dated July 9, 2003 and can be found at tab 54. I'm not going to belabour the point. We went through it, what was enclosed in there. And at the end I note:
>
> "I trust the foregoing is the information you require. If you need any elaboration on the enclosed material please don't hesitate to give me a call."
>
> We heard nothing, nothing, for 11 months.[116]

[231] This is not persuasive enough to overwhelm the force of the Respondent's argument which in my view, is logically presented and well supported by the evidence. Accordingly, should a finding be required in respect of the application of subsection 247(4) after the Minister has made her reconsideration and reassessment, I find that the Appellant has failed to provide records or documentation that fulfil the requirements of subparagraphs 247(4)(*a*) and specifically, that the July 9, 2003 Response is not sufficient to satisfy subparagraphs 247(4)(*a*)(v) and (vi). Accordingly, the Appellant is deemed not to have made reasonable efforts to determine and use arm's length transfer prices and is liable to a penalty in respect of the 2001 taxation year under subsection 247(3).

VI. Costs

[232] Counsel for the Appellant submitted that should the appeals be allowed, the Appellant ought to be awarded party-and-party costs. The primary basis for the Appellant's request was that the failure of the federal Crown to secure the attendance of the Primary Auditor at examination for discovery caused the Appellant costs that could easily have been avoided.

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[116] Transcript, page 1126, line 23 to page 1127, line 8.

[233] As noted earlier in these Reasons for Judgment, the Primary Auditor, who retired before discoveries could be conducted, declined to attend as the Respondent's nominee at discovery because government policy dictated that he be paid less than what his full salary had been prior to retirement. As a result, another nominee had to be selected and discoveries were adjourned for approximately four months to permit the Nominee Auditor to prepare.

[234] In requesting special costs, counsel for the Appellant did not attribute any fault to either counsel for the Respondent or the Primary Auditor for his decision not to attend. His contention was that the federal Crown ought to be held to account because the additional amount it would have had to pay to secure the Primary Auditor's attendance was minimal in comparison with the resulting additional costs incurred by the Appellant.

[235] As a result of the Crown's actions, counsel for the Appellant argued, the Appellant was unnecessarily required to spend time on the issue of the "admissions" made by the Nominee Auditor and their effect on the Minister's reassessments. Counsel for the Appellant further contended that the Crown's refusal to fund the Primary Auditor's attendance required the Appellant to bring a motion seeking to prevent the Primary Auditor from testifying at the hearing. Counsel went on to say that when he:

> … did get Mr. Stasiewski [the Primary Auditor] in the witness box, … even when presented with compelling evidence that there was direction, certain activities were undertaken, he stayed intransigent on his position that there was no evidence of any contribution being made by SII and SWI. So he went through a long battle to gain nothing"[117] [Emphasis added.].

[236] The second concern driving the Appellant's request for special costs was "the failure on the part of the Crown to provide an expert's report that complied with even the basic standards of admissibility"[118]. Counsel noted that even though he had gone on the record on the first day of the hearing regarding the Appellant's belief "that [the] report was fundamentally flawed, [the Respondent] persisted"[119].

[237] In my view, there is no merit to any of the Appellant's arguments in support of its request for special costs. Beginning with the Respondent's expert report, although the Appellant's argument for its exclusion was granted, it was open to the

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117 Transcript, page 1046, lines 9-15.
118 Transcript, page 1046, lines 2-4.
119 Transcript, page 1046, lines 7-8.

Respondent to challenge the Appellant's objection to its admission, leaving it for the Court to decide its admissibility.

[238] As for the Primary Auditor's non-attendance at discovery and the Appellant's contentions regarding the attendant consequences thereof, in my view, counsel for the Appellant is, again, overstating the matter. It was the Appellant's choice to object to the Primary Auditor's being called as a witness and in the end, that motion was dismissed.

[239] As for the Primary Auditor's refusal to accept the Appellant's representations of the roles played by Mr. Csumrik, SWI and SII, it is simply incorrect for counsel for the Appellant to characterize the Primary Auditor's behaviour as "intransigent". The Primary Auditor accepted the answers of the Nominee Auditor on examination for discovery and his responses conformed to the Respondent's undertaking to the Court not to resile, in any way, from the position taken by the Nominee Auditor at examination for discovery. The Primary Auditor acknowledged that Mr. Csumrik, SWI and SII may have been a little more involved in the Appellant's marketing efforts than he found them to be during the audit but remained firm that there was still insufficient proof to justify the amounts paid to SII by the Appellant. I must say, having carefully reviewed the same documents and having had the added benefit of hearing the sworn evidence of the Appellant's witnesses, I have reached the same conclusion.

[240] For the reasons set out above, there is no reason for the Court to exercise its discretion to award special costs.

[241] In view of the Appellant's limited success in these appeals, costs are awarded to the Respondent.

VII. Conclusion

[242] In accordance with the Reasons for Judgment attached, the appeals of the 2000 and 2001 taxation years are allowed, in part, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that an arm's length's party would have paid an amount to Starline International Inc. that exceeded the fees paid by Starline International Inc. to Starline Windows Inc., but only in the amount of US$32,500 in each of 2000 and 2001.

[243] In view of the Appellant's limited success in these appeals, costs are awarded to the Respondent.

Signed at Ottawa, Canada, this 10th day of June 2014.

"G. A. Sheridan"

Sheridan J.

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COURT FILE NO.:	2010-860(IT)G
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