CURRENT CASES

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THE FEDERAL COURT OF APPEAL

AMBIGUITY RESOLVED: NON-RESIDENT CORPORATIONS THAT LATE-FILE NIL RETURNS ARE SUBJECT TO PENALTIES

Exida.com Limited Liability Company v. Canada
2010 FCA 159

KEYWORDS: NON-RESIDENT ■ PENALTIES ■ TAX ■ RETURNS ■ CORPORATIONS

A previous case comment[1] analyzed the contradictory decisions rendered by the Tax Court of Canada in *Goar, Allison & Associates Inc. v. The Queen*[2] and *Exida.com Limited Liability Company v. Canada*.[3] In *Goar*, the taxpayer, a non-resident corporation, successfully challenged the imposition of a late-filing penalty under subsection 162(2.1) of the Income Tax Act.[4] The penalty had been assessed on the basis that although no part I tax was payable, the taxpayer had nevertheless failed to file its Canadian income tax return in a timely manner. Only a few months later, in *Exida.com*, Woods J of the Tax Court reached the opposite conclusion, holding that a subsection 162(2.1) penalty should apply to non-resident corporations when they fail to

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1 Michael Friedman and Ashley Palmer, "The P Factor: The Puzzling Predicament Posed by Problematic Penalty Provisions—Are Non-Resident Corporations That Late-File Nil Returns Subject to Penalties?" in Current Cases feature (2009) vol. 57, no. 4 *Canadian Tax Journal* 871-77.

2 2009 TCC 174.

3 2009 TCC 373; aff'd. on other grounds 2010 FCA 159.

4 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act and the regulations thereunder.

file a Canadian income tax return on time, even if they have no Canadian taxes owing for the relevant year. The ambiguity that resulted from the Tax Court's contradictory decisions in *Goar* and *Exida.com* has now seemingly been resolved by the Federal Court of Appeal in its consideration of the taxpayer's appeal in *Exida.com*.

THE STATUTORY FRAMEWORK

In an effort to ensure that all non-resident corporations that may be subject to Canadian tax file Canadian income tax returns on a timely basis, the government introduced a special computational provision. Subsection 162(2.1) provides that non-resident corporations that are "liable to a penalty" under subsection 162(1)[5] in respect of the late filing of a tax return are subject to a penalty equal to the greater of

- the amount of the penalty otherwise payable under subsection 162(1), and
- an amount equal to the greater of $100 and $25 times the number of days, not exceeding 100, from the day on which the return was required to be filed to the day on which it was filed.

Subsection 162(2.1) was intended to subject a non-resident corporation that late-files its Canadian income tax return to a penalty at least equal to the penalty imposed under subsection 162(7) for the late filing of "information returns" (paragraph 162(7)(a)) or for failing to comply with a duty or obligation imposed by the Act (paragraph 162(7)(b)).[6]

THE FACTS

In *Exida.com*, the taxpayer was a corporation resident in the United States that carried on business in Canada during the 2003-2005 taxation years. The taxpayer did

5 Subsection 162(1) provides that every person who late-files an income tax return is generally subject to a penalty equal to a stipulated percentage of the tax payable for the relevant tax year. Subject to subsection 162(2.1), when a person is not liable for Canadian tax for a particular year, no late-filing penalty arises under subsection 162(1).

6 The technical notes released by the Department of Finance in connection with the introduction of subsection 162(2.1) provide as follows:

> New subsection 162(2.1) thus operates to subject non-resident corporations to the effect of the "regular" penalties under subsections 162(1) and (2) in respect of a failure to file an income tax return and, consistent with the role of that tax return as an information return for those corporations that claim an exception from Canadian tax as a result of the application of a tax treaty, to the alternative penalties that would apply under subsection 162(7) if a separate information return had been required in respect of those corporations.

See Canada, Department of Finance, *Explanatory Notes to Draft Amendments: 1998 Budget Income Tax Proposals* (Ottawa: Department of Finance, October 1998).

A subsection 162(7) penalty is generally computed on the basis of the number of days by which the relevant failure continues, up to a maximum of $2,500. Subject to certain exceptions, subsection 162(7) does not apply when another provision of the Act "sets out a penalty for the failure."

not file Canadian income tax returns on time in respect of each of the three years. The minister of national revenue assessed the non-resident corporation on the basis that although no part I tax was payable, a late-filing penalty of $2,500 in respect of each year was payable under subsection 162(2.1).

THE FEDERAL COURT OF APPEAL'S JUDGMENT

The issue before the Federal Court of Appeal was whether a late-filing penalty may be assessed against a non-resident corporation under subsection 162(2.1) if the non-resident corporation did not have Canadian taxes payable for the relevant year.

In reviewing the legislative history of subsection 162(2.1), including the Department of Finance's technical notes that accompanied the introduction of the provision, the court observed that Parliament clearly intended to impose a penalty on non-resident corporations that failed to file their Canadian income tax returns on time, regardless of whether Canadian taxes were payable for the relevant year. Nevertheless, the court found that the explicit language of subsection 162(2.1) makes the imposition of penalties under the subsection conditional on the non-resident corporation being "liable to a penalty" under subsection 162(1) or 162(2), "and no such liability can exist in circumstances where a non-resident corporation has no taxes payable."[7] In effect, the Federal Court of Appeal held that because of a "fundamental drafting error" in the formulation of subsection 162(2.1), the operative terms of the statutory provision did not reflect the intention of Parliament.

In its analysis, the court considered whether a legislative "drafting error" could be cured by a purposive interpretation of subsection 162(2.1) and concluded that it could not. The court rejected the Tax Court's analysis of the meaning of the word "liable" on the basis that Woods J's reasoning "results in a penalty being levied under subsection 162(2.1) even though the stated condition precedent for its application . . . is not met."[8] In the court's view, "[w]hile a contextual and purposive analysis is useful in identifying, amongst the meanings which a word (or phrase) can have the one that best reflects Parliamentary intent, it cannot be used to give the legislative language a meaning which it cannot bear."[9] Accordingly, the court held that non-resident corporations that have no taxes payable under part I of the Act cannot be liable to a penalty under subsection 162(2.1).

In the alternative, the court considered whether the non-resident taxpayer could still be liable to an equivalent penalty under subsection 162(7) for its failure to timely file Canadian income tax returns, even though no Canadian tax was payable in respect of the relevant years.[10] Consistent with the Tax Court's analysis in *Goar*, the court found that paragraph 162(7)(a) had no application to the taxpayer because an income

7 Supra note 3, at paragraph 28 (FCA).

8 Ibid., at paragraph 32.

9 Ibid.

10 The minister raised the issue of the application of subsection 162(7) as an alternative argument before the Tax Court.

tax return filed by a taxpayer for a taxation year retains its character as an income tax return (that is, it is not an "information return") under the Act.

However, the court ultimately held that the taxpayer was liable to a penalty under paragraph 162(7)(b), which generally provides for a penalty in respect of any failure to comply with an obligation under the Act where no other provision of the Act "sets out a penalty for the failure." In making its determination, the court noted that although subsection 162(1) sets out a penalty for failing to timely file a Canadian income tax return, the subsection does not apply to non-residents; instead, non-resident corporations are governed by subsection 162(2.1), which applies "notwithstanding" subsection 162(1). On that basis, the court reasoned that a "penalty," as defined by several dictionaries, "involves some form of punishment or disadvantage,"[11] and thus a penalty of nil is not a penalty. Accordingly, the court concluded that the Act does not set out a penalty in respect of circumstances in which a non-resident corporation fails to file a tax return for a taxation year for which no tax is payable.[12]

On the basis of the foregoing analysis, the court ruled that the non-resident taxpayer was liable to a penalty under paragraph 162(7)(b), because no other provision of the Act sets out a penalty for the failure to file the subject returns. As a consequence, the taxpayer's appeal was dismissed.

COMMENTARY

The inconsistency in the Tax Court's decisions in *Goar* and *Exida.com* as to whether a non-resident corporation may be liable to a penalty for failing to file a Canadian income tax return in a timely manner when no part I tax is payable is arguably strong evidence that the proper interpretation of subsection 162(2.1) is unclear. Faced with the task of interpreting subsection 162(2.1), the Federal Court of Appeal rejected Woods J's approach to interpreting the provision. The court noted the usefulness of a contextual and purposive approach to statutory interpretation, but it ultimately found that such an approach cannot be used to assign a meaning to a provision that is incompatible with the language used in the provision. It was on this basis that the Federal Court of Appeal found that the appellant was not subject to a penalty under subsection 162(2.1) for failing to file a nil Canadian income tax return on time.

Despite what at first seemed like a win for the taxpayer, the Federal Court of Appeal went on to find that the appellant was liable to a penalty in the same amount

11 Supra note 3, at paragraph 37 (FCA).

12 In this regard, the observations of the court appear to differ from the views expressed in the technical notes released by the Department of Finance, supra note 6, which suggested that "[n]ew subsection 162(2.1) . . . is a special rule for the computation of penalties *under* subsections 162(1) . . . and 162(2) of the Act" (emphasis added). Consistent with such statements, the penalty provision in subsection 162(1) is arguably incorporated by reference into subsection 162(2.1) by virtue of the explicit cross-reference in paragraph 162(2.1)(a).

under paragraph 162(7)(b). As described above, paragraph 162(7)(b) generally provides for a penalty in respect of any failure to comply with a duty or an obligation under the Act where no other provision of the Act sets out a penalty for the failure.

It was not contested that the appellant failed to comply with its statutory obligation to file a Canadian income tax return. However, in applying paragraph 162(7)(b), the court appears to have given significant weight to the distinction between a failure to file a nil Canadian income tax return and a failure to file a Canadian income tax return where taxes are payable. Such a distinction, coupled with the court's view that a penalty of nil is not a penalty, appears to have been the basis for the court's finding that the Act does not set out a penalty for the appellant's failure to file its Canadian tax returns.

Although the results of the Federal Court of Appeal's analysis are consistent with its understanding of the legislative intention behind subsection 162(2.1) (that is, Parliament intended that taxpayers like the appellant should be subject to a penalty for a failure to file a return), it is open to debate whether the method employed by the court to arrive at its result reflects an accurate application of paragraph 162(7)(b). The obligation imposed by the Act with which the appellant failed to comply was the obligation to file a return of income in respect of the taxation years in question. Subsection 162(1) expressly provides for the imposition of a penalty on "every person who fails to file a return of income for a taxation year as and when required by subsection 150(1)." Subsection 162(1) does not distinguish between the failure to file a return of income in respect of a taxation year in which the taxpayer earned no income and one in which the taxpayer earned income. As indicated by the clear wording of subsection 162(2.1), and as supported by the technical notes released by the Department of Finance, subsection 162(2.1) is not a separate penalty provision; rather, it is a computational provision that directs the computation of the "amount of the penalty" levied under subsections 162(1) and (2). In light of the wording of the operative provisions in section 162, one might question the accuracy of the court's proposition "that non-resident corporations are not governed by subsection 162(1) but by subsection 162(2.1), which applies 'notwithstanding' subsection 162(1)."[13] Given that subsection 162(1) captures "every person" who fails to file a return of income (regardless of the person's residence), it is seemingly debatable whether it is reasonable to assert that subsection 162(1) does not set out a penalty for the failure to file a tax return and therefore paragraph 162(7)(b) applied to levy a penalty on the appellant.

If a nil penalty is not a penalty, then a Canadian-resident corporate taxpayer that late-files a nil tax return (or a return showing taxes that were paid on time)[14] is also not subject to a penalty, and, on the reasoning of the Federal Court of Appeal, will

13 Supra note 3, at paragraph 37 (FCA).

14 The subsection 162(1) penalty is calculated on the taxes that are unpaid on the filing due date, so that a taxpayer that late-files its return, but has paid all the taxes due by the filing deadline is also subject to a penalty of nil.

therefore arguably be subject to the penalty imposed by paragraph 162(7)(b). However, this outcome appears to be contrary to Parliament's intent, at least in respect of Canadian residents, which is that the penalty is to be nil on a late return when no taxes are outstanding.

Notwithstanding the foregoing, given the binding precedent set by the Federal Court of Appeal in *Exida.com*, it appears that the unresolved issues relating to the penalties that may be imposed on non-resident corporations that have failed to file Canadian income tax returns on a timely basis may now have been settled.

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REASONABLENESS, BUSINESS REALITIES, AND TRANSFER PRICING

Glaxosmithkline Inc. v. Canada
2010 FCA 201

KEYWORDS: ARM'S LENGTH ■ PHARMACEUTICALS ■ REASONABLE ■ TRANSFER PRICING ■ WITHHOLDING TAXES

On July 26, 2010, the Federal Court of Appeal released its much anticipated judgment in *Glaxosmithkline Inc. v. Canada*,[15] which allowed the taxpayer's appeal and referred the matter back to the original Tax Court judge for a rehearing and reconsideration. Although the tax reassessments at issue in *Glaxo* most notably related to the application of former subsection 69(2),[16] the principles emanating from the Federal Court of Appeal's judgment have broad implications for the future adjudication of transfer-pricing disputes in Canada.

THE FACTS

The appellant, GlaxoSmithKline Inc. ("Glaxo Canada"), was a wholly owned Canadian subsidiary of Glaxo Group Limited ("Glaxo Group"), a UK corporation that was a wholly owned subsidiary of another UK corporation, Glaxo Holdings PLC ("Glaxo Holdings"). Throughout the relevant period, Glaxo Holdings led an integrated multinational group of companies that developed, manufactured, and distributed pharmaceutical products around the world. The Glaxo group of companies produced a number of widely recognized branded pharmaceuticals, including the anti-ulcer drug Zantac.

The Zantac trademark and the patents in respect of the drug's active ingredient (ranitidine) were owned by Glaxo Group. Glaxo Group licensed the use of the trademark and patents to Glaxo Canada pursuant to the terms of a licence agreement. Under the licence agreement, Glaxo Canada agreed to pay Glaxo Group a

15 2010 FCA 201; rev'g. 2008 TCC 324 (herein referred to as "*Glaxo*").

16 Former subsection 69(2) was replaced by the new transfer-pricing rules in part XVI.1 of the Act.