proposals from 2010 and 2011. Finance plans to reintroduce the FA dumping rule in a bill in the fall of 2012.

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OECD Transfer-Pricing Guidelines, Part 1

Canadian courts have generally accepted, without in-depth analysis, that the OECD transfer-pricing guidelines aid in interpreting and applying current subsection 247(2) and former subsection 69(2). (See, for example, *SmithKline Beecham Animal Health Inc.* (2002 FCA 229), *GlaxoSmithKline Inc.* (2008 TCC 324), and *General Electric Capital Canada Inc.* (2009 TCC 563).) The CRA also accepts the guidelines as a relevant interpretive aid, and IC 87-2R draws heavily on the 1995 guidelines. In contrast, extensive jurisprudence considers the relevance of the OECD model treaty and its commentary in the interpretation of Canada's tax treaties and also which edition of the OECD model is relevant. (See *Crown Forest Industries Ltd.* ([1995] 2 SCR 802), and *Prévost Car Inc.* (2009 FCA 57).)

The lack of analysis on the guidelines' weight is problematic: several reasons suggest that the guidelines have less relevance than the model treaty. First, OECD member countries can register observations and reservations on the OECD model and thus illuminate particular members' support for particular paragraphs, but no equivalent opportunity exists for the transfer-pricing guidelines. Second, a domestic treaty's provision can be compared to the OECD model provision, and thus the related commentary should be more persuasive in the interpretive process if the provisions are similarly worded. No equivalent comparative exercise exists for the guidelines.

There is limited discussion of which edition of the guidelines should be referred to in a given case. In *SmithKline Beecham*, the FCA noted that there had been at least one edition since 1979 but felt that the differences could be disregarded in the context of the case. In *GlaxoSmithKline*, the TCC used the 1995 edition: that edition postdated the relevant taxation years, but it was more detailed and provided more examples than the 1979 edition, and neither party pointed to any inconsistencies between the editions.

In contrast, in *Alberta Printed Circuits Ltd.* (2011 TCC 232), the TCC referred to the 1995 transfer-pricing guidelines because the 2010 update was well beyond the taxation years in issue. The brevity of the analysis on the point is disappointing, because the choice of edition was significant to the TCC's preference for the taxpayer's proposed transfer method and the result (that the taxpayer did not pay more than an arm's-length price). Before July 2010, the guidelines recommended a hierarchy in which traditional transaction methods ranked higher than transactional profit methods; the July 2010 edition removed the hierarchy and shifted the focus to the most appropriate method for a particular case. Alberta Printed Circuits relied on the comparable uncontrolled price (CUP) method (at the top of the pre-July 2010 hierarchy); the minister relied on the transactional net margin method (last in the hierarchy). On the basis of the 1995 guidelines and IC 87-2, the TCC found an "overwhelming preference" for the CUP method, which supported the price paid by the taxpayer for services. Curiously, the reasons for judgment do not show that the hierarchy's removal from the guidelines was put before the court.

It seems clear that the OECD transfer-pricing guidelines will be an influential aid in determining arm's-length terms and conditions in transfer-pricing disputes. Although important questions regarding their use have yet to be examined, more in-depth judicial consideration of the guidelines' role will surely emerge as more transfer-pricing cases reach the courts. When the SCC heard the appeal in *GlaxoSmithKline Inc.* on January 13, 2012, it asked a number of questions about specific paragraphs of the 1995 guidelines. Part 2 of this article will review the court's comments regarding the guidelines' role in the interpretation and application of Canada's transfer-pricing rule.

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Lower Penalties More Punitive

When are 10 percent civil penalties for omitting income greater than 50 percent civil penalties for omitting the same amount either wilfully or in circumstances amounting to gross negligence? The TCC in *Knight* (2012 TCC 118) answered as follows: "When there are matching omission and gross negligence penalties under both the federal and the provincial income tax acts the omission penalty will very frequently exceed the gross negligence penalty." This is so because the 10 percent federal omission penalty applies to unreported income but the 50 percent gross negligence penalty applies to the related tax, and because of other differences in the penalty bases.

The TCC said that "when taxable income is below $35,716 the combined federal and BC omission penalty would be close to 100% of the federal and BC tax on the omitted amount; a federal and BC gross negligence penalty in respect of the same amount would be half as much." Even at the top marginal rate, the combined federal and BC omission penalties are still 91.5 percent of the gross negligence penalty. In Alberta, the combined federal and provincial omission penalties (20 percent) always exceed the combined gross negligence penalties (19.5 percent at the 29 percent top federal marginal tax rate) because Alberta has a 10 percent flat personal income tax rate.

Moreover, the TCC noted that CRA administrative policy requires auditors to apply subsection 163(2) gross negligence penalties if the unreported amount exceeds $5,000. Thus, the 10 percent penalty—for failure to report income more than once in four years—may most often apply to taxpayers with lower income, and thus under less blameworthy conditions the 10 percent penalty exceeds the 50 percent penalty. Furthermore, because subsection 163(1) takes into account only unreported income and not related unpaid tax, the 10 percent penalty applies even if the taxpayer's employer withheld tax on the income that the taxpayer left unreported. *Knight* was such a case.

In *Knight*, the taxpayer reported $44,000 of employment income, slightly more than half his total employment income of $85,000. The CRA applied the 20 percent combined federal and provincial omission penalties, which resulted in about 29 percent more penalty than under the gross negligence rule. The total penalty was about $8,200, but because tax was withheld at source, the total unpaid tax was only about $3,600, excluding interest. Thus, the 20 percent omission penalties were 225 percent of the unpaid tax, effectively higher than the maximum fine for tax evasion, on indictment, under subsection 239(2).

The minister has the burden of proving the facts justifying an assessment under section 163. Subsection 163(1) appears to be a strict liability penalty for which the minister need not show negligence but simply that an amount was unreported more than once in the last four years. But the cases have made it clear that a taxpayer can excuse himself if he shows he was diligent in reporting his income, showing either that he "made a reasonable mistake of fact, or that [he] took reasonable precautions to avoid [understating his income.]" Reasonable mistakes for this defence relate to the making of the omission, not to its consequences. Accordingly, even though Mr. Knight expected the CRA to correct his error when it received the T4 from his employer and thus prevent any loss of tax revenue, the court did not excuse his failure to report. The TCC closed its reasons with a wish that the minister waive most of the penalty to reduce it well below the unpaid tax; it encouraged the taxpayer to apply for a waiver but noted that subsection 220(3.1) does not require an application: the minister may waive a penalty without a request.

Another interesting feature of subsection 163(2) not discussed by the TCC is the calculation formula in paragraph 163(2)(a). The penalty rule reduces the underlying understatement of income by deductible amounts "wholly applicable to" the unreported income. (Oddly, no deduction is allowed if part of the deduction relates to reported income: see subsection 163(2.1) and CRA document no. 2009-0344291I7. Of this rule, the FCA said in *Richard Roy* (A-660-97, November 3, 2000): "As the purpose of the penalty is dissuasion and the deterrent effect usually increases with the extent of the unreported income, this result seems absurd. The penalty is less if all the income is concealed than it would be if the income were only partly concealed.") Subsection 163(1) takes a different approach: it applies to an amount that a person "failed to report" and that was "required to be included in computing the person's income." Thus, subsection 163(1) seems to apply to gross income without any allowance for deductions. And because that penalty applies only to amounts that must be included, it does not apply to cases of fictitious expenses; subsection 163(2) may apply because of those false expenses. (See also CRA interpretation 2009-0328171I7, June 25, 2009.)

A taxpayer may consider a penalty to be excessive, but the CRA can refuse to waive it under subsection 220(3.1). In *Spence* (2012 FCA 58), the taxpayer did not report $36,000 of his income for 2006 and did not claim credit for the $9,000 of tax withheld at source, resulting in a $123 excess refund. The CRA assessed a penalty of $7,600 and refused a requested waiver. Both the FC and the FCA affirmed the CRA's position. The CRA says that there is some basis for the harsh penalty, because it applies only to repeat offenders—taxpayers who have failed to report income in two returns in four years. Thus, even though Mr. Spence "had previously left out [only] a small amount of income in respect of his 2004 return," that small amount was enough.

Subsection 163(1) applies only if the failure to report occurs more than once: the repetition presumably reveals a pattern of non-compliance and blameworthiness. But the penalty does not apply if a taxpayer can show that she was diligent in reporting her income, notwithstanding her failure to include an amount. The courts have held that the due diligence defence applies to either of the underreported tax years, not just to the tax year to which the penalty applies. Thus, if a taxpayer failed to report income in both 2007 and 2008, she may escape the penalty imposed for 2008 if she can show that she was duly diligent in reporting either her 2007 or her 2008 income. (See, for example, *Chan* (2012 TCC 168)).

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Corporate Rate Update

The federal general (and M & P) rate declined from 16.5 to 15 percent on January 1, 2012, causing combined 2012 corporate rates to fall in all jurisdictions. The federal government's goal of a 25 percent combined federal-provincial and federal-territorial tax rate by 2012 is achieved for general (and M & P) rates on January 1, 2012, in Alberta, British Columbia, and New Brunswick. However, British